October 2018 Thoughts and Insights

We'd like to start off the fourth quarter with an invitation to visit our newly refreshed offices and investor lounge. We have reconfigured our reception space to include a coffee/wine/beer station (depending on the time of day, of course), club chairs, Bloomberg TV, Wi-Fi, and a high top table for those who prefer to meet standing up.   Please come by anytime to see and enjoy the space.

Our end-of-cycle forecast leading into the 4th quarter has not changed. In fact, during the month of September, we rebalanced our equity portfolios by lightening up Financials, Energy, Materials, and Industrials. We added to positions in Consumer Staples, Real Estate Investment Trusts (REITs), and Healthcare. We still believe in being fully allocated to equities because earnings have been strong and the tax bill encouraged capital expenditures that could extend the cycle. However, valuations are high, trade issues present uncertainty, and Fed policy all cause us to prefer a more defensive stance at this point in the cycle.

The 10 Year Treasury these past few weeks moved from 2.9% to 3.23% which is a huge move in the interest rate world. The Fed voted last week for its third rate increase of the year and changed the language in the minutes to indicate even more rate hikes in 2019. We think we may be range bound at this point since 10 year yields trend below nominal GDP growth, which is estimated between 3.5% and 4%. However, a risk to watch is that of unexpected inflation due to the combination of fiscal stimulus and a widening budget deficit coupled with low unemployment. Otherwise said, if everyone is working, and tax rates are low, it will be hard for the government to increase revenue to pay down the deficits. The flip side to higher rates is that our cash positions can now earn 2%. As rates rise, prices fall, so the bond market in aggregate is down for the year. This has been highly anticipated and we protected on the down side by staying in shorter securities that are less sensitive to price changes and focusing on income. Changes in bond price in the intermediate term will not affect the income generation, or principal value of the bond. We believe, given where we are in the cycle, bonds are an increasingly important piece of the portfolio.

4th quarter is also election season, and this November, US voters will determine whether or not Republicans will maintain control of both chambers of Congress. While the outcome may create short-term volatility in the markets, we believe current market and economic fundamentals will remain in place after the election regardless of the outcome. Putting the politics aside, we are focused on the economic policies and how these policies may affect the fundamentals of corporate earnings, economic growth, and inflation—each of which will influence how markets evaluate the future.

The key initiatives of President Trump's agenda so far have been corporate tax reform, including the cut in corporate tax rates, and measures to reduce the regulatory burden on companies. Those two initiatives alone have created a 25% increase year-over-year in U.S. corporate earnings which, in turn, have sustained the strong stock markets into 2018.

While tax reform and deregulatory initiatives have had a positive impact on financial markets, other policy initiatives are questionable. The administration's immigration policies, for example, may reduce the labor supply in the United States. A lower labor supply could aggravate inflationary

pressures, lowering U.S. economic growth long term. Also, if trade and tariff disagreements between the United States and other nations are pressed further, that will certainly increase inflation.

To provide some perspective, we can speculate on the potential election outcomes with those market initiatives that are important to the current administration.

Democratic House, Republican Senate (most likely scenario)
Tax cuts have generally been supportive to the economy. A split congress would likely stop, or at the very least limit, the Republican policy agenda going forward. The result of which could be slowing economic growth due to more intense confrontations and battles in congress regarding appropriations bills, debt ceiling debates, continuing resolutions, etc. Additionally, potential congressional investigations could weigh on consumer spending and the business investment. Trade policy, tariffs, and potential trade wars have affected market action temporarily, but the economic impacts of these decisions haven't been fully realized in economic data as there is lag between implementation and effects showing up in the data. The executive branch has broad authority on trade, and changes in control of congress would likely have no impact on these policies.

Republican House/Republican Senate (second highest probability)
Under this scenario, we should expect more of the same from a policy perspective which would likely be viewed positively by markets and business community which would support business investment. However, more stimulus through tax cuts or other policies would likely lead to an acceleration in inflation, prompting interest rates to rise faster.

Democratic House/Democratic Senate (lowest probability)
This scenario would have the greatest potential impact on markets given that it is unexpected. The markets would price in uncertainty and higher volatility.

In Any Scenario
Historically, event risk, and specifically political event risk, generally provide short-term opportunities in the marketplace. Any long term impact on fundamentals would be much more slow-moving. In the current environment, with fundamentals being as strong as they are, we expect the midterm elections to potentially provide some volatility and we will be watching for potential buying opportunities.

As always, we remain dedicated to serving your investment needs according to your goals. Please call or write with any questions you may have, or join us in the lounge with the beverage of your choice for enlightening discussions.

Michelle & Kyle