



Quarterly Insights October 2018

U.S. investors are increasingly optimistic about the future as they continue to pour more money into our stock market. The U.S. is one of only three global stock markets (along with India and Australia) making new highs recently, supported by a much stronger domestic economy. From this perspective, President Trump has delivered on his promise with an “America First” policy. But can the U.S. remain an oasis during this global correction while China and many developed countries struggle for higher growth? Wall Street forecasters see three scenarios for the remainder of this year: 1) the skeptics believe a market correction is probable; 2) those with less conviction see foreign markets catching up while the U.S. market temporarily pauses; and 3) the optimists are calling for foreign markets to begin participating in this uptrend while the U.S. maintains its dominance. With the wide range of opportunities and concerns in this current news-rich environment, we’d like to clarify the most important issues related to these potential scenarios and your portfolio.

The first important issue to future stock market performance is that although upcoming corporate financial results will likely be very good, they may not meet investors’ lofty expectations. A stronger economy and corporate tax cuts have served as catalysts for companies to deliver gains in excess of 20% during the last 12 months. However, future expected company profits, although impressive by most historical measures, are not expected to be as good as last quarter. If the upcoming corporate earnings do manage to beat Wall Street expectations, then the U.S. stock market has a stronger likelihood of continuing its positive momentum.

A second important issue to the future of financial markets is investors’ perception of inflation and interest rates. Up to now, investors and analysts alike have viewed the rise in inflation and interest rates as validation regarding the durability of our economy rather than an indication that it is overheating. The Federal Reserve appears to agree, clearly signaling that the strength of the economy warrants continuing to raise interest rates at its current slow and steady pace. The Fed has increased short-term interest rates three times this year and is planning another quarter percentage point increase later this December.

The strengthening economy has led to a flight into riskier asset classes, such as stocks and real estate, at the expense of money fleeing safer alternatives such as bonds. In other words, investors’ bets on stronger economic growth and inflation result in increased selling of bonds, putting downward price pressure on these investments. However, as interest rates continue rising, bonds become increasingly attractive. Investors that were previously sellers become buyers, reversing the flow of funds and therefore, the relative performance between risky and safer asset classes.

The third important issue to continued prosperity relies on The Fed not causing the next recession by raising rates *too* quickly. Such a potential misstep is the largest threat to the nine-year old bull market in stocks. This late in an economic cycle, The Fed is hopeful for a soft landing as the U.S. economy's rate of growth cools. Fed Chairman Jerome Powell recently stated, "There's no reason to think this cycle can't continue for quite some time, effectively indefinitely", suggesting that he sees little risk that the economic expansion will be derailed.

But when economies do occasionally fall into recession, no asset class historically performs as well as high quality bonds. During these conditions, quality bonds have been an efficient diversifier by appreciating and offsetting falling prices in stocks, real estate and other more speculative investments. Therefore, removing bonds from a portfolio leads to lower diversification and greater downside risk. Since most economists and investors have failed to predict every recession in recent history, the inclusion of bonds in a portfolio are best used as a long-term core holding.

In conclusion, this is a short list of the opportunities and risks that our firm is monitoring closely on our clients' behalf. As economic cycles advance, opportunities and risks change. These changes require prudent adjustments in investment portfolios so that exposure to both reward (positive return) and risk (volatility) remain compatible with each investor's expectations. We are privileged and grateful to assist our clients in this endeavor.

Sincerely,



Randy Garcia
Chief Executive Officer

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