The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets October 2018

From: *Philadelphia* Investment Management Group

OVERVIEW

- *U.S. Economic Fundamentals Remain Strong but May Move at a Slower Pace*
- *Geopolitical and Non-Economic Headwinds are Creating Volatility in the Markets*
- *Equity Markets Will Continue to be Basically Supported by Fundamentals*
- *Federal Reserve Policies Will be the Major Influence on the Fixed Income Area*

THE ECONOMY

Strong economic growth, in place for the first half of 2018, carried through the third quarter. As reports filtered in, it was evident to most that the general domestic economic outlook continued to look good via robust corporate earnings in the first two quarters, to be followed by the same in the third quarter that ended September 30. High business and consumer confidence and an unemployment rate at its lowest level in nearly two decades are catalysts that are supporting the economy.

Analysts also credit the economy's growth to the tax overhaul passed last year. The changes, which included a cut to the corporate tax rate, sent companies' profits sharply higher through the first two quarters of the year, and analysts expect third-quarter earnings to be robust as well, but somewhat lower than the first two periods.

At the same time, the solid expansion has led to only modest wage gains and a rate of inflation that has struggled to reach the Fed's 2% target, even after massive stimulus from last year's $1.5 trillion tax cut. The Consumer Price Index (CPI), which gauges what Americans pay for consumer goods, rose 2.7% in August from a year earlier, a slowdown from the nearly 3% annual gain in the prior two months, and the first monthly decline for the year.

The U.S. dollar's surge this year is likely to dent third quarter earnings at large multinational corporations and stir concerns in markets that are already grappling with trade tensions and higher interest rates. The dollar has risen about 4.3% against a basket of 16 other currencies in 2018, which makes converting foreign profits into U.S. currency more expensive, dragging earnings lower at those companies.

Overall, profits in the S&P 500 are expected to be up about 20% from a year earlier in the third quarter, marking a slowdown from the 25% growth in the first and second quarters. Robust earnings have helped propel U.S. stocks to records in September, but concerns about peaking profits, along with continuing trade tensions and monetary tightening by the Federal Reserve, have spooked investors for much of the year.

Although investors overwhelmingly expect the Federal Reserve to raise short-term interest rates in December for the fourth time this year, there have been few signs inflation is spiraling out of control or that the U.S. Central Bank will abandon its commitment to a course of gradual rate increases. As a result, equity market indexes reached record highs in September, while interest rates across the full yield curve trended higher during the period.

The streak of strong profit growth has made stock market valuations much more attractive than they were earlier in the year at the market's previous peak, easing investors' concerns that stocks may be too pricey. Many investors, however, feel that the markets will be able to weather the dual threat of trade tensions and higher interest rates.

We, thus, have a positive view toward further economic growth in the U.S. We do think, however, that trade issues and concerns about non-U.S. economic growth will need to ease, giving support to the financial markets. Trade remains a significant wildcard, but we are optimistic that tensions will ease in the coming months, as they recently have with Mexico and Canada. We hope the U.S. and China will also be able to come to some agreement, which will reduce the uncertainty that is becoming more of a headwind for businesses and the consumer.

Yes, we are optimistic, but remain cautious. The general economic outlook looks bright, though the markets, both equity and fixed income, face a number of obstacles in the next three months. As stated, the Federal Reserve is expected to raise interest rates again in December; the U.S. has yet to resolve its trade disputes with all of its partners; and the coming mid-term election cycle is anticipated to be contentious. China stimulus and the direction of the U.S. dollar dominate our near-term outlook. At this juncture, U.S. recession risks appear low. Corporate earnings growth in the U.S. has exceeded industry analysts' expectations. We believe the hurdle for U.S. earnings to surprise on the upside going forward may be a slight headwind. The impact of corporate tax cuts on earnings will soon disappear, and both borrowing costs and wages are headed higher. There

are a lot of things that could go wrong, but the risk of things going right is equally as likely.

All of this suggests that the global economic backdrop will support U.S. corporate earnings. Profits are, as stated, likely to fall next year compared to 2018, as the effect of tax cuts wears off and companies face higher interest rates and the lingering impact of the rising U.S. dollar. Nevertheless, we think the effect of moderating profits may have already been factored into the financial markets, meaning the decline should not disrupt stock prices. As long as the global economy does not experience a significant disruption, we feel equity prices may continue to rise over the coming years.

For the last several years, investors have been paid for being long just about any asset (other than commodities), as the exceptional influence of Central Bank liquidity and lower long-term interest rates boosted valuations. At this stage in the business cycle, however, with the Fed actively hiking rates and reducing the size of its balance sheet, valuations have been stretched, and we should start to see greater dispersion in returns across all market sectors and regions.

FINANCIAL MARKETS

EQUITIES

U.S. stocks are entering the fourth quarter near records, even as risks abound, as indicated, prompting some investors to question how much further stocks can increase following a nine-year rally. Major indexes slumped into correction territory in early February and have slowly churned higher to top their previous highs. As the U.S. has continued sparring with key trading partners, tariff threats have roiled individual stocks, particularly auto, machinery and conductors, as well as technology, but the threats to date have had only a marginal impact on the broader stock market. Other political bickering in Washington, along with the coming mid-term elections, has largely been dismissed as "noise" by investors, who are more interested in data showing a robust pace of job creation and economic expansion.

All in all, one of the prime reasons for cautiousness is the longevity of the current bull market, which, by some measures, in August became the longest in history. But then others say valuations are reasonable because earnings have been quite strong and that the economic environment can keep driving stocks higher.

U.S. stock indices reached record highs during the month of September, normally a negative period for the markets along with August, which was also a good month. The Dow Jones Industrial Average, home to big multinational conglomerates and, therefore, more sensitive to trade talks, outperformed other U.S. indexes in the quarter, logging a 9.63% gain, as reflected in the following table. The S&P 500 climbed 7.71% in the third quarter, its best performance since the fourth quarter of 2013. The NASDAQ Composite rose 7.14%, extending its streak of gains to nine consecutive quarters.

	Equity Returns*			
Index	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	7.71%	3.43%	-0.76%	10.56%
Dow	9.63%	1.26%	-1.96%	8.83%
NASDAQ	7.14%	6.31%	2.32%	16.56%
Russell 2000	3.58%	7.75%	-0.08%	11.51%

*Total: price change + reinvested dividends

The Russell 2000, the benchmark index for smaller company stocks, climbed 11.51% through September, eclipsing the 10.56% rise in the S&P 500. Investors view small to mid-cap names, with more U.S. exposure, as a safe place where they will not have to deal with the trade war. Earnings for this group posted a 48% increase, according to FactSet. For the third quarter, the estimate is a further increase of 36%, higher than the S&P 500's 20%.

The strength of the market in the quarter and year to date are reflected in the performance of the eleven broad market sectors shown in in the following table. Health Care and Industrials achieved double-digit returns for the quarter. Industrials stocks rebounded in September as investors bet on a healthy economy, offsetting uncertainty over the global trade policies. Health Care stocks emerged as market leaders in the third quarter. Many investors are embracing the sector as a safety play, particularly after the big technology stocks stumbled in September due to concerns of new regulations. Its 14.53% return is the strongest showing in more than five years. Valuations are more in line with the full S&P 500 and, to many, the group is defensive in nature. For the year to date, Consumer Discretionary led the sectors, followed by Technology and, again, Health Care. Only Materials and Consumer Staples, both of which make up only 9.1% of the Index, were negative for the year to date.

	S&P 500				
		Returns*			
Sector	**Weight**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
• Energy	6.0%	0.61%	13.48%	-5.88%	7.46%
• Materials	2.4%	0.36%	2.58%	-5.52%	-2.73%
• Industrials	9.7%	10.00%	-3.18%	-1.56%	4.84%
• Cons. Discretionary	10.3%	8.18%	8.17%	3.09%	20.64%
• Consumer Staples	6.7%	5.70%	-1.54%	-7.12%	-3.34%
• Health Care	15.0%	14.53%	3.09%	-1.22%	16.63%
• Financials	13.3%	4.36%	-3.16%	-0.95%	0.09%
• Info Technology	21.0%	8.80%	7.09%	3.53%	20.62%
• Communication Svcs	10.0%	9.94%	-0.94%	-7.48%	0.75%
• Utilities	2.8%	2.39%	3.74%	-3.30%	2.72%
• Real Estate	2.7%	0.86%	6.13%	-5.02%	1.67%

09/30/18
*Price + income
Source: S&P Dow Jones

Financials and other rate-sensitive sectors, like Utilities and Consumer Staples, that pay steady dividends were held back by the choppy upward move in interest rates during the year. But technology-driven companies remain the biggest drivers of the market rally this year.

So far this year, the Consumer Discretionary, Health Care and Technology sectors, which together account for about 46% of the Index's market capitalization, have gained at least 16%. None of the other sectors have risen more than 8%. Given the Index's top-heavy performance, global economic concerns and other issues, as mentioned, the upcoming earnings season will have a lot to tell us.

All eleven sectors of the S&P 500 are expected to report higher earnings in the third quarter, with seven sectors on track for double-digit growth, according to FactSet. And the leaders are not Technology companies, but Energy and Financials.

With the September quarter past, earnings season is upon us. Expectations for the quarter remain high with the projected per-share profit growth of 20% for the S&P 500 Index, as stated above. While the Index has posted a solid total return so far this year of 10.56%, the bull market has a lot to prove in coming weeks. With international operations accounting for nearly 40% of the Index's total revenue, tariffs or a slowdown in growth overseas could impact earnings. Keep in mind that October is also known as the best month for stocks (volatility notwithstanding). In fact, studies show the months of October, November and December are the three best months in a row.

Earnings growth is broad, with lots of companies and industries participating. Recent strength in both cyclical and value stocks has given support to the upward move in the equity markets. Of course, bullish does not have to mean bull-headed; and as always, we suggest keeping our eyes firmly on the road ahead. Overall, we continue to have a pro-growth stance toward the equity markets. For now, we believe they are supported by relative economic conditions, monetary and fiscal policy trends and the political backdrop. However, these trends may reverse, or at least become less strong over the next six to twelve months.

***In late September, Standard & Poor's reorganized its equity market sectors. One of the chief motives behind the moves was to scale back the Information Technology sector's outsized presence in the S&P 500 Index. Tech stocks represented about 26% of the Index's market value, roughly 12 percentage points above the next-largest sectors, Financials and Health Care.

The newly created Communication Services sector replaced the former Telecommunication Services sector. Restructuring the Communication Services sector reduced the Technology sector's weighting to about 20%, with some of the largest stocks in the Index moving into this new group. Part of the reason for the shift was that the former Telecommunication Services sector housed only three stocks. This sector's influence on the broader S&P 500 had waned over the years because of consolidation in the industry, and the group could swing widely when the stock price of just one company moved up or down. The new sector is populated by telecom stocks as well as certain stocks from the Information Technology and Consumer Discretionary categories.

FIXED INCOME

At the start of the year, the market thought there was only a 20% probability that, by now, the Federal Reserve would have already raised rates three times this year. Even at the start of July, markets thought there was a 40% chance that the Fed would not increase rates again in the third quarter. However, by the time the Fed raised rates in late September, bond markets had already fully priced in the increase, with Treasury yields drifting higher over the quarter, as reflected in the table below. Treasury yields rose, as investors bet the Fed would maintain its policy of raising interest rates, as the recent acceleration of economic growth increases the potential for inflation to accelerate.

Base Interest Rates

	U.S. Treasury Yields				
	Maturity				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2017	1.38%	1.88%	2.21%	2.41%	2.74%
Jun 30, 2018	1.91%	2.53%	2.73%	2.85%	2.99%
Sep 30, 2018	2.20%	2.81%	2.95%	3.06%	3.20%
Change:					
6/30-9/30/18	0.29%	0.28%	0.22%	0.21%	0.21%
12/31-9/30/18	0.82%	0.93%	0.74%	0.65%	0.46%

To review, the yield curve traces the yield on varying bond maturities, from the shortest (three months or less) out to as far as 30 years. U.S. Treasuries are universally used as the basis because of their absence of credit risk, which makes them the benchmark for all dollar-denominated debt.

What has gotten the yield curve back into the headlines has been its steady flattening, specifically the sharp narrowing in the spread between the yields on the 10-year and 2-year notes. As reflected in the table above, the spread was 25 basis points at the end of the quarter versus 53 b.p. at the end of 2017, the lowest month-end reading since it went down to 16 basis points in June 2007, a cautionary sign about the economy that has investors reassessing earlier predictions that rates would continue to rise.

Fixed income yields rose across all market sectors during the quarter, as all groups essentially followed the base U.S. Treasury market. Shorter-term yields, which tend to be driven more by expectations for Central Bank moves, have climbed more quickly, as the Fed has indicated they will continue to move rates higher. The taxable area, including governments and corporates, had a nominal return, as indicated in the following table, of 0.04%, basically from interest earned. Municipals, on the other hand, experienced a slight overall loss of 0.25% due to their lower interest rates. Although there were periods when bond prices did rise, the basic trend of the markets has been negative for the year to date.

Fixed Income Returns

Index	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
Corporate/Govt.	0.04%	-0.30%	-1.56%	-1.82%
Int. Corporate/Govt.	0.26%	-0.01%	-0.96%	-0.71%
Long Corporate/Govt.	-0.67%	-1.23%	-3.46%	-5.29%
U.S. Treasury	-0.66%	0.11%	-1.21%	-1.75%
- Intermediate	-0.11%	0.07%	-0.70%	-0.75%
- Long	-2.80%	0.28%	-3.18%	-5.63%
Corporate	0.96%	-0.94%	-2.20%	-2.19%
- Intermediate	0.85%	-0.15%	-1.46%	-0.77%
- Long	1.22%	-2.78%	-3.89%	-5.43%
- Quality				
- AAA	0.11%	-0.38%	-2.85%	-3.11%
- AA	0.60%	-0.41%	-1.88%	-1.70%
- A	0.71%	-0.77%	-2.37%	-2.44%
- BBB	1.26%	-1.20%	-2.08%	-2.04%
Municipal	-0.25%	0.89%	-1.15%	-0.51%
- Intermediate	-0.01%	0.76%	-0.57%	0.18%
- Long	-0.41%	0.99%	-1.54%	-0.98%

Source: BofA Merrill Lynch

The corporate sector was the better performer in the taxable group related to the strength of the economy, which gave support to the lower-rated and higher-yielding BBB area, and which now makes up close to 50% of the investment grade corporate market. As the anticipation of higher rates increased, the rush to raise debt before the rise and the demand by investors for yield gave attention to this area of the market. However, for the year to date, BBB underperformed, along with other quality areas, due to the rapid rise in interest rates in late January, as investors, at that time, thought the Fed would become more aggressive in raising rates related to faster economic growth. Shorter maturities outperformed their brethren in all market sectors as the result of the overall increase in interest rates during the quarter and year to date.

Yields are likely to rise modestly based upon Fed policy, inflation and strong Treasury bond issuance. With short-term bonds yielding almost as much as long-term bonds, investors can minimize interest rate sensitivity and still generate decent yield by gravitating towards short-to-intermediate term, high quality fixed income holdings. Junk and high yield bonds have performed well this year but are not providing meaningful compensation (added yield) for taking quasi equity-like risk. Investment grade credit valuations are expensive by historical comparisons, but solid corporate fundamentals, a healthy domestic economy and still supportive monetary conditions justify a neutral allocation.

Late in a business cycle, credit risk, that is, the risk that bond issuers will default on their debt, can become more prominent. As monetary policy tightens, the cost of credit rises; and eventually, lending standards tighten and over-leveraged borrowers, whether individuals, companies or countries, may default on their debts. Therefore, although one may give up some income, we feel the investment grade area, for all fixed income, is the place to be for income that now is above inflation and for the liquidity factor that may become more important as we move further on.

The municipal sector, although showing negative returns, outperformed the government group for the quarter and was ahead of both taxable areas for the year to date. Muni bonds remain an attractive investment option for high net worth investors, in our view, although we may be in the later stages of the economic cycle. And that could strain credit conditions for some municipalities; however, credit quality for most investment grade municipal bonds is generally high to begin with. Unlike the corporate sector, two-thirds of the municipal bond index are rated either AAA or AA.

We have favored keeping the average duration or maturity in fixed income within the short range to mitigate the negative impact of rising rates. Now that longer-term yields have moved above 3%, there is a view, to some, that now may be the time to add some duration or maturity to portfolios. However, we are not ready to make that call. Yes, yields have risen but are expected to increase more, given the comments by the Federal Reserve.

We expect the Fed to continue unwinding its balance sheet at a modest and deliberate pace. Late in 2019, monetary policy could become slightly restrictive, if the growth trend weakens. While this may put additional pressure on the fixed income markets (and economic growth, in general), domestic credit and economic fundamentals appear robust for the time being.

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