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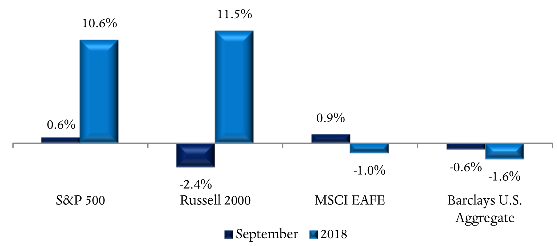
Markets

The S&P 500 index (+0.6% in September, +7.7% in Q3, +10.6% ytd) had its best quarterly gain in four years, scaling record levels, as investors prioritized strong corporate earnings over escalating trade tensions and rising interest rates. The smaller capitalization Russell 2000 index also added to its 2018 gains (+3.6% in Q3, +11.5% ytd), thanks to strong demand for domestic facing businesses which are resistant to trade war issues.

Overseas equities also posted broad-based quarterly gains, but trail their US counterparts thus far in 2018. While the global macroeconomic outlook is positive, political risks in Europe, revolving around the new populist government in Italy, and the escalating US-China trade war, have led to investor caution. The MSCI EAFE index rose +1.4% in Q3 (-1.0% ytd). European stocks, as measured by the Stoxx 600 index, advanced +1.3% in Q3 (+1.4% ytd). In Asia, Shanghai equites rebounded +0.3% during the quarter, but remain -12.6% thus far in 2018. Japan's Nikkei 225 index was the star in Q3, rising +8.9%, re-entering positive territory, +7.8% ytd. Emerging market stock indexes were the exception to the rising tide, declining -1.0% in Q3 (-7.5% ytd) on the back of several severe currency devaluations, including Turkey (over 40% since the start of 2018), Argentina (over 50%), Iran (circa 70%), as well as currency plunges of approximately 20% in Brazil, Russia and South Africa.

A booming US economy, Federal Reserve monetary tightening, and creeping inflation have driven US Treasury yields higher throughout 2018, and the shape of the government bond yield curve has flattened for seven months in a row. Fixed income returns have been lackluster, with high yield credit outperforming government bonds. With this backdrop the Barclays US Aggregate index rose 2 basis points in in Q3 (-1.6% ytd).

Crude oil closed the third quarter near 2018 highs in



both Brent ($82.72, +23.7% ytd) and WTI ($73.25, +21.2% ytd). Continued requests by President Trump for the Saudis and other US allies in the Middle East to increase their output has not resulted in much additional supply, while demand continues to grow. The other standout commodity of late has been Palladium (primarily used in automotive catalytic converters), which reached $1,073/oz at quarter-end, bumping up against the metal's all-time high, achieved in 2001.

Geopolitics

On the last day of September, the US reached an agreement with Canada, paving the way for the continuation of trilateral trade in North America. The 24-year-old North American Free Trade Agreement (NAFTA) will be replaced by the United States-Mexico-Canada Agreement, or USMCA, which is set to last 16 years, unless all three countries agree to extend it, at mandatory member meetings to be held every six years. The counterparts are expected to sign the deal by the end of November. The US Congress must then approve the deal, which is likely to be voted on early next year. During the negotiations, America's focus had been on Canadian dairy tariffs. Under the new deal, American farmers will have greater access to the Canadian dairy market, potentially increasing US dairy exports by several hundred million dollars annually. The other concession, originally agreed with Mexico, calls for 75% (up from 62.5%) of the content of an automobile to be sourced from the region, plus the requirement that 40% to 45% of automotive parts be made by workers earning at least $16 per hour. The update also includes a provision that hinders members from entering into free-trade agreements with any country that has a "non-market economy," seemingly aimed squarely at China. Also embedded in the agreement is a foreign-exchange provision to deter countries from manipulating their currencies. The resolution of disputes over US tariffs on steel and aluminum imports from Canada and Mexico were not addressed and will have to be negotiated separately.

United States

In September, US consumer confidence hit its highest level since 2000. Driving positive sentiment was an unemployment rate that fell to 3.7%, the lowest level since 1969, coupled with solid wage growth on track to top 3% this year, the highest since 2009. In-turn, consumer spending drove retail sales growth of over 7% year-on-year. Also, the National Federation of Independent Business's survey showed that small businesses were the most optimistic they've been since the survey began in 1974. Manufacturers are, however, overwhelmingly concerned about trade-related activity, including how reciprocal tariffs will impact company revenue and current manufacturing locations. The Atlanta Fed's GDP estimate for Q3 was recently increased to 4.1%, strong enough to trigger a Fed Funds rate increase in September, with a high likelihood of another in December.

Europe

Since the beginning of the year, there has been a weakening in eurozone manufacturing (linked to a drop in exports to China). Consumer confidence has also declined, potentially related to higher energy prices. With a particularly sharp decline in France, the EU's second largest economy, to the lowest level in two years, on concerns over inflation and personal finances. As such, EU GDP growth eased to an annualized rate of 2.2% in Q2 (vs 2.4% in Q1). On the positive side, consumer spending has been supported by falling unemployment, which has dropped to a post-crisis low of 8.1%. Joblessness in the region is lowest in Germany, reaching 3.4%, but still remains high in the periphery, with Greece at 19.1% (down from 27.9% at the peak).

Dominating the headlines of late are Italian populist political efforts, namely the government's new spending plan, which is forecast to produce a 2.4% fiscal deficit in 2019, a figure which is targeted to decline to 1.8% in 2021. Such shortfalls do not appear excessive, however Italy has sovereign debt of €2.4 trillion (140% of GDP), a level which historically has been troublesome to manage.

The UK economy and local consumer confidence has been weighed down by fears of a "no-deal" Brexit. Should such a scenario come to pass, the Pound Sterling would likely come under pressure, serving to boost the UK's global competitiveness, especially for export oriented businesses. However, such an outcome may also increase the prospect of a Labour government with a populist agenda. Our base case is that a satisfactory agreement will be achieved, which would be bullish for the currency and equities.

September 2018 Economic Statistics

	Sep-18	Dec-17	Dec-16
Federal Funds Target Rate	*2.00 - 2.25%*	*1.25-1.50%*	0.50 - 0.75%
Consumer Confidence Index	*138.4*	*122.1*	113.7
Manufacturing PMI Index	*59.8%*	*59.7%*	54.7%
Unemployment Rate	*3.7%*	*4.1%*	4.7%
JPY/USD	*113.68*	*112.67*	116.87
USD/EUR	*1.1608*	*1.1996*	1.0513
Gold/oz.	*$1,191.69*	*$1,302.45*	$1,151.46
Oil (WTI)/bbl	*$73.25*	*$60.42*	$53.72

Asia

The unadvertised reality of the US-China trade conflict is that the drivers are not solely economic. Subsequent to the momentous constitutional change of earlier this year, Premier Xi is no longer bound by term-limits. This solidification of power should allow China to execute on its long-term goals and prepare for a worst case trade scenario. Recall that the Chinese government has embarked on "Made in China 2025," a state-led industrial policy that seeks to make the country dominant in global high-tech manufacturing. Various programs aim to use government subsidies, mobilize state-owned enterprises, and pursue intellectual property acquisition to catch up with, and then surpass, Western technological prowess in advanced industries. This is a clear threat to the United States and the repercussions, aside from the trade negotiations, may affect the path of globalization.

In Japan, there are now more jobs available per applicant than at any point since 1974. Banks also continue to expand credit, in stark contrast to previous deflationary periods over the past two decades. The recent weakness of the yen (-7.0% versus the US Dollar during the past two quarters), spurred by a dovish central bank monetary policy and rising interest rate differentials, has served to reinvigorate Japanese exporters, which should lead to more robust and consistent economic growth.

Outlook

Overall, global growth remains positive, but less synchronized than last year, with the US leading the way. The main short-term risk appears to be that the US-China trade conflict will escalate, which is likely to cause uncertainty for businesses and consumers alike. From an economic perspective, tariffs are inflationary and can lead to slower growth, which would produce a headwind during the later stages of the business cycle. Thus far, the US has imposed tariffs on $250 billion worth of Chinese goods, to which China has retaliated with their own taxes on $110 billion of US commodities and products. Unless a deal is reached, the US tariff rate is scheduled to increase from 10% to 25% in January, with the threat that this could be expanded to all Chinese imported goods. The US trade deficit with China was $375 billion in 2017, which exists because exports to China were $130 billion (led by commercial aircraft, soybeans and autos) while imports from China were $506 billion (driven by computers, cell phones and apparel). A downside scenario could prove a meaningful drag on global growth, as supply chains adjust, while pushing prices higher. On the positive side, trade relations with Europe have thawed (though details are scarce) and the USMCA (NAFTA 2.0) trilateral agreement has been reached, indicating that the potential for an eventual US-China trade deal exists.

With the US midterm elections approaching on November 6, there will be a significant increase in political activity. This may lead to increased financial market volatility as investors attempt to handicap the eventual outcome. The unlikely event of a Democratic sweep, would be a worry for investors, given the potential for corporate tax reform to be reversed post 2020. Our base case is that the Senate remains under the control of the Republican Party and that a split congress potentially stalls legislative progress until the following elections.

US large capitalization stocks, as benchmarked by the S&P 500 index, are trading at un-demanding valuations (16.5x 2019 earnings), aided by a strong economy and still-low interest rates. US corporate earnings are growing rapidly, further boosted by lower taxation, with analyst revisions to forward estimates consistently to the upside. As such, it is no surprise that the Investor's Intelligence sentiment readings reveal a low level of pessimism (18.3%). It is, however, notable that such high levels of bullishness have almost always been followed by either a decline in equities, or a change in stock market leadership. Our research favors the latter, which may result in a shift from a united upward move of most stocks (a byproduct of passive benchmark investing), to an environment that features crosscurrents which favor "stock-pickers." For example, the FANG's have begun to splinter in 2018, with Amazon and Apple making new highs, while Facebook and Netflix experienced corrections. There have also been large divergences between global equity markets, with China the worst performing in 2018. Importantly, from such volatility, value can emerge, as seen by Shanghai stocks trading at 12x earnings (1.5x book value). In time, we forecast a broadening of returns to include a catch-up by European and US value oriented socks.

Global bond markets have begun to sell-off, with significant yield increases occurring in the US, a function of strong economic growth, rising inflation pressures, and deteriorating fiscal deficits. We note that the US Treasury-Bund 10 year spread is near the all-time wide point, circa 270 basis points. Should these trends continue, we expect Fed Chairman Powell and other FOMC members will increase their hawkish comments to prepare the markets for more rapid interest rate hikes. As such, we continue to recommend a cautious stance towards fixed income, preferring non-market correlated alternative assets.

Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal