

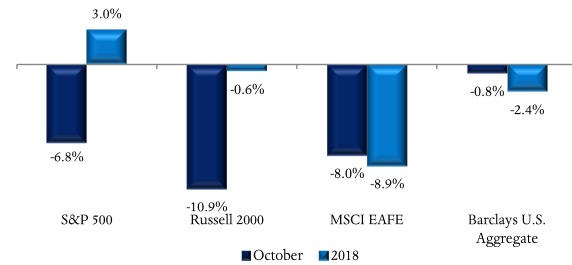


## MARKETS

Investors encountered a severe bout of equity volatility in October seemingly driven by an increase in US yields, quantitative tightening (QT) and buying exhaustion. The S&P 500 ended the month down -6.8% (+3.0% ytd). The more volatile smaller capitalization Russell 2000 fell -10.9% in October (-0.6% ytd). The Nasdaq index pulled back -9.2% (+6.7% ytd) as select technology oriented sectors were routed, suffering their worst monthly loss since October 2008. With the exception of the US, virtually all major global stock markets are down thus far in 2018. The MSCI EAFE index has declined -8.9% year-to-date. European equities dropped -5.5% during the month (-4.2% ytd), as measured by the Stoxx 600 index. In Asia, markets were also broadly lower. The Shanghai Composite entered bear market territory during October, ending down -7.1% (-19.4% ytd). Tokyo's Nikkei 225 index retracted -9.0% (-2.0% ytd). The MSCI Emerging Markets index softened a further -8.7% last month (-15.5% ytd), having borne the brunt of increasing US interest rates, especially those with high dollar-denominated debts.

In fixed income markets, US 10-year Treasury yield breached 3.2% in October, which led to a risk-off period in financial markets. However, it is important to note that the main driver of the increase in yields appears to be real rates moving higher, rather than rising inflation (the consumer price index decelerated to 2.3% in October). The Barclay's US Aggregate Bond index declined -0.8% during the month, leaving it down -2.4% thus far in 2018. European sovereign bonds were flat overall in October. German 10-year Bund prices rose by +0.6% in a flight to safety, while Italian 10-year BTP's fell -1.4% (the yield spread between the two sovereignties rose to 320 basis points).

Crude oil closed out the biggest one-month loss in over



two years in October (WTI -10.8%), declining from recent four-year highs, after government data showed an increase in U.S. stockpiles. The Trump administration officially placed sanctions on Iran's oil exports, but granted waivers to eight countries, allowing them to continue to import oil from Iran for a six-month period. In the metals markets, Palladium reached a record closing high of \$1,140/oz during October, while Platinum staged a resurgence off a multi-decade low, bouncing +9.4% to \$836/oz.

## GEOPOLITICS

Amidst the strongest turnout in decades, Americans voted in highly anticipated midterm elections. The Democrats retook control of the House of Representatives for the first time since 2010, on the back of wins in a number of suburban districts. A majority of the House, albeit with seven seats, will give Democrats subpoena power, potentially leading to investigations of President Donald Trump's administration. Republicans did, however, expand their majority control of the Senate. This will allow President Trump a continued free hand at nominating Supreme Court, Cabinet, and other political candidates for the next two years. Democrats also fell short in some of the most sought-after gubernatorial races, including Florida. Notably, a record number of women were elected into office. A splintering of Congress means that Republicans will no longer be able to pass legislation with GOP votes alone.

In Europe, political concerns have yet to dissipate. The Italian government submitted a budget plan to the Eu-

ropean Commission that would see its 2019 deficit rise to 2.4% of GDP. The Commission rejected the proposal and has asked that revisions be made so that the budget meets the fiscal targets set by the European authorities. Italy's sovereign debt was downgraded by one notch but, importantly, remains investment grade.

#### UNITED STATES

The US Bureau of Economic Analysis reported that the economy grew at a robust annualized rate of 3.5% in the third quarter. The current 112 month economic expansion is on track to match the longest in American history, which was the ten-year period ending in 2001. Thus, it is no surprise that confidence remains high among both consumers and business leaders. Over the past year, employers have added an average of 210,000 jobs a month, with a healthy 250,000 in October. There was also evidence that previously discouraged workers are not only feeling optimistic about job prospects but are actually finding work, which is why the jobless rate remained unchanged at 3.7%. An estimated 711,000 people joined the labor force last month, raising the labor force participation rate to 62.9% (now in line with the long term historical average, which features a range of 58.1% to 67.3%). Wages are up too, rising 0.2% in October and 3.1% over the past year.

US manufacturing continued its expansionary trend, but at a slightly slower pace. Demand remained strong, with inventories remaining low (driven by continued supply chain tightness, notably labor and transportation). Consumption softened from prior high levels, with production and employment continuing to expand, but at lower levels. The Commerce Department reported that the U.S. is exporting less for the fourth-straight month, partially related to a strong Dollar, and that the trade deficit with China rose to a record \$40.2 billion.

The Fed, which has increased interest rates three times this year, albeit off low levels, is expected to raise them again to an upper bound of 2.5% in December, as a hedge against inflation. Looking into 2019, it is unclear how many further rate hikes the Fed will follow-

**October 2018 Economic Statistics**

	Oct-18	Dec-17	Dec-16
Federal Funds Target Rate	2.00 - 2.25%	1.25-1.50%	0.50 - 0.75%
Consumer Confidence Index	137.9	122.1	113.7
Manufacturing PMI Index	57.7%	59.7%	54.7%
Unemployment Rate	3.7%	4.1%	4.7%
JPY/USD	112.93	112.67	116.87
USD/EUR	1.1310	1.1996	1.0513
Gold/oz.	\$1,214.14	\$1,302.45	\$1,151.46
Oil (WTI)/bbl	\$65.31	\$60.42	\$53.72

through with. The market is forecasting two more in 2019, but Fed actions will likely be influenced by the progression of future economic data points. Looking ahead, GDP growth is forecast to steadily slow as the effect of tax cuts wears off, compounded by annualizing headwinds of a stronger Dollar.

#### EUROPE

Eurozone purchasing managers' indices (PMI's) continued to disappoint, with the composite dropping to 53.1 in October (the weakest reading since 2016) from a high of 58.8 in January. Manufacturing data in Germany (5 month low) was dragged lower by new and time-consuming car emissions tests. In Italy, seemingly a weak link, output dropped to a 59 month low, while picking up in France and Spain. Trade concerns may be affecting business activity, as new export orders have fallen sharply, in spite of a more competitive Euro currency. On the positive side, loan growth to corporations picked up to 3.1% year-over-year, as per the latest reading, the highest since 2009. Bank lending surveys from the European Central Bank (ECB) also suggest that credit demand is persistent and lending standards remain loose, providing a tailwind to regional economies. In an encouraging statement, the ECB remarked that while recent data was somewhat weaker than expected, it was within parameters consistent with an ongoing broad-based expansion. Thus, the central bank remains on course to end its net asset purchases in the new year.

In the UK, economic data was broadly positive. Wage growth grew at an annual pace of 3.1%, the highest

rate in the past decade. In a reversion, post the Sterling devaluation, imported inflation has begun to fade but domestic inflation appears to be firming. The combination of declining inflation and rising wages should be supportive of the UK consumer and the overall economy. Britons now anxiously await the outcome of Brexit negotiations, with a separation due to take effect on Mar 29, 2019. An agreement is taking shape, with the potential for the EU to permit the UK to stay in a customs union, thus avoiding a hard border with Northern Ireland. UK PM Theresa May is also said to be on course to secure a political deal on a “future economic partnership” with the EU that will offer Britain the prospect of a free trade deal resembling the one with Canada.

### ASIA

There have been concerns over a broader slowdown in China, partly due to the increase in trade tensions with the US, as well as the ongoing intentional shift from the Chinese authorities to slow the pace of credit growth. China recorded GDP growth of 6.5% in Q3. While the rate of economic growth is below historical norms, it is still robust, especially off an ever-larger base. While the US tariffs were intended to become a headwind for China’s exports to the US, the depreciation of the renminbi against the US Dollar has provided a buffer. China noted a trade surplus of \$31.8 billion with the U.S. in October, down from a record \$34.1 billion in September. The country’s cumulative trade surplus with the U.S. in the first 10 months of the year was \$258.15 billion. Given the worry of an impending economic slowdown, Chinese authorities have begun the implementation of financial stimulus, including a further cut to the banking reserve requirement ratio, which should be supportive of bank credit growth (yet allowing for the continued focus on limiting the pace of credit growth in the shadow banking sector).

### OUTLOOK

Equity investors entered October with significant optimism. Post the month’s equity index selloff which featured the second, roughly 10% peak-to-trough, drawdown of 2018, sentiment is more balanced. It is interesting to note that over the past four decades the average draw-

down, during a positive year for US equities, has been -11%. The current investor caution is healthy and should bode well for an advance during the tail end of the year, especially given that the fundamental economic and corporate earnings backdrop has not changed materially. The US economy, even though furthest along in the cycle, is still growing at a healthy pace. There are some worries regarding Europe, with continued Brexit uncertainty and concern over the Italian government’s fiscal position. However, the US-China trade conflict remains the largest near-term risk, potentially affecting corporate supply chains, prompting a resurgence of inflation, and dampening the economic growth outlook. On the optimistic side, we believe there is the potential for US bipartisan support for a much needed infrastructure spending bill. The upgrading of transportation, municipal services, and electrical grid would be constructive for the US economy, from an employment as well as efficiency perspective, and could be financed with the assistance of private funds, in a deficit-neutral manner.

Looking ahead, we foresee a normalized level of equity market volatility, as investors debate economic growth, earnings, trade and central bank activity. Equity markets appear reasonably priced (16x 2019 earnings for the S&P 500), assuming no significant additional rise in bond yields. In fact, the current environment seems well suited for active portfolio management, favoring stock picking over indexation. Perhaps most importantly, we encourage investors to remain patient and focused on the long-term.

From a fixed income perspective, interest rates have moved rapidly higher throughout 2018 (2-year Treasury Note yield at 2.94%) and thus may be poised to flatten for a period of time, before ultimately resuming an upward trend. For the first time in a decade, bond investors are achieving a positive real yield, and can prudently invest in short duration bonds as ballast to portfolios.

To deal with rising periods of volatility, and as we approach the later stages of the business cycle, risk-averse investors may wish to consider building some resilience into portfolios. As such, select value added alternative investments may be considered as a tool to diversify and reduce overall market correlation.

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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