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From the Curb

Letter to Clients

Quarter Ending September 30, 2018

Investors endured some heady head winds in this last quarter but it ultimately didn't matter. The third quarter ended up being the best-performing quarter for markets so far this year as the major U.S. stock indices each hit new all-time highs. The S&P 500's 7.7% rate of return made it the best third quarter return since 2010. The broad market gains were driven by strong economic data, solid earnings growth and improved clarity on global trade.

Interestingly, those positive factors were often overlooked as news headlines focused on various political firestorms and the continued uncertainty with regard to the U.S. and China trade relationship. But, in what has become a recurring theme for the 2018 market, positive economic and corporate fundamentals once again outweighed unnerving political and geopolitical antics.

Starting with current economic growth, it's simply the best we've seen in years. The final reading of second-quarter GDP showed growth above 4% annually, and according to the Atlanta Federal Reserve "GDP Now" estimates, we can expect near 4% GDP growth for the third quarter as well. For context, the last time the U.S. economy posted two consecutive quarters of annual GDP growth close to 4% was in mid-2014, and prior to that, it was late 2004!

Corporate earnings growth also remained very strong during the third quarter, as more than 80% of S&P 500 companies reported earnings above consensus expectations. According to financial data firm FactSet, that's a record high. Aided by the tax cuts passed at the end of 2017, S&P 500 corporate earnings growth for 2018 is expected to rise above 20% year over year. Just as importantly, analysts expect strong earnings growth to persist into 2019, with current estimates calling for 14% earnings growth for the S&P 500 next year.

Global trade concerns about the U.S. and Chinese trade relationship remain, but the third quarter also saw important resolution to numerous other trade situations. First, in July, the United States and the European Union reached a trade agreement that would prevent retaliatory tariffs and promised to investigate ways to further promote free trade between the U.S. and the E.U. Then, in August, the United States and Mexico agreed to a trade framework to replace NAFTA, and on the final day of September, Canada and the United States reached an agreement for Canada to join the existing U.S./Mexico deal, settling another potential trade dispute. So, we started the third quarter of 2018 with

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four areas of trade-related concerns: The EU, Mexico, Canada and China and we end the quarter with just one area of legitimate trade concern: China. And, while the U.S./China trade relationship certainly represents a potential risk to the global economy and markets, it's important to remember that so far in 2018, a strong U.S. economy and healthy corporate fundamentals have powered stocks higher through multiple periods of trade, political and international uncertainty—and that's critical context to consider as we enter the final quarter of the year.

Lastly, on the fixed income front, the Bloomberg Barclays US Aggregate Bond Index, the most widely used benchmark for bonds, declined for the second consecutive quarter; marking this the first time in over four years that a leading bond benchmark has reported back to back negative returns. The Federal Reserve has increased interest rates eight times by 25 basis points since December 2015, with another rate increase slated for December of this year. The pressure of increasing interest rates and rising inflation will continue to place strain on fixed income markets along with the U.S. economy.

As we enter the final quarter of 2018, U.S. economic and corporate fundamentals remain very strong, and those two factors combine to provide firm support for the markets. That is an important fact to remember as those core fundamental positives have helped markets move higher in 2018 despite a return of volatility. And, we fully expect continued market volatility in the fourth quarter, as investors face several potentially significant unknowns, including:

- Whether the U.S. and China can strike a trade deal
- If corporate earnings growth continues to meet expectations
- The possibility of disruptive political events from Washington (midterm elections, personnel turnover, spontaneous tweets)
- Continued Federal Reserve action

It's unclear how, or when, these events will be resolved, and what those implications will be for markets. Yet as 2018 has shown us so far, uncertainty is not, by itself, enough to offset the strong fundamentals in the U.S. economy and corporate America.

Instead, these and other market uncertainties require an intent focus on financial markets, economic data and political news. Put more generally, markets always face uncertainties at the start of a new quarter, but over the long-term, it is core economic and corporate fundamentals that drive market returns, not the latest sensational headlines.

Our years of experience in all types of markets (calm and volatile) have taught us that successful investing remains a marathon, not a sprint. As this year has shown us, trade conflicts, political dramas and short-term market volatility are unlikely to impact a diversified approach aligned to meet your long-term investment goals. Therefore, it remains critical to stay invested, remain patient, and stick to a plan. Thank you for your ongoing confidence and trust as we navigate this changing market environment.