October 2018 Commentary

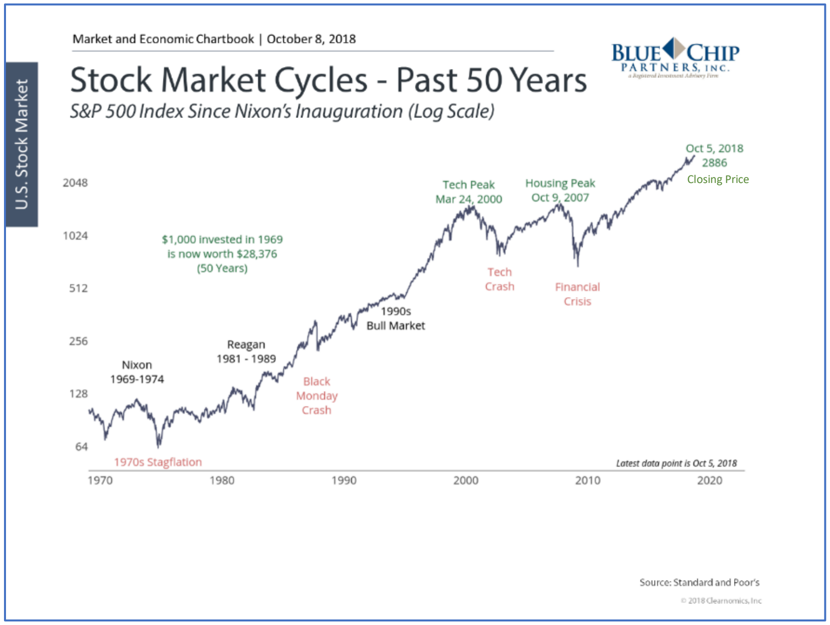
As we enter the fourth quarter, it's important to reflect on the market developments of the past year and what they tell us about investing at this stage in the cycle. This is now the longest bull market in history, interest rates are beginning to rise, and the Fed continues to raise rates. At the same time, the perfect storm of trade wars, weak currencies, and rising oil prices is pummeling many international markets. What are investors to do when markets diverge?

These events highlight the importance of diversification and asset allocation in achieving long-term financial goals. The future is neither obvious nor predictable. **The goal isn't to pick individual stocks and bonds that outperform all of the time. Instead, it's to construct a balanced portfolio that performs well over time.** This is best done by holding assets that outperform in varying market environments.

There are still many reasons to be positive on the market outlook, but staying balanced is especially important given the late-cycle dynamics in the economy. It would also be foolish to ignore some basic economic facts: the unemployment rate is near historic lows, inflation is beginning to tick up, and the yield curve is as flat as it can be without inverting.

These indicators don't necessarily predict how much longer the cycle will last - the yield curve can be flat for quite some time. But even the most bullish investor must agree that eventually there will be a spike in market volatility, a bear market, or a recession, even if it's years away. For most investors, staying disciplined today will help them to be properly positioned when the time comes.

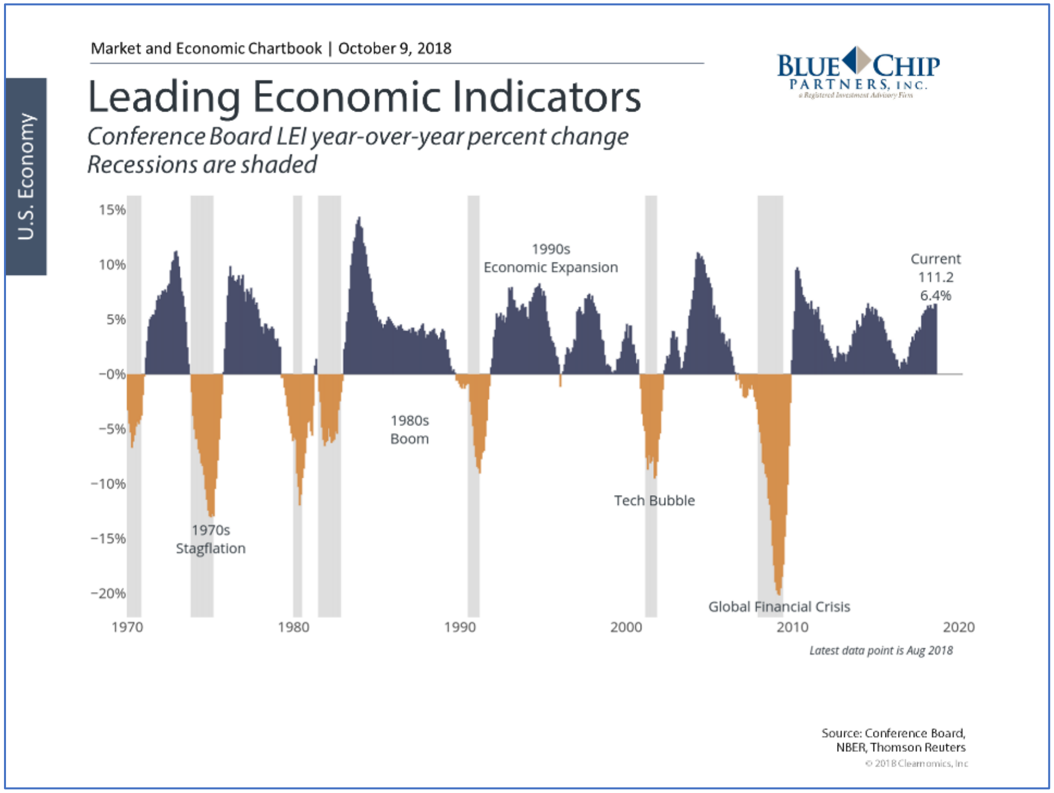
1. This is the longest bull market in history



The current bull market is now officially the longest on record, surpassing the 1990's bull run. Over the past nine and a half years, the S&P 500 index has risen 331%, the Dow Jones Industrial Average 304%, and the NASDAQ Composite 534%. Valuations have also risen over this period, although there's still no sign of irrational exuberance. Can this continue?

Market cycles don't operate on a set schedule, and bull markets do not die of old age. Over time, the real key to sustainable market rallies is economic growth and corporate earnings. With this backdrop, corporate earnings-per-share have grown by over 150% since 2009, boosting stock prices across sectors. While there are signs that the pace of corporate earnings may have peaked, they are likely to remain healthy for some time.

2. The economy is growing at a healthy pace



The health of the U.S. economy is the driving force behind portfolio returns. The chart above shows an index of leading economic indicators. These indicators usually turn negative several months before a recession - this is clearly seen prior to the financial crisis in 2008 and before the tech bust. At the moment, these leading economic indicators confirm the strength of the U.S. economy.

This chart also highlights the ups and downs in economic growth over this cycle, a reflection of everything investors have had to worry about over the past nine years. Despite this, the pace of growth has been enough to push unemployment to historically low levels and generate strong corporate profits, elevating stocks to record highs.

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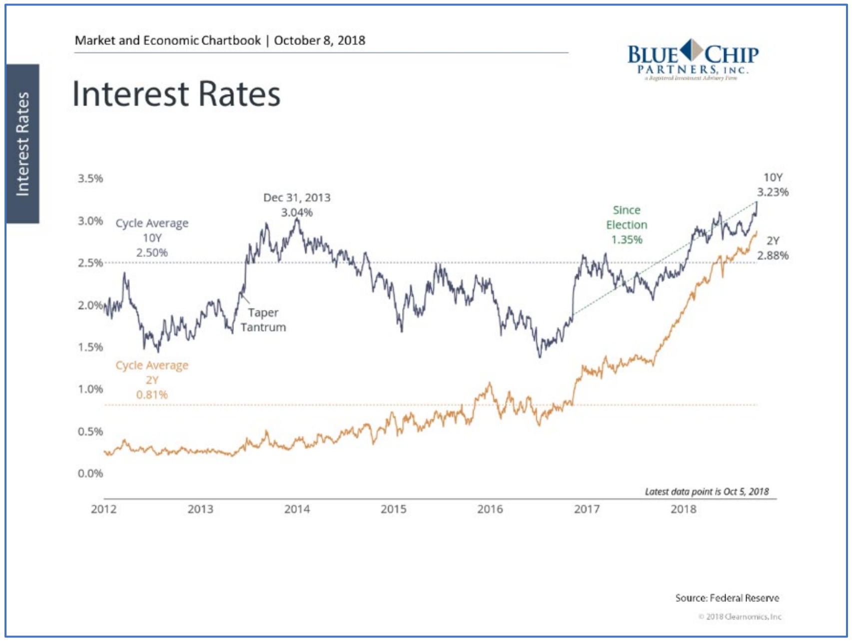
3. Interest rates are slowly rising



Interest rates fell to historic lows following the financial crisis due to slow global growth and easy central bank policy. This created a challenging environment for millions of investors who rely on their portfolios to generate income. Long-term interest rates have only begun to rise again recently. The 10-year Treasury yield is finally above 3% after being stuck in a range over the past five years.

This chart also shows how quickly short-term rates have risen relative to long-term ones. A flatter curve, especially when driven by the short-end rising, is often taken as an indication of a maturing business cycle. It doesn't predict the exact timing of recessions, and there are often false positives. Still, the yield curve is flashing yellow which is consistent with other economic indicators.

What's the bottom line? The market developments that have affected investors in 2018 reflect an aging business cycle and international challenges. It's more important than ever to stay balanced in this environment.

Sincerely,

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