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FINANCIAL MANAGEMENT, INC.

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## **Subject: 2018 3rd Quarter Review**

The intent of this review is to keep you up to date with some key securities market and macroeconomic happenings. **These reviews are too lengthy and detailed for most clients to read. To shorten your reading time, you can read the bold print and summary, or just the summary.**

October was the most impactful month of the year. Although, it is outside the 3<sup>rd</sup> quarter scope of this review, it will be addressed.

Stocks were up through the 3<sup>rd</sup> quarter year to date and finished October in the red. Intermediate term bonds were down through the 3<sup>rd</sup> quarter and continued down in October. Short term bonds were up a bit through September and declined marginally in October.

**Through the third quarter, a 100% stock portfolio with dividends reinvested was up 7.82%. By the end of October, an all-stock portfolio with reinvested dividends was down 0.38% year to date.**

**Barclay's Aggregate Bond index of intermediate investment grade bonds was down 1.67% through the end of September and down 2.49% through the end of October. Further, the Lipper index of short term investment grade bonds was up 0.71% through the end of September and up 0.69% through to end of October.**

## **Stock Perspectives / Growth vs. Value**

- Growth stocks continue to outperform value stocks in 2018.
- Growth stocks led Value stocks by 12.62% through the second quarter this year. Therefore, value stocks trailed an index of all stocks by 6.31%. These spreads were reduced to 7.24% and 3.62%, respectively by the end of October.
- **Stock valuations are on the high side, but growth stocks are skewing overall valuations above the fair value range. Based upon P/E ratios, it would be safe to say that Value stocks as a whole are valued between the mid-point and the high end of the fair value range, where Growth stocks are still valued above the fair value range.** An example of growth causing distorted valuations can be seen in the small cap index. The trailing twelve month P/E ratio is 58.6, yet if you exclude companies that did not make a profit, the P/E ratio is 20.7.
- **As of the 3<sup>rd</sup> quarter end, price to book value ratio (P/B) for Growth stocks continued to rise to 7.78, and are now 61% above the long term average (7.78 vs. 4.83). Price to book value ratio for Value stocks ticked up to 2.17. This is now 7% above the long term average (2.17 vs. 2.03).**
- **With the help of the tax code change for 2018, corporations in the S&P 500 index saw their earnings rise just about 25% in each of the first three quarters this year. Favorable comparisons of this size will be next to impossible to achieve in 2019 in comparison to the robust and tax code aided gains this year.**



## **Bond Market**

- As mentioned above, intermediate term bonds have continued down this year, while short term bonds have eked out a gain.
- **We have been discussing the flattening of the yield curve (the spread between the 10 year Treasury and the 2 year Treasury). Further, a flat yield curve would cause earnings problems for banks and therefore a reduction in lending from banks. This is not good for the economy. This year the spread had declined from 0.54% down to 0.18% by late August. The spread has since increased back to 0.25%. This isn't a big move, but it is an encouraging move in the right direction.**
- **Last year, intermediate term and long term bond yields increased at a slower rate than the FED's rate increases (flattening of the yield curve). This was due to lower interest rates in developed Europe and Asia. The Federal Reserve has made clear that they still want to steer interest rates very gradually upward. The good news is that the Fed is confident that the U.S. economy is on solid footing.** Historically, when raising interest rates to combat inflation, the Federal Reserve raises interest rates at a rate of 1% per year.
- For those keeping score, the Federal Funds rate increases by the Federal Reserve Bank (FED) was about equal to the market increase in the 10 year Treasury (market controlled) through September since the tax code change passed last year. As of the end of October, the 10 year was up 0.82% and the Federal Funds rate was up 0.75%. So, again we are teetering on the point where the FED is going from a position of leading interest rates to where the FED is following market interest rates. This is a stage of the economy where one of two things are true: 1) interest rates are market controlled instead of driven by the Federal Reserve, or 2) the market believes the Federal Reserve will continue to drive rates up to an economic neutral level or beyond to a point of constraining the economy. It is likely a moot point, but either way, **it (rising interest rates) is one of the key sources of concern and one of the drivers of stock market volatility in October.**
- **The FED is targeting one more increase in the Federal Funds rate this year given the strength of the economy (four for the year). Employment is available for all who want a job and inflation has hit the Federal Reserve's target of 2%. Assuming that the economic strength holds, there will likely be three more increases of 0.25% in 2019.** This will bring the Federal Funds rate to a range of 3% to 3.25%. This is a stopping point that is about 1.5% below former targets for interest relative to inflation. This is due to fact that the U.S. economy has grown quite large and the belief that it is not capable of past intermediate and long term economic growth rates.
- If the FED increases the Federal Funds rate beyond 3.25% in 2019, they would again be steering interest rates to constrain the economy in order to avoid higher inflation (greater than 2.25% or 2.5%).
- **DBFM has made great strides in lowering interest rate risk (going to shorter term bonds) over the last three years.**
- **High yield bond spreads did not jump during the month of October. If we were toward the end of the business up-cycle the spread would have widened significantly. The economy may have reached its peak, but we are in agreement with the FED in believing we are two plus years away from a recession.**

## **Data and Commentary**

- 2016 Real GDP growth: 1.5%
- 2017 Real GDP growth: 2.3%.
- 1<sup>st</sup> Quarter 2018 Real GDP growth: final estimate was 2.2%.



- **2<sup>nd</sup> Quarter 2018 Real GDP growth: third estimate was 4.2%.**
- **3<sup>rd</sup> Quarter 2018 Real GDP growth: first estimate was 3.5%.**
- **Estimates for 4<sup>th</sup> Quarter GDP growth rate centers around 2.8%.**
- Estimates for 2019 center around 2.5%.
- Estimates for 2020 and 2021 are about 1.9%.
- The IMF has lowered the world forecast for real GDP growth from 3.9% to 3.7% for 2018 and 2019.
- **Let us look around the world.**
  - **Eurozone real GDP growth slowed to an annualized rate of 0.8% from 1.6% in the 1<sup>st</sup> two quarters.** This after registering 2.5% for the year 2017, the fastest pace in a decade. **Europe's expansion is now 22 consecutive quarters long, although it is slowing this year.**
  - **China's real GDP growth has slipped from 6.8% in Q1 to 6.7% in Q2 and down to 6.5% in Q3. The biggest near term issue for China besides the trade war with the U.S., is high corporate debt.** It is 181% of GDP. Government and private debt total 277% of GDP in China. For comparison purposes, U.S. corporate debt to GDP is 30.9%, but total government and private debt is 189% of GDP.
  - **Japan's 2<sup>nd</sup> quarter GDP growth rate recovered to 1% from the disappointing 1<sup>st</sup> quarter GDP decline of -0.6%. 2017 GDP growth was 1.6%. The decline in the 1<sup>st</sup> quarter ended the longest growth streak since 1989. Japan's 3<sup>rd</sup> quarter GDP was down 1.2% as factories and domestic spending was impacted by major flooding, earthquake, and a typhoon.**
  - **With stronger growth in the U.S. than in Europe and parts of Asia, we are seeing the dollar gain strength. This is a problem for emerging economies that have loans denominated in dollars.** This issue has been exacerbated in Argentina and Turkey due to poor fiscal and monetary policies. **Emerging market stocks and bonds are in negative territory this year. DBFM does not pursue emerging market investments due to their high volatility and longer term under-performance.**
- Quarterly corporate results continue to be excellent with mid-20% earnings gains in the first three quarters this year.
- **Trade war of words = uncertainty.**
  - **NAFTA to become USMCA: A deal has been reached,** but it has to be signed off by leaders of the three countries and approved by Congress and legislators in Mexico and Canada. Most provisions would not take effect until 2020. **A new source of uncertainty revolves around whether or not the Democrat controlled House of Representatives will support it. That is not a given.**
  - **President Trump and European Commission President Jean-Claude Juncker agreed at the White House on July 25<sup>th</sup> to avert a trade fight and work toward "zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods." Both sides remain committed to achieving the goal. Progress will likely be slow.**
  - **Negotiations with China over tariffs with respect to business practices (read ownership levels and technology theft) appear to be a stand-off. China's position is stuck in "denial" gear. The only surprise would be a quick resolution. The tariffs are creating supply chain havoc. This situation can only be disruptive in the short term.**

- **The tariff situation with China has been projected to reduce earnings gains in the USA in 2019 from 9% down to 5% or 6%.**
- **The conditions that normally lead to a bear market decline are either not present or not forecastable, including an oncoming recession, a hostile Federal Reserve, dangerous inflation, investor exuberance, speculative valuations or geopolitical shock.**
  - **The Federal Reserve is the opposite of hostile. The Fed is actually still accommodative. The Federal Funds rate is 2.23%. The FED has stated that the natural interest rate is 1%. This means that the Federal Funds rate would become neutral at 3.00 to 3.25% (with core inflation between 2% and 2.25%).** Newly appointed Fed Chair, Jerome Powell is telegraphing little change in policy with the exception of a lighter hand on regulation.
  - **Dangerous inflation is not on any radar.** Inflation has reached FED's target of 2% in June and continues at this level through October. Recent gains in wage growth are not expected to materially impact inflation.
  - **Investor exuberance:** Famous investor John Templeton argued that "bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria". **This market does not resemble the euphoria of the dangerous years of 1929 or 2000.** Since this bull market began, individual investors pulled money from stock mutual funds every year until the last two years. The inflow in 2016 and 2017 was not been exceptional by any means and has reversed in 2018. **Further, investors dealt valuations a strong blow in October.** Speculative valuations are present in some well-known growth stocks as well as some young biomedical companies. **Growth stocks as a whole remain significantly overvalued. Overall market speculative valuations certainly are not present as they were in the late 1990's.**
  - **Geopolitical shock: Brexit negotiations seem deadlocked within the U.K. parliament with a 3/29/19 deadline looming. Brexit without a deal would be disruptive.** North Korea. Middle East. Italy (budget problems and potential to leave the EU?). **Keep an eye on trade policy.**
  - **Oncoming recession (?):**
    - Macro-economically speaking, this is not in view at this point.
    - Although, earliest prognostications of recession are for late 2019. The basis of this prediction is an inverted Treasury bond yield curve; this concern has abated for now. **Most prognostications for a recession center around 2021.**
    - **The most likely source of recessionary pressure resides in geopolitical shock via trade war with China or a no deal Brexit for the U.K from the European Union.**
- **Economic Indicators:**
  - **The Leading Economic Indicators are up 4.8% this year through the end of September, from 107 to 111.8.** "The U.S. LEI improved further in September, suggesting the U.S. business cycle remains on a **strong growth trajectory heading into 2019.** However, the LEI's growth has slowed somewhat in recent months, suggesting the economy may be facing capacity constraints and increasingly tight labor markets," said Ataman Ozyildirim, Director and Global Research Chair at The Conference Board.
  - **Higher interest rates are beginning to impact home and automobile sales.**
    - **Housing data can be volatile, but existing home sales and housing starts are beginning to look like they have peaked out in the first quarter this year.** Existing



home sales have declined 7.4% this year from 5.56 million to 5.15 million annualized pace in September. Housing starts are down 1% from year ago levels. Supply of homes for sale ticked up but remains at a depressed level of 4.4 months. Six months is considered a balanced supply of homes for sale. **Forward looking information is contrary to sales and construction numbers.** Building permits comparison for the first nine months are up 3% from 2017. Household formation has jumped to an annualized rate of over 2 million in 2018 from just shy of 1 million in 2017. **We would estimate that limited housing supply, construction labor shortage, rising prices, and higher mortgage interest rates will keep a lid on housing.**

- **Annualized automobile sales have leveled off this year as compared to 2017 at just over 17.5 million vehicles.**
- **New orders for durable goods (annualized) are up 6.6% over 2017 through Q3 this year.**
- **Consumer spending is up 3.6% from 2017 year end through Q3 this year. That is a 4.8% annualized rate of gain.**
- **Consumer confidence has been gradually trending up since July 2007. The consumer confidence reading hit a 17 year high in October 2017 at 125.9. Fast forward to October this year the reading is 137.9. Readings for current conditions and expectations continue to increase each month.**
- **The Personal Savings Rate:** Hmmm...the Bureau of Economic Analysis recently revised their analysis of the personal savings rate in the U.S. They indicate that they had been leaving out dividends, interest, and business owner's profits. **The personal savings rate in September was 6.2%. It appears that the U.S. has been saving near this rate since 2010.** The recent low point was 2.4% in 2006. This revelation of a higher savings rate is not likely to change the prospects for our economy given that it has always been present, just not measured. The savings rate from the late 1950's through 1985 was double to half again as high as it is now.
- **Business investment continues to ramp up and remains at elevated levels in the 3rd quarter this year.** The annualized level is in excess of \$656 Billion. This is an increase of about 25% from 2017 year end. This is nice, but in addition, corporations are expected to apply \$800 Billion to stock buybacks and \$500 Billion to paying dividends. Business investment in capital leads to higher levels of productivity, employment, output, and income. **Expectations for increases in business investment was higher than reality coming into 2018 given the opportunity to repatriate money held overseas by corporations as a result of the 2017 tax deal.**
  - **Manufacturing capacity utilization remains below 78%.** Levels exceeding 80% would create greater need for business investment. Levels exceeding 82% could be considered inflationary. **The present level of utilization is limiting investment and inflation.**
- **Institute of Supply Management continues to be strong: Readings above 50 mean growth. Readings above 60 are rare.**
  - **Institute of Supply Management – Manufacturing (12% of the U.S. economy): 57.7 was the reading in October. The September reading was 59.8.** Manufacturing has been on a strong up-trend for the last 29 months. **On the net, the USA has gained 1,278,000 manufacturing jobs since the end of 2009. That is a gain of 11.14%**



- Institute of Supply Management – **Service (80% of the U.S. economy): The September reading was 61.6. October was 60.3.** Readings have been above 50 since early 2010.
- **Employment**
  - **Monthly hiring remains strong:** 2016 average was 180,300. 2017 average was 170,500. The average for the first ten months of 2018 is 198,800.
  - The four week moving average for unemployment claims has leveled off at a very low 215,250. This reading has been below 300,000 for 195 weeks in a row. Readings below 300,000 point to continued substantial monthly hiring.
  - A review of the unemployment, underemployment, and the labor force participation rate indicates that we are 3% away from full employment. Presently, there is more than one job opening for every officially unemployed person in the U.S.
- **Financial Stress Index is very low (lack of stress).** The average reading this year is a negative 1.151. Negative 1.0 is a very low reading, meaning **positive for the economy**. The reading was negative 0.997 at the end of October. This reading points to a bit more stress, but still at a low level. The most likely culprit is the increase in interest rates with more increases expected.
- **Strength of the Dollar: Presently, the relative value of the dollar is neutral with regard to manufacturing and exports.** The dollar reached a recent low point on 1/25/18; it was down 12% since the end of 2016. The dollar is now up 7.8% for this year. It is still down 5.1% since the end of 2016. This is not an impactful move at this point except for emerging market debt issued in dollars.

### Summary / Additional Comments

- The U.S. economy remains strong. Job creation is exceptional. Inflation has arrived at a level the Federal Reserve has been seeking since the financial crisis. Labor supply is becoming a limiting factor.
- Corporate earnings gains have likely reached a peak. Comparisons in 2019 will be difficult given the comparison to one-time gains related to the corporate tax code change.
- The housing market may be peaking, not from a lack of demand, but rather from a limited supply, higher interest rates, and rising prices.
- Higher interest rates may be affecting car sales which have leveled off at the 2017 level.
- Along with higher interest rates, the yield curve steepened in the 3<sup>rd</sup> quarter. This steepening of interest rates has led many to believe that the greater threat to the bond market is a strong economy and rising prices as opposed to a weakening economy and a flat or inverting yield curve. This entrenchment of higher interest rates also caused investors to question the valuation levels of the stock market in October.
- The employment participation rate is increasing and the under-employment rate is falling. There are more job openings than applicants. Labor shortages are problematic in many industries and communities. Labor supply will eventually constrain economic growth in the U.S. unless proactive steps in the area of training and immigration are taken.
- Economically, the positives significantly outweigh the negatives. Leading economic indicator trends are strong.
- Economic and corporate strength seems to be at a peak domestically. The pace in Europe and Asia has slowed this year. But, Europe should not have peaked out at this point.
- The prospect of slower economic and corporate earnings growth rates, higher interest rates, trade uncertainty,





and Brexit risk have resulted in greater uncertainty and stock market volatility, more so for growth stocks.

- A Brexit deal and a trade arrangement with China would reduce uncertainty significantly and likely result in a return to strong synchronous world-wide growth.
- We will keep an eye on rising inflation. Inflation has been at the Federal Reserve's target of 2% for the last five months.
- Heretofore, we have not mentioned the federal government budget. The annual federal government deficit is returning to the trillion dollar level this year. Federal debt held by the public remains at 75% of GDP. Projections indicate this will increase to 100% by 2028. Studies show that economic gain can become constricted or crowded out by national government debt at levels around and above 90% of GDP. It is time to deal with this issue.
- We remain focused on the long view of value investing and seeking income as well as long term appreciation of investments. Our focus on the status of the economy is not directed at seeking market exit and entry points. Rather, it is intended to help us target potential tactical adjustments to an optimally balanced portfolio. It is also intended to keep you informed.
- While we are monitoring the economy and the risks to equity and bond markets, periods of decline are unavoidable. Nothing can replace the decisions / choices you make (such as controlling expenses with an eye towards saving more and reducing debt) with regard to growing your wealth over the long term.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

A handwritten signature in black ink that reads "Dave Dickmeyer".

Dave Dickmeyer, M.B.A.  
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A handwritten signature in black ink that reads "Ian D. Boyce".

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