AMB Newsletter
4th Quarter 2018

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3rd Quarter 2018 Review

A divergence in equity market performance around the globe occurred in the 3rd quarter. US equity markets, measured by the Standard and Poor's 500 index, performed the best by a wide margin. This was the strongest quarter of the year posting a return of 7.71%. Returns were driven by continued strength in corporate earnings and solid economic growth as investors continued to shrug off trade war fears and other geopolitical worries. The leading sector for the quarter was health care which posted a return of 15%, driven by rising profits and stronger forecasts by major drug manufacturers such as Pfizer, who is at its highest level in 10 years. Large cap stocks were the best performing group and once again growth outpaced value by a wide margin.

International developed equities did not fare as well as their US counterparts. The Eurozone measured by the MSCI Europe index was up 1% for the quarter. Even though corporate profits remain strong economic growth fears seemed to temper enthusiasm in the equity markets. GDP growth slowed to just 2.1% for the 2nd quarter, this is down from 2.4% in the 1st quarter and lower still from the 2.7% growth at the end of 2017. To make matters worse, the ECB has taken a more hawkish stance while economic growth is slowing, which leads to fears that this may not be just a blip. However, Mario Draghi sees this as temporary, caused by the global trade negotiations. The ECB backed this up by continuing to phase out the ECB's bond buying program. AMB will be keeping a close eye on Eurozone growth trends as their equity markets seem to be undervalued compared to the US; but if the recent GDP numbers continue, they may not be as cheap as they appear.

Japanese equities rallied at the end of the 3rd quarter and posted a solid 6% gain measured by the MSCI Japan index. The rest of the Asian-Pacific markets did not fare as well as the MSCI Pacific ex Japan finished up only 1%. The market action at the end of the quarter was promising as it seemed investors were starting to focus less on global trade tensions. Economic growth numbers in Japan have been a mixed bag. Second quarter numbers were the highest since 2016 followed by a dramatic slowdown the following month. Shinzo Abe's reelection was the biggest news for markets as it will allow for continuity on economic policy going forward.

Emerging market equities had another tough quarter, as dollar strength continues to weigh on debt and currency markets. Performance for the year now stands at -8% which is almost a 2000bps difference from US equity market performance over the same time period. This was caused by a number of factors including China's trade dispute with the US, Argentina's hyperinflation situation, and the Turkish Lira plummeting. AMB believes the move in Turkey's currency was the most disturbing because it showed the vulnerabilities of other emerging countries. Emerging markets equities do look attractive from a valuation standpoint; however, with US economic growth continuing to pick up and rates trickling higher, we believe there is more downside in the future.

Interest rates around the globe have continued to tick higher as Central Bank policies move to a more hawkish stance. In the US, Federal Reserve President Jerome Powell hiked the fed funds rate again in September which takes the range to 2-2.5%. The market is also pricing in 3 more hikes for 2019. This has moved rates higher across the curve in the US and around the globe. Because of the move up in rates, fixed income markets have had a tough year. The US market, measured by the Bloomberg Barclay's US Aggregate, is down 1.6% for the year. As a whole, global debt markets, measured by the Bloomberg Barclay's Global Aggregate, are down 2.37%.

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4th Quarter 2018 Outlook

Economy (Global)

The global economy was looking strong to start the year but has slowed in recent months. US growth continues to impress with the latest GDP numbers coming in at 4.2%; however, growth overseas has slowed. China, the world's second largest economy, has started to show signs of weakness and its current trade dispute with the US is not helping matters. Japan, who started the year reporting its highest GDP number in two years seemed to slow in the third quarter. The Eurozone is still above 2% growth but has been on a downtrend over the last three quarters. Lastly, emerging markets growth has slowed due to the resurgent strength of the US dollar and rising rates. Although recent global numbers have shown some weakness, they are telling us where we have been. What is important to us and the market is where we are going.

Our outlook for the global economy for the rest of 2018 and 2019 remains optimistic for these reasons:

- The US looks to be on pace for 3% growth in 2018. At the same time fiscal policy continues to be easy which has increased corporate profits, and in our view, will increase fixed capital investments going forward. The employment rate in the US continues to fall which we believe should affect wages in a positive way in the near future. New trade agreements between the US and its allies will also be a net positive going forward.
- Even though Eurozone growth has slowed in the near term, we do expect it to pick up through the end of 2018. The ECB has laid out a plan to end its bond buying program and begin to hike rates next year; however, Mario Draghi has also mentioned that all policy tools will be on the table if things begin to turn the other way.
- Japan had a strong start to the year but has cooled in recent months. This slowdown is Mother Nature-related, and we believe growth will stabilize going into the end of 2018.
- China has slowed in recent months due to increased uncertainties, credit concerns, and trade conflicts; however, the PBOC has implemented easing measures to try and stabilize the currency and ease credit conditions which should help the economy in the near term.

Even though we remain optimistic, global economies will be facing obstacles going into the end of the year and on into 2019 such as the following:

- In the US, the federal reserve has continued to tighten financial conditions and it seems this trend will continue into 2019. The strengthening job market may turn up inflationary pressures which would cause the Fed to move even faster. The 4.2% GDP number for the 2nd quarter was very strong, but we expect a downward trend to start in the 3rd quarter.
- In Japan, adverse weather over the summer has caused the economy to slow but has been offset some by increased wages. We expect underlying Japanese growth to continue to slow into 2019. A positive was the re-election of Shinzo Abe as this will allow for continuity of the economic plan going forward. Demographics will continue to play a major role in the Japanese economy, and we do not expect this to change in the near future.
- In Europe, The ECB has a plan to end their bond buying program this year and begin to raise rates sometime next fall. This is occurring while Eurozone GDP begins to slow which could lead to increased recessionary pressures. Germany, the growth engine of the EU, is also beginning to show cracks in its armor as uncertainties rise. Last but not least, Italy has once again become a problem.
- In China, growth has slowed as the trade conflict with the US has increased uncertainties about the future. At the same time, we have started to see credit growth slow as debt levels rise. This will become a problem in the future and may lead to an economic hard landing in China.

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<u>US Equity Market</u>

The US equity market through the first 9 months of the year has been strong returning 10.57%, measured by the S&P 500. This has been driven by strong corporate earnings numbers in both the 1st and 2nd quarters. As we mentioned in the summer of 2016, we felt the trough for earnings was in and that the 2nd leg of the bull market would be earnings driven instead of Fed driven. This has been the case with companies reporting growth on the top and bottom line. We do expect continued strength in earnings as the administration continues to implement more business-friendly policies.

Going into the 4th quarter and on into 2019, our thoughts on equities remain positive. AMB believes corporate earnings will remain strong even in the face of higher comps coming into next year. Economic strength remains a bright spot and that continued strength should help drive the top and bottom line in the near future. The current administration's low regulation, low tax, and pro-growth approach should also help drive corporations going forward. The importance of lower taxes can't be overstated. The amount of money being repatriated and reinvested in the US is staggering. We believe these repatriated dollars will be a major driver for the economy going forward.

Even with the number of positives, the picture is not all rosy and there are a number of headwinds that could hurt performance going forward. Political concerns are a major issue. We expect the midterm elections in November to be a volatile time for the markets; and depending on the outcome, we could see major swings to either the up or downside. Inflation expectations are currently on the rise which will increase the cost of company inputs. Only so much can be passed on to the consumer before margins begin to squeeze. Wage growth expectations have increased and could also damper margins. Geopolitical concerns will continue especially on the trade front. These concerns will increase uncertainties and could cause markets to pause. Increasing interest rates are also becoming a worry. However, we still believe that as long as rates are increasing for the right reasons, it will not hamper equity performance.

All in all, we believe the current positives outweigh the negatives. AMB believes the stock market should continue to move higher through the end of the year and on into 2019. Our thoughts of a rotation from growth to value is still intact and we will be adjusting portfolios to reflect this. The positive economic backdrop and continued top and bottom line strength of corporate revenues and earnings should be enough to keep this bull market going. Our end of year theme is for markets to move higher, but with increased volatility and as we mentioned, our bull market projection remains intact.

<u>US Fixed Income Market</u>

Interest rates have started to move higher across the curve in recent weeks. We believe this is due to a culmination of factors including increased US growth projections, increased inflation expectations, the Fed's hawkish stance and dollar strength. The biggest in our view being dollar strength. Emerging markets (EM) that have debt denominated in US dollars have been under siege as the dollar marches higher. EM's are having to sell treasuries to pay interest and help stop the bleeding of their currency by buying it on the open market. This can easily be seen in China, as the PBOC continues to try and stabilize its currency with the outright buying of the Yuan and selling of US Treasuries. We project the selling in treasuries will abate and intermediate to longer dated securities will move lower. .

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<u>US Fixed Income Continued</u>

We believe the curve will resume its flattening pattern in the 4th quarter and on into 2019. We continue to believe the intermediate to longer end will stay subdued as the front end moves higher. Listed below are a few reasons why we believe this.

- Wage growth has shown signs of life this year, but we have still not seen a trend for higher wages develop.

  Consumer spending is the growth engine of the US, and without rising wages, we do not believe inflation will take hold

- Rates in the US remain at premiums to other developed nations.

  Even though we have seen foreign investors step away from treasuries recently, we believe their appetite for our higher yielding debt will return

- Increasing amount of debt could strangle growth.

  Corporate and government debt in the US continues to increase. As this happens, future growth potential diminishes. This could drive growth and inflation expectations lower leading to lower rates

- US dollar continuing to strengthen.

  A strong dollar hurts corporate earnings growth and will also dampen inflation as import prices decline. If inflation expectations start to diminish rates will follow

- FOMC remaining hawkish

  Continued rate hikes may begin to hamper growth as borrowing slows

Even in the face of rising rates Investors should remember why we invest in fixed income. It is not the growth engine of portfolios. It brings stability and predictability. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

<u>Conclusion</u>

Volatility has continued in both equity and fixed income markets and we expect this to continue throughout 2018 and into 2019. Even with the geopolitical turmoil, the markets fared well in the 3rd quarter returning 7.71%. The trend of growth companies outperforming value has continued, but we expect this to change in the 4th quarter. Our overall view on the equity market remains positive, but we do believe political uncertainty will cause increased volatility. Fixed income markets have struggled in the first half of the year, and the continued flattening pattern is worrisome when extrapolating to future expectations. However, credit markets have held together which is a positive sign on the overall economy. As always, we appreciate the opportunity to help you achieve your financial goals.

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