October 2018

Market and Economic Outlook

Economic Indicators Look Bright, But Risks Lurk in the Shadows

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In the third quarter of 2018 we witnessed a continuation of familiar themes, including rising U.S. stock prices, falling prices (and rising yields) of U.S. Treasury securities, and global trade tensions. We also observed that the "synchronized global growth" of 2017 has come to a crashing halt, as overseas markets — especially emerging markets — saw significant economic turmoil and volatility.

Positives	Negatives
Employment is strong	Future returns (for the next seven to 10 years) from stocks and bonds are expected to be lower than long-term historical averages
Housing market is firm	Escalating global trade tensions, which could derail economic growth and possibly lead to a trade war
Risk of a U.S. recession appears low, near term	Uncertainty on the effects of global central banks removing monetary stimulus measures
Consumer and small business confidence remains high	Very mature bull market with high valuations creating a "head wind" for the markets
U.S. corporate earnings are firm and expected to increase with tax reform	Increasing gas prices and other signs of emerging inflation

U.S. economic conditions are looking bright

At a September press conference following the most recent Federal Reserve rate hike (more on that later), Federal Reserve Chairman Jerome Powell stated that the U.S. economy is experiencing a "particularly bright moment." It would be hard to disagree with that assertion. You do not need to look through rose-colored glasses to see the brightness:

- **Jobs** — We've seen 95 consecutive months of jobs growth (October 2010 to August 2018), by far the longest such streak in history. The headline unemployment rate is a minuscule 3.9 percent (U.S. Bureau of Labor Statistics), the lowest rate since the 1960s.
- **Wage growth** — Average hourly earnings rose by more than forecast in August, up 2.9 percent from a year earlier. This is the highest reading since the recession ended in 2009. (Bloomberg)
- **Consumer confidence** — At its highest level since 1999. (Conference Board)
- **CEO confidence** — In August, Business Roundtable's survey of CEOs remained near a recent peak-level reading.
- **Manufacturing** — The Richmond Fed's regional manufacturing index recently hit the highest level on record.

The fiscal stimulus provided by the current administration has likely had an impact on the strong sentiment readings. Tax reform lowered taxes for both corporations and individuals, creating the potential to spur spending and investment. One such tax incentive aims to activity steer long-term investments into economically distressed Opportunity Zones.

So what could there possibly be to worry about at such a bright moment? One risk that we've mentioned in previous issues of *Market and Economic Outlook* remains, i.e., a full-blown trade war. The U.S.-China trade dispute appears to be escalating. This creates uncertainty and has the potential to significantly derail United States and global economic growth and create turmoil in international capital markets.

Another point to consider is that many of the positive metrics are what economists would call *current indicators* — as distinct from *leading indicators*. Consumer confidence for example, is highly correlated with current economic conditions and tends to peak before recessions (Federal Reserve Bank of St. Louis). In other words, much of the positivity may already be "priced into" the market.

Technology stocks keep surging as Amazon tops $1 trillion

U.S. stocks posted strong returns in the third quarter. Large company shares rose 8 percent and are now up double-digits for the year (+11 percent). The S&P 500 appears headed for the 10th consecutive year of positive returns — an astonishing run. Small company shares also continue to do well in 2018, as the Russell 2000 posted a positive return for the quarter and is up 12 percent year-to-date.

Meanwhile, both non-U.S. developed markets and emerging markets stocks are negative year-to-date. Emerging markets suffered an especially volatile third quarter, with crises occurring in some peripheral emerging markets (e.g., Turkey) and major emerging markets seeing losses. China's sinking market is having the largest impact on this asset class. The Shanghai Composite Stock Index reached a four-year low in September (Bloomberg). Meanwhile, U.S. investment-grade bonds, as gauged by the Bloomberg Barclays U.S. Aggregate Bond Index, eked out a small positive return for the third quarter, but is down 1.8 percent for the year.

Total Returns (%) as of September 30, 2018

Index Name	Capital Market Segment	3nd Quarter 2018	Year-to-Date 2018	2017
Bloomberg Barclays U.S. Aggregate	U.S. Broad Market Bonds	0.0	-1.6	3.5
S&P 500	U.S. Large Cap	7.7	10.6	21.8
Russell 2000	U.S. Small Cap	3.6	11.5	14.7
MSCI EAFE	Non-U.S. Developed Markets	1.4	-1.4	25.0
MSCI EM	Emerging Markets	-1.1	-7.7	37.3
Hypothetical 60/40 Portfolio*	Diversified Mix of Indexes	2.9	2.9	15.3

* 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM

An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

Source: Morningstar

Amid a fairly volatile third quarter for U.S. stocks, there were several notable events at the individual company level. Shares of Facebook, one of the bellwether technology names, fell by nearly 25 percent in a single day (July 25, 2018) after the release of a disappointing quarterly earnings report. This equated to Facebook's market capitalization falling by $120 billion, the largest single-day loss in one stock in history (Wall Street Journal). On that same day, another important tech name, Amazon, also lost 8 percent. Some market-watchers were then asking:

Is this the beginning of the end for FAANG (Facebook, Amazon, Apple, Netflix, Google) and the market leadership of tech stocks?

That turned out not to be the case. Although Facebook posted a negative return for the third quarter, the broader technology sector gained more than 9 percent and is up 20 percent year-to-date (Dow Jones U.S. Technology Index, Morningstar). Meanwhile, Amazon continued to surge during the third quarter and is up more than 70 percent in 2018 (Bloomberg). The Seattle-based cloud computing and e-commerce juggernaut also reached an impressive milestone, becoming the first $1 trillion dollar company. Having grown from a $1 billion dollar company to a $500 billion dollar company between 1997 and 2007, Amazon required only about one year to grow from $500 billion to $1 trillion.

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Amazon's Market Cap Milestones

September 2018	$1 trillion
October 2017	$500 billion
June 2012	$100 billion
October 2009	$50 billion
November 1998	$10 billion
September 1997	$1 billion

Source: Bloomberg

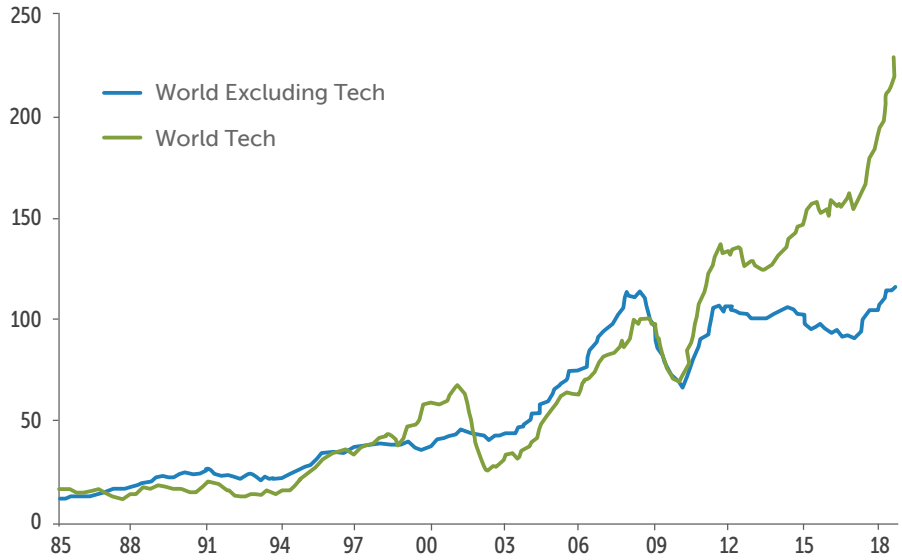
While tech shares continue to have an outsized impact on the broad market (see Share of S&P 500's Year-to-Date Driven by Each Stock), tech leadership is not just a U.S. phenomenon. One way to demonstrate this is to show how corporate earnings — excluding tech companies — are at roughly pre-financial crisis levels (see World Reported Earnings).

Share of S&P 500's Year-to-Date Driven by Each Stock

Source: Wall Street Journal, September 25, 2018

World Reported Earnings (Last 12 Months)

1/1/2009 = 100



Sources: Worldscope, Datastream, Goldman Sachs Global Investment Research

Growth stocks are beating value stocks

The extent to which technology shares have led the market has also had an impact on the relative returns of growth and value stocks. But first, let's quickly define growth and value. Growth stocks are a subset of the equity universe comprised of companies that generate substantial positive cash flow and whose revenues and earnings are expected to increase at a faster rate than the average company within the same industry. Value stocks are a subset of companies that, based on various valuation metrics, such as price-to-earnings or price-to-book value ratios, have a lower relative price. A key large company growth index is the Russell 1000 Growth Index, which is more than 36 percent tech stocks, while the Russell 1000 Value Index is less than 10 percent tech. This is certainly one reason why growth stocks have soundly beaten value over the recent cycles.

Total Return Percent (as of August 31, 2018)				
Name	2018 YTD	Trailing 12-month	Trailing 5-year	Trailing 10-year (annualized)
Russell 1000 Growth Total Return	16.44	27.23	17.47	12.84
Russell 1000 Value Total Return	3.71	12.47	11.22	8.93

Source: Morningstar

Growth versus value performance is not merely a theoretical matter. Indeed, it is important for investment strategies that seek to systematically overweight value stocks. Those strategies have lagged the broad market indices due to value's underperformance relative to growth.

Let's pause here to note that the reason for constructing portfolios with an overweight to value is that, on average and over time, value has provided higher returns. The figure below graphs the rolling 10-year returns of value versus growth. The current cycle is the worst value bear market in modern market history. No one can predict when this tide will turn, but we believe value will, at some point, once again lead growth.

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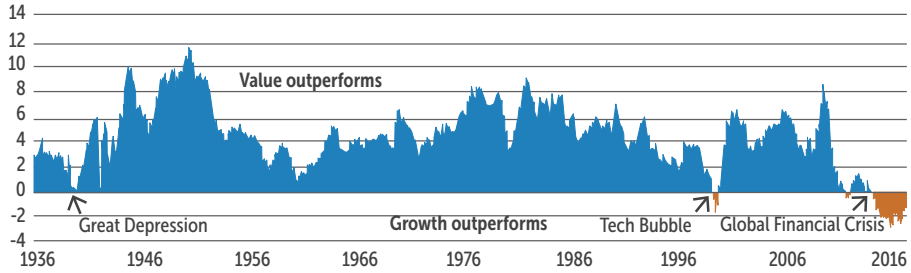
Rolling 10-Year Annualized Return of Fama-French Value Factor (%)



Based on monthly returns of the U.S. Fama/French HML (High Minus Low) Factor. HML is the return on the "high" portfolio minus the return on the "low" portfolio, where book-to-market is used as the value metric.

Source: Kenneth French's Data Library and Schroders. Data from July 31, 1926 to December 29, 2017.

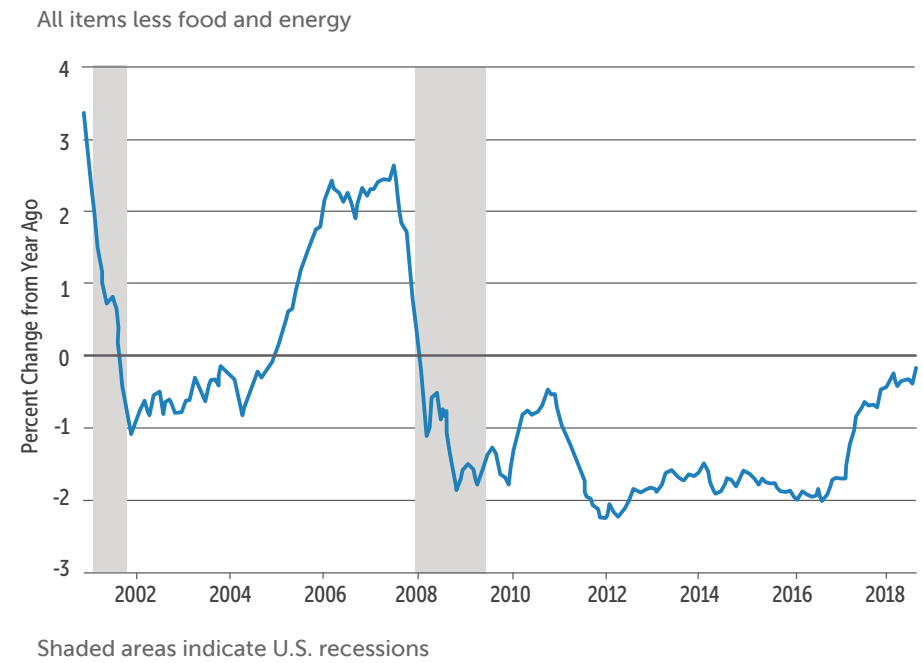
Bonds deliver rising yields and a flattening curve

In late September, the open market committee of the Federal Reserve (the Fed) hiked rates for the third time this year. This was widely expected. The Fed also indicated there will be one more increase before year-end. With this gradual rate increase regime as a backdrop, yields of shorter-term U.S. Treasury obligations continue to soar. The three-month U.S. Treasury Bill, a proxy in the investment world for cash, now yields nearly 2.2 percent. From a very long-term perspective, 2 percent-plus T-bills may not seem noteworthy, but after many years of post-crisis zero interest rate policy (ZIRP), these yields seem downright scintillating.

Three-Month U.S. Treasury Yield

Sources: Bloomberg, @charliebilello

Three-Month Treasury Bill: Secondary Market Rate — Consumer Price Index for All Urban Consumers



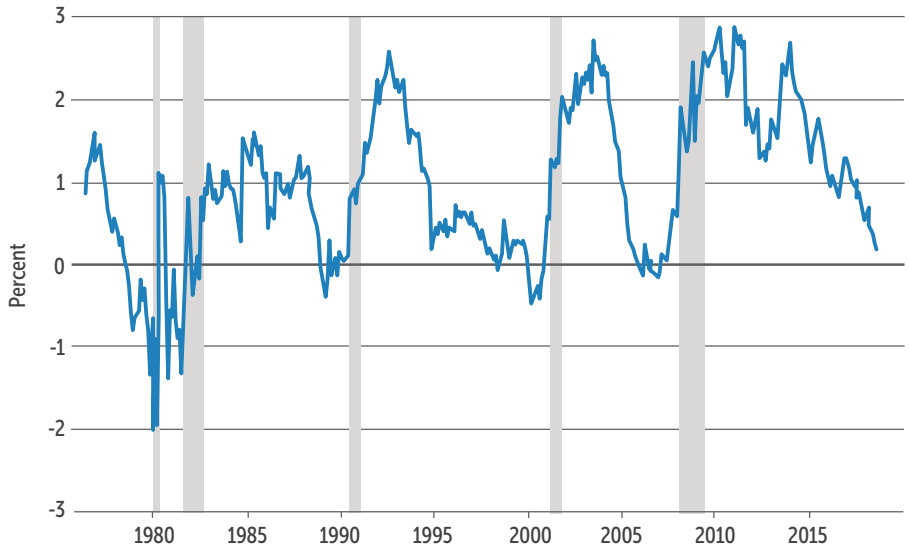
Sources: Bureau of Labor Statistics, Board of Govenors

The three-month T-bill is even on the verge of providing a positive real yield, meaning that, after subtracting the rate of inflation, the yield is above zero. Again, this would stand in sharp contrast to the post-financial-crisis era, where T-bills had a negative real yield. This development, and the fact that short-term rates are broadly higher, is very much welcomed by holders of money market and bank savings accounts.

Does flattening yield curve signal recession?

As we've touched on in recent issues of *Market and Economic Outlook*, bond market watchers have observed that the yield curve is flattening. The yield curve is a way to compare yields across maturities; the term refers to the shape of the curve on a graph when yields are plotted against the time a bond has to run until maturity. The flattening of the yield curve refers to how the spread, or difference in yields, between short-term and long-term bonds is becoming very small. Most analysts focus on the spread between the 10-year and two-year Treasury. Currently, the 10-year yields only 0.23 percent more than the two-year (St. Louis Federal Reserve).

10-Year Treasury Constant Maturity Minus Two-Year Treasury Constant Maturity



Shaded areas indicate U.S. recessions

Source: Federal Reserve Bank of St. Louis

Why does this have the attention of market analysts? Because all seven U.S. recessions since 1970 have been preceded by an inverted yield curve.

Yield Curve Inversions Before Recessions

Yield curve inversion	Recession start date	Lead time (months)
July 1969	January 1970	6
June 1973	January 1974	7
November 1978	April 1980	17
October 1980	October 1981	12
May 1989	October 1990	5
August 2000	April 2001	8
August 2006	January 2008	17

Note: The yield curve, as measured by month-end data using the spread between the 10-year and three-month U.S. Treasury yields, did not invert prior to the 1957 and 1960 recessions, although it narrowed to 6 bps and 30 bps, respectively.

Sources: Bloomberg, Vanguard

There is debate among central bankers and market analysts about whether this signal has been distorted — as have so many things in capital markets — by the extraordinary policies of the Fed (such as quantitative easing or QE). Still, we will be watching the yield curve closely. As the Fed continues to increase short-term interest rates, while longer term rates appear to be range-bound, the possibility of inversion may increase next year.

What we talk about when we talk about diversification

Diversification — the strategy of not putting all of your money in one asset type, but instead thoughtfully spreading it around — can lower an investment portfolios risk without lowering returns. When this happens we say the portfolio is more efficient, which is a good thing. The American economist and Nobel laureate, Harry Markowitz, once called diversification "the only free lunch" in investing. We share Mr. Markowitz's esteem for diversification, but we must also recognize that the free lunch can sometimes taste like a bitter pill.

Reaping the benefits of diversification requires patience. This is perhaps especially true when, as has been the case lately, large company U.S. stock indices, such as the S&P 500 and Dow Jones Industrial Average, are surging, while overseas markets stumble. Unless we get a big reversal in the fourth quarter, 2018 will be the seventh of the last nine years in which U.S. stocks (as measured by the S&P 500) will have beaten developed economy international stocks (as measured by the MSCI EAFE Index).

Total Returns (%) as of September 2018

		2018	2017	2016	2015	2014	2013	2012	2011	2010
Asset	U.S. Stocks Win-Loss	W	L	W	W	W	W	L	W	W
U.S. Large Cap	S&P 500 TR USD	10.6%	21.8%	12.0%	1.4%	13.7%	32.4%	16.0%	2.1%	15.1%
Foreign Developed	MSCI EAFE NR USD	-0.4 %	25.0%	1.0%	-0.8%	-4.9%	22.8%	17.3%	-12.1%	7.8%

Source: Zephyr

It may be natural to ask, "Why do I own anything besides U.S. stocks?" Our memories being short, we may not recall that for most of the first decade of this century, international stocks consistently beat U.S. issues.

Total Returns (%) as of September 2018

		2009	2008	2007	2006	2005	2004	2003	2002
Asset	U.S. Stocks Win-Loss	L	W	L	L	L	L	L	L
U.S. Large Cap	S&P 500 TR USD	26.5%	-37.0%	5.5%	15.8%	4.9%	10.9%	28.7%	-22.1%
Foreign Developed	MSCI EAFE NR USD	31.8%	-43.4%	11.6%	26.9%	14.0%	20.7%	39.2%	-15.7%

Source: Zephyr

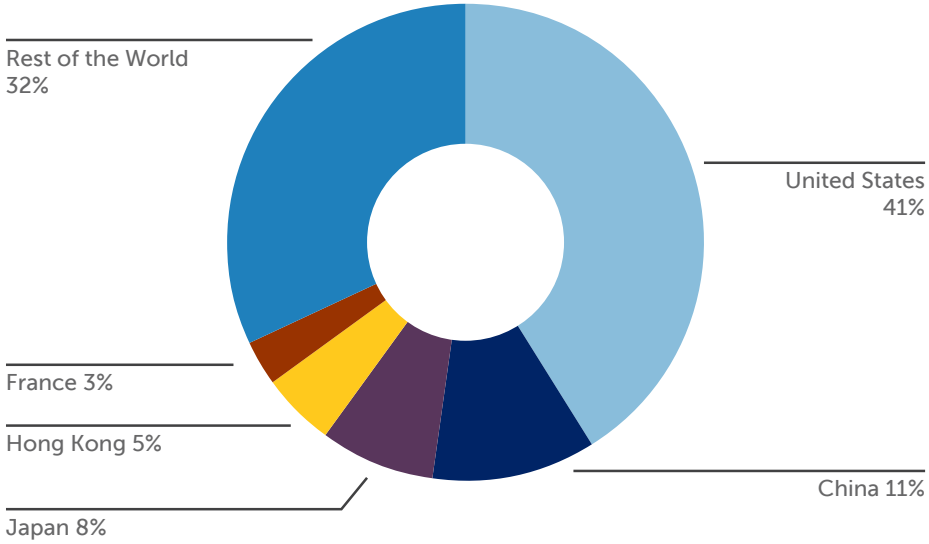
Diversification may not seem rewarding in any given year or even over a certain multi-year period, but we believe it is a prudent practice over the long term.

Let's dive a little deeper into U.S. and international equity diversification. If we agree that diversification has merit, and therefore, an equity allocation of 100 percent U.S. or 100 percent international wouldn't be appropriate, what is the right mix of U.S. to international stocks?

A good starting point for this decision might be: What is the value of U.S. publicly traded stocks as a percentage of the world's total? The answer may surprise you: U.S. stocks comprise about 41 percent of the world's total market capitalization.

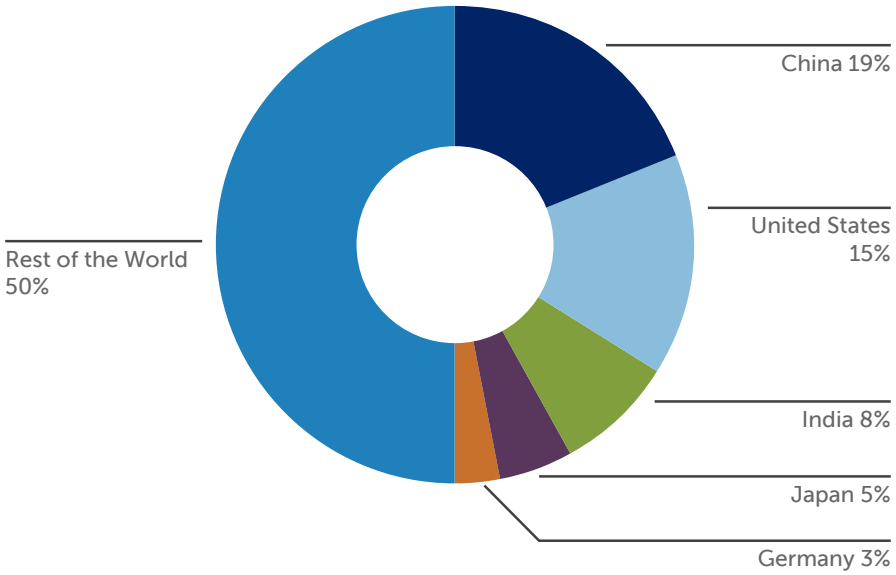
Another way to frame this question could be: What percentage of the world's economic output, as measured by Gross Domestic Product (GDP), is attributable to the U. S. economy? Again, you may find the answer to be surprisingly low.

Market Capitalization Percent of World Trade



Sources: World Outlook Economic Database, April 2018; World Bank

GDP Percentage of World Total



Sources: World Outlook Economic Database, April 2018; World Bank

There are differing methodologies for figuring world market capitalization, and some arrive at different conclusions. The MSCI All Country World Index, for example, currently breaks down as about 54 percent U.S. stocks and 46 percent international (Morningstar as of August 31, 2018).

In other words, if you were to take a passive approach to U.S. and international allocations, you might arrive at about a 50/50 split. We favor an allocation of 65/35 U.S. stocks to international stocks.

A 65/35 split does demonstrate what finance professionals may call a "home country bias" versus a passive, market-capitalization-weighted approach. We believe that the U.S. economy is likely the most innovative and robust in the world, and our target allocation acknowledges that. We do, however, want to capture the long-term benefits of having a material allocation to non-U.S. equity markets.

We would also point out that, in terms of current valuation, international and emerging market stocks are far more attractive.

Selected Stock Valuation Metrics (Lower = More Attractive Valuation)

	PB (Price/Book)	PE (Price/Earnings)	Shiller PE (CAPE)	Dividend Yield (%)
United States	3.3	21.4	31.2	1.7%
Developed Markets	2.2	18.1	25.9	3.1%*
Emerging Markets	1.7	14.4	16.4	2.6%*

*Non-U.S. stocks are cheaper and pay higher dividends

Source: Star Capital

Lower valuations and higher dividend yields imply that international and emerging markets may outperform in the years to come. This is another reason we will adhere to the discipline of global diversification.

We love the bull market, but don't get too comfortable

The first three quarters of 2018 have seen a continuation of the U.S. economic expansion and a historically long bull market in stocks. How long will this "particularly bright moment" last is anyone's guess. As always, we will work hard to monitor the markets and thoughtfully prepare our clients for an unknown future.

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