Market Review and Outlook— October 5, 2018

A Pleasant Domestic Surprise — The US stock market has pleasantly shocked most analysts this year with returns crossing 10% YTD. The general consensus of analysts and economists anticipated modest returns for both the US and foreign stocks. US stocks are up but most of the foreign stock markets are nearly flat. This not only goes to show that predicting short term market returns is a fool's errand, it also shows the importance of maintaining diversified holdings across all major markets. It is impossible to know exactly where returns will come from, so holding some of everything allows you to participate anywhere growth comes from.

A Rough Year for Emerging Markets — In the investments world, many analysts are discussing and publishing papers attempting to explain this year's drop in Emerging Markets. Aside from a cyclical backdrop, there are short term tensions driven by trade, US interest rates, and the value of the dollar all pushing people to shift dollars from Emerging Markets, making this dip a potential buying opportunity.

Chase Returns or Chase Values? — The chart at the bottom of this page shows recent and historical returns data. Tracking past returns is important, but it is equally important to look forward, and consider how expensive or inexpensive stocks are. The recent outperformance in the US has driven US prices up, and the recent underperformance in foreign markets has kept their relative prices lower. As an investor looking ahead, using recent data about the past, it's important to avoid making investment decisions by chasing past returns or else you end up buying on the highs and selling on the lows.

The Modest Story of Bonds — Broadly, bonds continue to have modest returns while the Fed continues to modestly raise rates. The bond yield curve is nearly flat, which means shorter term bonds are returning very similar rates to longer term bonds. A flat yield curve is neither good or bad alone, but it is important to recognize that it can encourage investors to move toward short term bonds, further depressing long and intermediate term bond returns.

The drop in some foreign stock markets and the slight drop across the bond market in recent months provides opportunities to rebalance your portfolio, and capture lower prices in those asset classes.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Govt Cash Reserves	0.42%	1.25%	0.57%	0.34%	0.30%
Intermediate Term Bond	0.20%	-1.06%	1.65%	2.14%	4.21%
Intermediate Muni Bond	-0.16%	-0.03%	1.81%	2.88%	3.98%
Large-Cap Stock	6.67%	15.35%	15.17%	11.93%	10.84%
Mid-Cap Stock	3.94%	11.68%	12.85%	9.78%	10.76%
Small-Cap Stock	2.79%	12.14%	14.73%	9.71%	10.67%
Foreign Large-Cap Stock	0.79%	1.55%	8.71%	4.05%	4.98%
Foreign Small/Mid Cap Stock	-1.50%	0.82%	10.89%	5.95%	8.53%
Diversified Emerging Markets	-2.47%	-3.63%	10.09%	2.54%	4.91%
Financial	1.72%	6.61%	13.49%	10.65%	8.27%
Health	10.56%	19.89%	13.35%	14.62%	14.98%
Real Estate	0.58%	3.39%	7.24%	8.56%	7.13%
Technology	5.62%	24.23%	24.64%	18.14%	15.73%
Moderate Allocation (50-70% stocks)	3.19%	6.75%	8.80%	6.67%	7.58%

The data in this table comes from Morningstar and is as of September 30, 2018

Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect, transactions in securities, or the rendering of personalized investment advice for compensation.

Driving the Portfolio — When driving a car, we have a rear view mirror that we check periodically, but we focus on what is beyond the windshield. On the first page, we noted what investment classes have done, what has been hot, and what has been cold. That is good to know, but, again, we need to focus on where we are now, and where we are going. With investing in particular, strong results from one type of investment is often followed by weak results from that same type of investment, known as 'reversion to the mean.'

US stocks, especially large-cap, and growth-oriented US stocks, have done very well over the past nine years, and, in the past seven years, they have sharply outperformed foreign stocks. In recent quarters we have boosted foreign stocks while reducing US stocks. That course of action has reduced our recent investment results. With 20-20 hindsight (thanks, rear view mirror), we know that we have been early in our expectation of superior foreign stock returns.

Arriving Early for a Sale — Over the past 20 years, foreign stocks have typically been 10% cheaper than US stocks, based on P/E levels; today they are 23% cheaper. Dividend yields for foreign stocks are 1.4% larger than for US stocks, so you are being paid an extra 1.4% to patiently stick with foreign stocks. The sharp outperformance of US versus foreign stocks since 2011 appears to us to have created a significant opportunity for superior results. Acting on such opportunities always carries the risk of 'being early,' as we have been lately. However, being early can be well rewarded, over time, when coupled with patience.

US Stocks — Despite that foreign stock cheerleading, we like US stocks. While their prices have risen steadily this year, their earnings have risen further, so we are not too concerned with overvaluation. The US economy looks to continue its long, steady expansion, at a bit of a better pace this year before slowing its growth next year. There is a lot to like in US stocks at this time.

Foreign Stocks — Here we see better potential, but disappointing results so far this year. Some of that is due to the US dollar which surprised many by reversing its trend and rising earlier this year, partially in response to the trade tensions. We expect these tensions to steadily recede, for the US dollar to rise no further, and for global investors to eventually see the greater upside and greater downside protection that foreign stocks offer, versus US stocks. We are particularly pleased with prospects in Asia.

Rising Rates Continue, for a Bit — Just as we feel that the US stock market is nearing the end of its recovery, we feel that interest rates are nearing the end of their climb. The very steady rate of increase, about 1% a year, is gradual enough to prevent any sharp losses for bond investors. We foresee beginning to unwind our strategy of short-duration coupled with substantial opportunity bonds as early as next year, as interest rates for intermediate-term bonds become more attractive, and risk of an economic slowdown continues to grow.

What are Ultra Short Term Bonds? — This year we have been using short-term CDs and ultra-short term bond funds. These funds must keep their average maturity under one year. The fund we use has an average duration of under two months. This drastically limits the risk of loss. With rising rates, we are no longer giving up much return for this level of safety. The fund we are using earned over ½% in the past quarter, easily outpacing the average quality bond fund. We plan to unwind this position as the risk of rising rates recedes.

Challenging Times — The past quarter brought a 13% range between the best and worst stock category on the table on the first page, and the past year had a swing of more than 23%. A well-balanced portfolio will never post the best results, but it will also avoid the worst results. We position portfolios to handle most scenarios, both the very likely and the much less likely, and we weight each scenario appropriately. While this produces some short-term disappointments, it is designed to provide the best, smoothest path for clients' goals.