1919 INVESTMENT COUNSEL
Complexity to Clarity

Investment Review and Outlook

October 2018

Introduction

Amidst a backdrop of an escalating trade war, rising interest rates, inflation pressures and rich valuations, global equities rose in the third quarter, primarily due to strength in US markets. The S&P 500 Index rallied 7.7% during the period, resulting in a year-to-date gain of 10.6%, supported by US economic growth and robust earnings. At the same time, while the Bloomberg Barclays US Aggregate Bond Index remained unchanged for the quarter, the benchmark 10-year US Treasury yield rose above the 3% threshold as government bond prices declined due to ongoing strong economic growth. Further contraction of the spread between 10-year and 2-year Treasuries continues to flatten the yield curve, leaving open the possibility that the yield curve inverts. This trend has received a great deal of recent attention and debate since, historically, an inversion of the yield curve has served as a warning sign of an impending recession in the 9 to 18 month time horizon.

While healthcare company stocks led all other sectors in the third quarter, stocks of both consumer discretionary and technology companies remain the leaders for the year, aided by strong consumer confidence and employment numbers as well as corporate earnings growth. On the other end, consumer staples stocks remain the laggards as their dividend focus becomes less competitive when interest rates are rising, and their relatively conservative growth rates do not warrant rich valuations. International stocks continue to lag as the impact of US dollar strength and trade disputes continues to be felt. Emerging markets fared the worst, declining another 0.9% this quarter, now down 7.4% in 2018. Meanwhile, those very same factors have benefitted domestically-focused small-cap companies, as evidenced by the 11.5% rally in the Russell 2000 Index this year.

US financial markets have taken much of the year's headline risks in stride, and equities have remained a great asset in which to be invested. However, the range of possible outcomes likely is widening as tighter monetary policy and elevated valuations remain headwinds and trade tensions remain high. The risk of recession appears low right now, but the Federal Reserve is poised to respond to economic strength and rising inflationary pressure with additional rate increases.

3rd Quarter Review

Performance Summary
Total Returns & Values for Selected Assets as of 9/30/18

	3Q 2018	YTD Return	Price / Value
Dow Jones Industrial Average	9.6%	8.8%	26,458
S&P 500 Index	7.7	10.6	2,914
Russell 2000 Index	3.6	11.5	1,697
MSCI EAFE Index	1.4	-1.0	8,055
MSCI EM (Emerging Markets)	-0.9	-7.4	2,335
Barclay's Capital US Aggregate	0.0	-1.6	99
Barclay's Capital Municipal Bond	-0.2	-0.4	106
Gold – Continuous Contract	-4.6	-8.8	$1,196
Light Crude Oil – Continuous Contract	-1.2	21.2	$73

Source: Factset

Economy

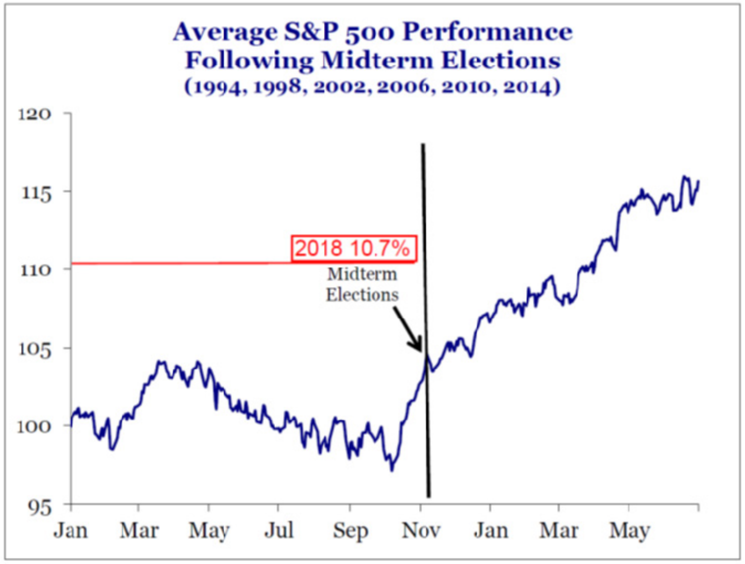
The 2017 Tax Cuts & Jobs Act continued to drive consumer and business behavior in the third quarter, underpinning a second consecutive period of above-trend GDP growth. While somewhat slower than the advance in the second quarter, a mid-3% pace is likely for the recent reporting period, well above the 2% rate many consider to be the trend. The solid showing occurred despite continued increases in interest rates by the Fed and the uncertain impact of tariffs, following an escalation of the trade dispute with China, although the latter's impact may become more pronounced in 2019. As is often the case in a consumer-driven economy, confidence arising from a healthy labor market and rising wages is the main driver of consumption trends. Unlike periods of past excess fueled by heavy borrowing, recent gains in retail sales have prevailed in a period characterized by solid household balance sheets and robust personal savings following meaningful deleveraging. Consequently, current activity seems on firmer footing and more durable. The prospects for an imminent recession seem unlikely, given that layoffs are running at the lowest levels since the late 1960s, the unemployment rate is at the lowest level since 2000, and wages rose just shy of the elusive 3% annual rate last seen prior to the financial crisis. The stimulative impact from the tax cuts reduces this likelihood as well. While limitations on the deductibility of state and local taxes (SALT) will negatively impact high-income earners in states such as New York, New Jersey, Maryland and California, in the aggregate tax cuts augment take-home pay in a rising wage environment, which is a good combination and encourages consumer confidence. Of equal importance is the tax cut's impact on the corporate sector, particularly with regard to the repatriation of overseas corporate cash to domestic shores. Admittedly, many expressed disappointment that more of the estimated $1.5 trillion of onshored cash did not fund more meaningful capital investment or even sturdier wage growth, instead flowing to equity holders in the form of stock buybacks and M&A activity. While true that equity holders were early beneficiaries, we believe capital expenditures will increasingly add to growth, as evidenced by the sharp increase in capital goods shipments during the period.

Our concerns remain the same as we last communicated. The trade war is an unknown danger, but there seems to be enough momentum, domestically, to overcome it for now. Inventory accumulation picked up in the third quarter (and will be additive to GDP growth) perhaps because companies want to make sure supplies are available to meet the prevailing demand should supply chains become interrupted by trade disputes. More important is the Fed and the level of interest rates across the yield curve. The most tangible evidence of the headwinds created by higher interest rates is the persistent weakness within the housing market. Mortgage rates reached a seven-year high at quarter-end as they marched towards 5%, and housing has been the lone disappointment within the economy despite improving trends in household formation, which typically drive activity. Meanwhile, the Fed raised short-term interest rates again in late September, and long-term bond yields seem to be moving higher as wage growth is picking up while overall inflation finally resides near the Fed's target.

As the government funds the tax cuts with heavier borrowing in coming quarters, interest rates could rise further, crowding out corporate and individual access to reasonably-priced credit and slowing the economy. We expect such a scenario is likely, although we have confidence that the Fed will downshift their already-measured pace of tightening and not choke the recovery after nearly a decade of sub-par growth following the Great Recession. Therefore, we do not see a recession this year or next, but feel the current pace of growth is unsustainable and inflated by the near-term benefits of the tax cuts. As a result, we expect the economy to downshift to a more trend-like 2% pace of growth by this time next year.

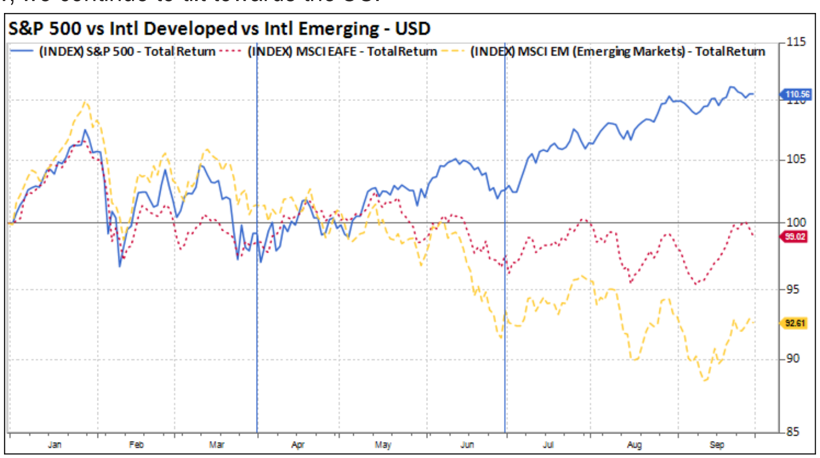
Equities

Buoyed by healthy US economic data, tax cuts and increased confidence, investors drove US stocks to record levels in the quarter while shrugging off trade battle salvos, emerging market turmoil and political drama. US large cap stocks led the way with a 7.7% return, which brings the 2018 return to a robust 10.6%, defying conventional wisdom and historical data that indicate returns for the first 9 months of a mid-term election year usually are quite weak but rally into year-end once the voting is complete. The S&P 500 has not declined in the 20 months following a midterm election since 1946 as presidents generally shift the focus to their own reelection and embrace policies that support that outcome.



Source: Strategas Research Partners

US markets continued to lead globally as concerns of slower global growth and a stronger US dollar impacted valuations in other parts of the world, especially in emerging markets. Developed international markets returned 1.4%, while trade concerns and dollar strength generated greater headwinds for emerging markets, which lost 0.9%. For the year, US stocks have dominated developed and emerging markets by 12% and 18% respectively. This deviation can persist for some time as the follow-on effects of fiscal stimulus flow through the US economy, but a reconciliation of return and valuation will eventually favor international markets. For now, we continue to tilt towards the US.



Source: Factset, 1919 Investment Counsel

Corporate tax cuts have provided a substantial lift to 2018 after-tax earnings-per-share (EPS) growth as recorded in the table below. Measures that capture pre-tax growth such as revenues, EBITDA, and EBIT, depict profit growth that is healthy but not heroic as compared with the lofty post-tax 21% increase in EPS. As the tax cut impact rolls off, companies are expected to report a slower rate of growth for both revenues and profits. A reasonable and bullish case argues that the corporate tax cuts will lead to a positive second-order effect from increased capital spending that can drive growth and productivity. If this were to occur, growth will exceed some of the more conservative forecasts. However, an important race is underway as tighter monetary policy acts as a headwind to future growth.

S&P 500 Post-Tax Earnings Rates of Growth vs. Pre-Tax Growth – Highlights Impact of Tax Cuts

	2017	EST 2018	EST 2019	EST 2020
Revenues	6.2%	8.3%	5.0%	4.5%
EBITDA	8.9%	10.4%	7.8%	7.0%
EBIT	9.9%	13.1%	8.9%	7.3%
EPS	11.9%	21.1%	10.1%	9.7%

Consensus estimates from FactSet
EBITDA – Earnings before interest, taxes, depreciation & amortization
EBIT – Earnings before interest & taxes

US market valuations remain above-average across many metrics. Of those listed in the chart below, the price-to-earnings ratio is the only measure that is not well above its long-term average, declining materially due to the lift in earnings from corporate tax cuts. Other pre-tax valuation measures, such as price-to-sales, are well above their 20-year average; in some cases they are close to the lofty levels reached at the end of the technology bubble in March of 2000. The values listed from March of 2009 serve as a reminder of conditions that prevailed at the market bottom during the financial crisis. While valuation measures are not helpful indicators of short-term market direction, the long-term averages offer some sense of where valuations may revert to once investors become less enthusiastic about the future. As the Fed continues to normalize rates and tighten monetary policy to ward off a spike in inflation, we expect aggregate demand will eventually respond to tighter conditions, and corporate profit growth will slow. Additionally, higher interest rates and labor costs should reduce margins. As this slowdown and profitability decline occurs, investors likely will reduce the price multiple assigned to both pre- and after-tax earnings and cash flows.

	MARCH 2000	MARCH 2009	9/30/2018	20 YR AVERAGE
Price / Sales - LTM	2.2x	0.7x	2.2x	1.6x
Median P/S - LTM	1.7	0.8	2.6	1.8
Price to EPS NTM	23.8	11.0	16.8	15.9
Pre-tax margin	11.2%	5.4%	12.4%	10.7%
Net margin	7.8	5.8	10.5	8.3

Source: Factset, 1919 Investment Counsel

We continue to believe strong corporate cash flows, associated share repurchases, and dividend increases will support equity markets. The near-term stimulative effects of tax reform have come to pass, and there is reason to believe a second-order positive effect will ensue from increased spending on capital expenditures and R&D, which will result in an increase in productivity. However, as the business and market cycles mature and interest rates continue to rise, we expect valuation pressures will increase, and investors will be more discriminating and demanding with their capital allocation. This increased scrutiny will limit market advances and eventually lead to below-average equity returns and increased volatility. However, companies that are able to deliver growth while maintaining healthy margins and balance sheets will garner attention and capital. We will continue to seek out these businesses for inclusion in our clients' portfolios.

Economic and Market Drivers

Tailwinds	Headwinds
Strong Corporate Cash Flows	Fed Policy – Rising Rates and Balance Sheet Runoff
Fiscal Stimulus Package	Protectionist Trade Policies & Supply Chain Disruption
Animal Spirits rising - Business Optimism	Tight US Labor Market & Rising Labor Costs
Improving Real Household Income	Midterm Election Uncertainty
Acceptable Inflation	Aging Demographics in Developed Markets
Low (but rising) Interest Rates	China Slowdown / Deleveraging
Household Formation Increasing	Political Pressure to Regulate Tech

Note: At the end of the quarter, S&P and MSCI restructured the groupings of the S&P 500 index companies as announced earlier in the year. No new companies were added or deleted as part of this process, and the respective index weights of each member did not change. The Telecom Services sector was renamed Communication Services, and its membership was broadened to include some companies previously categorized in Consumer Discretionary and Information Technology. Approximately, 10% of the index weight was included in the regrouping, and several very large companies were involved including Google, Facebook, eBay, Netflix, CBS, and Disney.

Bonds

The Bloomberg Barclays Aggregate Index posted a meager, but positive, return of 0.02% in the third quarter. Despite a significant rise in Treasury rates, investors were persuaded to take on more risk as trade tensions fell, supply waned, and earnings and domestic economic data continued to come in strong. While flattening a touch, the Treasury yield curve largely underwent an upward parallel shift by 20+ basis points, buoyed by a strong labor market and higher wages. Remarkably, Treasuries fell only 0.6% for the quarter, while investment-grade corporates gained 1.0%, with long BBB-rated corporates generating the highest returns.

This time around, the positive showing by corporates more than offset the weaker results from Treasuries. Going forward, the expected increase in Treasury supply to fund the budget deficit is expected to outpace the net supply of corporate debt and become a larger and more influential component of the bond market. Given this expected change, we have been increasing our allocation to Treasuries where we have been underweight for some time. Given the flatness of the curve, most of our buying has been in 0-5 years, or, for longer duration mandates, the 7-12 year area.

While the corporate sector has long benefited from both fundamental and technical factors, the latter may not be as helpful through the remainder of the year. Even though year-to-date supply has been lower than 2017 levels, it remains high with some large deals yet to be announced in the last few months of 2018. With increased issuance from the Treasury, competition for cash will be greater than it has been in the past. Flows into ETFs and mutual funds also have decelerated, which negatively impacts the demand side of the equation. As credit spreads are below the long-term median, we will continue to look for opportunities to decrease our overweight to corporates. That being said, we are comfortable with the solid fundamentals of the issuers owned in our portfolios and still believe a 2% economy is supportive of credit.

Municipal Bonds

Following the path set by Treasuries, yields in the municipal market continued to ascend over the third quarter. While we remain supportive of higher interest rates to augment tax-free income for high net-worth individuals, this benefit has come at the expense of a negative total return this quarter and year-to-date as well. The Bloomberg Barclays Municipal Bond Index, a proxy for the entire municipal market, posted a loss of 0.2% for the period, bringing the calendar year return to a loss of 0.4%. In the tax-free market, the increase in rates has been orderly and, while returns are negative, remains manageable on an absolute basis. 10-year AAA municipal bonds ended the quarter yielding 2.6%, equating to 4.8% on a taxable-equivalent basis (when accounting for the highest Federal tax bracket of 37.0%, an average state tax rate of 5.0% and the Affordable Care Act surtax on investment income of 3.8%). Similar to the taxable market, net inflows into municipal mutual funds began to slow over the quarter until the final week when redemptions outpaced purchases. Retail investors have not fled the market as of yet, but consistent outflows could result in higher interest rates as bond funds sell to meet redemptions.

Despite increased spending needs across the country, municipal issuance continues to lag both the pace of last year as well as investor needs. Through September, supply is down 14.9% versus the same period in 2017. Issuance is expected to pick up in the final months of the year even though a large federal infrastructure-spending program is unlikely to come to fruition. The lack of supply has been met with an influx of demand. As noted previously, limiting the deductibility of SALT has distorted the municipal market, most notably in high-tax states, lowering yields on bonds in these states relative to the national level. While the true implications of tax reform cannot be quantified until tax season, reducing the SALT deduction to $10,000 has renewed demand for tax-free municipals as investors attempt to salvage after-tax income.

In addition to tax reform, the flatness of the yield curve and a possible inversion continue to garner attention. However, the municipal yield curve is slightly steeper than the Treasury curve as municipal bonds compensate for tax uncertainty with higher yields on longer maturities. Given this additional yield pick-up, along with tax-free cash equivalents such as Variable Rate Demand Notes (VRDNs) earning over 1.50% at the close of the quarter, we see value across the maturity spectrum. We continue to have ample liquidity, via cash equivalents and upcoming maturities, should interest rates continue to march higher as expected, and remain conservative with regards to duration.

Conclusion

As we have mentioned in the past, the low interest rate environment over the past few years has helped mute stock market volatility. As interest rates rise, we anticipate a return to more normalized volatility with stock market corrections happening more frequently. In this environment, it is important to remain focused on a long-term investment plan and not overreact to short-term market volatility. Despite uncertainty surrounding the midterm elections and the trade war with China, US economic fundamentals remain solid. We believe this will drive corporate profits and stock prices higher over time.