



# FULLEN FINANCIAL GROUP

## Quarterly Market Summary – Q3 2018

### Market Results as of the Third Quarter of 2018

#### Selected Index Results for Q3 – 2018

<u>Index<sup>(1)</sup></u>	<u>%Growth For FY 2017</u>	<u>%Growth For YTD2018</u>	<u>%Growth For Q3 2018</u>
DJIA	25.08%	7.04%	9.01%
Leman Aggregate Bond Index (U.S. multi-sector bond)	1.18%	-3.48%	-0.75%
S&P 500 (large cap)	19.42%	8.99%	7.20%
S&P 400 (mid cap)	14.45%	6.26%	3.48%
Russell 2000 (small cap)	13.14%	10.49%	3.26%
MSCI EAFE Index (developed international)	21.79%	-3.30%	1.52%
iShares MSCI Emerging Market Index	34.59%	-8.91%	-0.95%
iShares Dow Jones US Home Construction	59.10%	-19.17%	-7.37%
MSCI US REIT Index	0.11%	-0.83%	0.01%
Amex Oil Index	5.33%	16.49%	2.63%
Barclays Global Agg ex-US Corp Bond Index	14.44%	-4.95%	-0.68%

(1) These results do not include reinvestment of dividends.

### Q3 Quick Summary

- U.S. equity markets continued to outperform foreign markets due to more favorable financial conditions in the U.S., despite more tightening from the Federal Reserve. Advanced economies outside the U.S. recognized tightening financial conditions, as did emerging markets.
- During Q3, U.S. bond markets operated within an established, narrow range; leaving the Bloomberg Barclays U.S. Aggregate flat for the period. Long-term Treasury yields rose modestly while corporate spreads tightened, and prices rose.
- Coming off a robust start to the year, the global economy continued its modest fade through Q3. Deterioration was most prevalent in emerging economies, while the U.S. remained as the key ballast globally.
- The U.S. Federal Reserve raised its benchmark rate once in Q3; pushing the upper bound to 2.25%. The European Central Bank reaffirmed its intentions to end bond purchases by January 1, 2019, but to maintain its benchmark rate through the summer of 2019. Emerging market central banks, meanwhile, struggled to bolster weak currencies.
- Stock prices remain at elevated levels, even after the pullback we saw in the month of October. Although the U.S. economy continues to perform well, we believe further declines in equity valuations are a distinct possibility.



### U.S. Equity Market Leadership...Again

Bullish economic data in the U.S., and Federal Reserve policy, reaffirmed a favorable foundation for equities. The S&P 500 Index (up 7.2% in Q3) and the Bloomberg Barclays U.S. High Yield Index (up 2.4%) highlighted the period. Again, the U.S. performance contrasted with modest gains in other developed markets (MSCI EAFE Index up 1.52%) and troubled conditions in the emerging world (MSCI Emerging Markets Index down 0.95%). Material economic and equity weakness in Turkey helped drive the EM stumble for another quarter, while China equity markets also suffered. Elsewhere, lingering risk of unsettling political leadership in Italy, waning economic numbers, and Brexit missteps prompted investors to forgo some exposure to the non-U.S. developed world. Japan’s equity market was one of the lone EAFE bright spots.

### S&P 500 Index Sector Returns – Q3 2018

Source: Bloomberg

Sector	Cyclical or Defensive	Total Return	Sector	Cyclical or Defensive	Total Return
Consumer Discr.	Cyclical	8.2%	Info Tech	Cyclical	8.8%
Consumer Staples	Defensive	7.5%	Materials	Cyclical	0.4%
Energy	Cyclical	0.6%	Real Estate	Cyclical	0.9%
Financials	Cyclical	4.4%	Telecom	Defensive	9.9%
Health Care	Defensive	14.5%	Utilities	Defensive	2.4%
Industrials	Cyclical	10.0%			

The U.S. Health Care sector (+14.5%) led all major S&P 500 Index groups; followed by a 10% gain for Industrials. Both groups have benefitted from stronger fundamentals of late and gains have also been helped by some rotation out of other sectors. The newly-minted Communication Services sector rose 9.9% and Technology again had a strong quarter (+8.8%). Consumer Discretionary also did well as retailers continued to advance.

Prominent to the downside, Materials stocks came under some relative pressure (+0.4%); as did the Energy sector. Despite oil prices that continued to rise, Energy stocks likely lost ground due to some profit-taking that followed robust Q2 returns. The Real Estate group rose a modest 0.9% for the period as higher market interest rates weighed on the space.

### Emerging Market Concerns Remained Front-and-Center

Emerging market risks remained elevated in Q3 as currency weakness strained the financial flexibility of some economies. A stronger U.S. dollar, fiscal conditions in Turkey, trade tensions, and concern over a China slowdown contributed to a laundry list of issues that prompted investment outflows from emerging markets. These issues led to considerable weakness in emerging market currencies and a widening of sovereign debt spreads for bonds denominated in U.S. dollars and those in a local currency. While the



spread widening was notable and indicated risk aversion, emerging market bond conditions have yet to reach other post-crisis periods of weakness.

Broader macro risk levels, however, point to concerns that rival those found during the financial crisis. The current contrast with what many believed were favorable emerging markets conditions just ten months ago has left many market participants flat-footed. In our view, the stronger dollar exposed notable risks in the U.S. dollar (USD)-denominated debt market which has sparked some early emerging market contagion concerns. Emerging market bond issues denominated in USD have reached record levels. This leaves sovereign and corporate debt issuers vulnerable to a rising dollar and resulting weakness in local currency; making it more difficult to pay back debt upon maturity. To combat weak currencies, many emerging central banks have had to raise interest rates, effectively causing economic pressures. This dynamic can lead to an additional confidence erosion and thus spawn the contagion concerns. Notably, elevated risk levels and capital outflows in the developing world have already helped lead to an 8.9% drawdown in the MSCI Emerging Markets Index year-to-date.

**Have Advanced Economies Peaked?**

Across developed economies, ex the U.S., economic momentum continued to wane in Q3, and expansion across the developed world became less synchronized. High-frequency data indicated that Q3 economic activity in the Eurozone, the United Kingdom, and Japan slowed from Q1 and Q2 levels. Indeed, these regions may have peaked economically in Q4 2017. Manufacturing and Services Composite readings seem to point to just that.

**IMF 2018 and 2019 GDP Forecasts for Key Countries/Regions (Year over Year %)**

Country	Forecast		Diff. from Prior	
	2018	2019	2018	2019
U.S.	2.9%	2.5%	0.0	-0.2
Eurozone	2.0%	1.9%	-0.4	-0.1
U.K.	1.4%	1.5%	-0.2	0.0
Japan	1.1%	0.9%	-0.1	0.0
China	6.6%	6.2%	0.0	-0.2
India	7.3%	7.4%	-0.1	-0.4
Brazil	1.4%	2.4%	-0.9	-0.1

Source: International Monetary Fund

“Prior” refers to IMF GDP forecasts published in April 2018.

Meanwhile, slower export growth, driven in part by tariff uncertainty, and higher oil prices, were key variables in the slower pace of economic growth in the developed world. Auto tariff worries were notable for key exporters such as Germany and Japan. Political uncertainty in Italy and the United Kingdom likely contributed to more cautious activity as well. The weakening momentum was evident in less-than-expected Q2 GDP readings, and the slower pace induced economists to lower their forecasts in the out quarters. Without the fiscal (tax) boost, similar to that found in the U.S., it seems other developed regions may have run out of economic steam more quickly. In its most recent World Economic Outlook, the



International Monetary Fund reduced many 2018 and 2019 GDP outlooks for the developed and emerging world, including those for the Eurozone, Japan, and the United Kingdom.

While U.S. manufacturing and services activity has eased just a bit from their summertime crescendos, U.S. Industrial Production, on a year-over-year percentage basis, is at highs last reached in December 2010. Meanwhile, NFIB Small Business Optimism remains at record levels for a data series that dates back to the 1970s.

Elsewhere, U.S. jobs numbers and consumer sentiment continued to improve in Q3. Highlighting the consumer strength, U.S. Retail Sales ex Autos grew 7.7% year-over-year in July, and followed that with 7.3% August growth. Such data has not been that robust since 2011. At approximately 70% of the U.S. economy, the recent strength expressed by the consumer has helped set the U.S. apart from its global counterparts in terms of economic momentum. Through Q3, it seems the tailwind of U.S. fiscal policy continued to provide the difference. Unfortunately, U.S. fiscal policy is being financed by rising U.S. deficits.

### **Global Treasury Bonds Lose Ground; U.S. Credit Gains**

Sovereign debt yields rose across global bond markets in Q3, as the Bloomberg Barclays Global Aggregate Bond Index fell 0.9%. Buoyed by U.S. Credit, the Bloomberg Barclays U.S. Aggregate Bond Index was flat for the period. However, the U.S. Treasury component of the U.S. Aggregate Index finished 0.6% lower. The specter of the European Central Bank rolling back its bond purchases contributed to the rise in Eurozone yields, although inflation in the Eurozone remained well-contained. Brexit uncertainty and concerns over the fiscal policy direction of Italy also added to the bond sell-off in the Eurozone and the U.K. Japan government bond yields also moved higher in Q3 as the Bank of Japan (BoJ) unexpectedly trimmed purchases of JGBs due beyond 25 years. Despite the slight policy shift, the BoJ continued its dovish commentary. Inflation in Japan, remains stubbornly low (less than 1%); indicating that rates may be capped by structural issues that are unlikely to be overcome in the near-term.

In the U.S., markets interest rates rose through much of the third quarter, prompted by Fed policy and upticks in inflation. CPI ex Food and Energy rose to 2.35% in July; the highest level since 2008; before sliding back to 2.16% in September. The Federal Reserve marched along on its path to increase its policy rate, moving the Fed funds target upper bound to 2.25% in late September. The Fed funds rate began the year at 1.50%. Fed policy and some inflation pressure contributed to a 20 basis point rise in the 10-year Treasury yield in Q3; leaving the benchmark rate at 3.06% to end the period.

While global Treasury rates moved higher and pressured prices, U.S. credit was the bond sweet spot in Q3. The Bloomberg Barclays U.S. Investment Grade Corporate and the Bloomberg Barclays U.S. High Yield Corporate indices returned 1.0% and 2.4%, respectively. Favorable economic and corporate conditions in the U.S. led to a narrowing of credit spreads relative to corresponding U.S. Treasuries. Both spread series moved back toward their cyclical lows, indicating investors remained decidedly comfortable taking material U.S. credit risk.



## **Outlook - Risk Management is Job One**

Global equity market conditions presented some challenges in Q3 and early Q4. Persistent headwinds in emerging markets and slowing economies in the developed world outside the U.S. have been a heavy drag on equity returns. Meanwhile, the sizeable Q3 equity returns in the U.S. have already been cut down to size in the early days of Q4. While U.S. short-term fundamentals are indeed a positive for stocks, we believe the good economic and earnings numbers realized of late will be hard to repeat as the momentum of favorable tax policy fades and we start to see the price that was paid to fund these short-term economic benefits

Given the rich equity valuations and more languid growth expectations ahead, we believe global equity upside is limited. In fact, as we take an early look into 2019, we believe the coming year could prove to be somewhat lackluster for stocks. Market participants should be aware of a likely low equity return environment ahead.

In fixed-income, we continue to believe positioning should be pointed toward shorter duration bonds versus the benchmark. While we view fixed income as an important component of a diversified portfolio, as with equities, we believe investors should be cautious with fixed income risk. U.S. credit spreads may be at or near their lows for their cycle, leaving limited upside for returns. We realize fixed-income returns overall are poor, however, investors should not forget that good core bond exposure does provide a buffer against fits of equity volatility that may arise.

## **Risks**

Investors should be aware of the risks associated with all portfolio strategies and variable market conditions. Monetary policy changes, global military activity, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance and the effectiveness of strategic and tactical portfolio approaches.

## **Conclusions**

Although the picture for the third quarter and the first nine months of 2018 is quite positive, the seemingly endless stream of good investment news came to an end in October. At one point during the month, gains in the S&P 500 had been wiped out for the year, although stocks have rebounded somewhat since then. The possibility of further correction is certainly there. As mentioned earlier, there is convincing evidence that over the next few years, investment returns will be lower and volatility higher. A moderately rising interest rate environment is hoped for even though it will include some negatives such as lower fixed income yields (compared to what we have experienced over the last couple of decades). Adding to the anxiety associated with a lower yield environment will be higher volatility; unfortunately, investors that choose to sit-out to avoid volatility will likely lose what investment yields are available, even if reduced. While there will be periods of negative returns, history tells us that equity and fixed income yields should still be positive (over time) and are highly likely the best alternative for the vast majority of investors (even at reduced levels).



In periods of higher market volatility, maintaining investment discipline within a lower overall yield environment will be more difficult emotionally. However, we need to remember that market timing as an investment strategy has never worked consistently (and results in lower longer-term yields). Trying to time markets in a lower yield environment has a high probability of creating permanent losses. Compounding the problem, a less favorable investment environment will increase the “sales pitches” of companies with products and strategies purporting phony and distorted claims that appeal to our emotions. Avoid the temptation to act in an undisciplined and consequently damaging way— no matter how slick the advertisements trying to sell a strategy or product may be. If a lower yield environment develops, no person or company is going to find a way around it – everyone is investing in the same lower yield environment. If someone appears to have found a way around it, be very wary – they are either not showing you all their “cards” or taking very high investment risk.

Fullen Financial is always available to help sort out false claims so don’t be concerned about asking us.

As always – stay with a consistent and disciplined investment strategy – it is the only course of action with any track record of success (in any investment environment). There is no reason to believe, even with the changing economic dynamics, that the disciplined approach to investments will be less effective than in the past at delivering the best possible relative returns.

At the most fundamental level, match your investment time horizon to your spending timeline – if you have short term cash needs then those funds should be in short term investments. If you have long-term spending needs (like 10 or more years into the future) then this cash should be in long-term equity investments. These are simple asset/liability matching principles practiced by the most sophisticated investment managers every day (but far too complex to explain in sound bites and not conducive to selling products). Additionally, don’t try to solve short-term financial problems with long-term equity exposure. If you try to chase returns, you may get lucky sometimes but, if pursued long enough, it always ends in extreme frustration and often with serious financial losses. The reality is that no one has ever consistently predicted investment markets and they never will - and there is always a consequence to continued unsound financial behavior.

As always, if your personal or family situation has changed (or is likely to) a discussion with us as to how this may impact your financial plan and your overall asset allocation is warranted. Or, if you simply feel a need to discuss any aspect of your portfolio and/or financial plan, or you haven’t had a planning update within the last 12 months, please contact us to review your financial plan and investments.

**Your financial plan is the most important financial document that you possess! Keep it updated and use it.**

Please note that you are entitled to receive Fullen Financial’s Form ADV whenever you would like to. This document outlines many details of who Fullen Financial is, their investment methodologies and their advisor’s education and experience. You may do so by contacting Lisa Bushman at [lisa@fullenfinancial.com](mailto:lisa@fullenfinancial.com) and requesting such. Alternatively, you can go to the Fullen Financial website ([www.fullenfinancial.com](http://www.fullenfinancial.com)), click on “Resources” in the top menu bar, and then on “Client Forms.”

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