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Stock Market Development

The S&P 500 Index was up 9% at the end of Q 3, but gains have been driven by fewer stocks. In fact, Amazon and Apple account for about one quarter of all stock returns this year. 200 companies of the S&P 500 were down this year and many entered bear market territory. The market was supported by low interest rates and lower corporate taxes, but these trends are losing momentum as the Federal Reserve Bank is increasing its pace of raising interest rates. The 10-year-treasury yield reached its highest level in 7 years. Corporate earnings should continue to grow for the rest of the year, driven by a strong economy. Earnings growth is expected to slow in 2019 when the tax cuts are likely to have a lesser effect and a weaker global economy filters through to the U.S. economy. Also, geopolitical risks for the markets are elevated and include the U.S. trade tensions in particular with China, the midterm elections, the political rift between Italy's ruling coalition and European Union officials, weakness in several emerging market economies, and Brexit uncertainties. Furthermore, although the impact of tariffs in the economy will be slow to surface as the service sector (80% of the U.S. economy) is much less exposed to changes in the trade policy, uncertainty in the market is rising. Given the persistence of protectionism in U.S. policy, and its now proven potency at the ballot box, markets are likely to remain volatile and in a risk-off-mode in Q 4.

Fixed-Income Market Developments

The U.S. government bond market often moves dramatically before it finds a new level and defines a trading range, for months or quarters. Early 2018 yields increased almost 1%, only to settle in a trading range of 0.4% for more than 6 months. The ten-year-treasury yield now reached a year-to-date high of 3.21% and the 2-to-30-year curve spread, which had reached a low of 0.4% increased to 0.5%. Given the robust economic trend, we think the market is likely to establish a higher trading range 3.25% - 3.60%. New issuance of treasuries are set to double this year. Demand for Treasuries is already decreasing as investors are worried about the rising deficit and inflation. If the recent sell-off were to increase the financing costs would rise for the government. Furthermore, the more short-term interest rates rise, the more hedging costs increase, which in turn dampens foreign demand for dollar denominated treasuries. All this does not bode well for the bond market. We, therefore, continue to recommend to invest defensively, diversify credit risk and take a balanced approach in a mix of laddered short term bonds up to one year and treasury bills, and for yield fixed and floating rate investment grade bonds of undervalued sectors. Floating rate notes and laddered short term corporate bonds are also an option, as well as bonds which pay a fixed interest rate for a certain period and then convert into floating rate bonds, e.g. perpetual bonds. The main investment objective in this current interest rate environment should be capital preservation followed by income.

The Economy

The U.S. Service industry (80% of GDP) unexpectedly rose to a near-record level in September (ISM) underscoring continued strength at service companies amid solid consumer demand underpinned by tax cuts and a strong labor market. The increase was broad-based, with gains across all four components: business activity, new orders, the labor market and inventories. The strength in measures of demand and employment indicate more momentum in the final quarter. Forecasts for GDP growth in 2018 were upgraded from 2.8% to 3.1% and in 2019 from 2.4% to 2.5%. The unemployment rate reached a low of 3.7% in September.

Federal Reserve Policy

The Federal Reserve Bank raised interest rates by 25 basis points to 2%-2.25% in-line with expectations. Core inflation reached 2% which the Fed describes as "near" target. The current level of the fed funds rate is comfortably below most estimates of the longer term neutral level. The updated economic projections signal an extended period of above-trend economic growth through 2020. The challenge will be for the Federal Reserve Bank to avoid becoming too restrictive when the effects of the tax cuts start to taper off and ultimately reverse and/or some impact of the trade war filters through to the U.S. economy. We, therefore, do not expect continuous interest rate increases as inflation expectations appear to be well contained.

Outlook

The scenario, as described above under Stock Market Development, is likely to represent a challenge to the equity market for the remainder of this year. The S&P's current price/earnings multiple of 17 is high versus 13 in 2011 when yields last reached that level. Shares of the S&P 500 companies with the highest tax rates are up 16% this year and companies with the lowest rates, therefore, those which did not benefit much from tax cuts, are up only 5%. Most of the increase in corporate free cash flow has gone into share repurchases, dividend increases and debt repayments, which have been all supportive of the stock market. S&P 500 earnings growth is estimated to be about 19%-20% this year. Roughly seven percentage points are due to the lower corporate tax rate, and are further supported by share repurchases.

Although mid-term elections have not historically had a short term impact on the markets, rate-sensitive sectors such as utilities, consumer staples, and real estate could perform relatively better if Democrats win more seats in Congress, which could mean lower interest rates, and if Republicans win, the economy is likely to be stronger and rates be higher. It all remains to be seen.

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We are aware of all the adverse currents in the market, but as long-term investors we see a healthy economy which was growing 2% a year before the tax cuts and is now likely to average between 3% and 3.5%. We also think that it is unrealistic to expect strong capital investments in the first six months after the passage of such a drastic tax reform. Share repurchases, debt reduction, dividend increases were the first steps taken by corporations which have all been positives for the market. We could very well now be in the early stages of capital investments and a rebound in productivity. These are positives too. Furthermore, fiscal policy is allowing monetary policy to normalize. It is either one or the other. We, therefore, believe that the environment for equities remains strong and we continue to stay our course. We are sufficiently diversified across sectors and industries and have trust in the quality of the majority of our investments.

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