third quarter 2018

INVESTMENT *perspective*

With the Federal Reserve continuing to raise interest rates and the U.S. economy producing strong nominal growth, global liquidity is fleeing international capital markets and seeking the perceived safety of U.S. assets. During the third quarter of 2018, the S&P 500 and Russell 2000 Value rose approximately 7.70% and 1.60%, respectively. Year to date the S&P 500 has appreciated approximately 10.5% while foreign equity markets have declined from as little as -8% in Germany to as much as -15% in China.

Despite the U.S. economy's strong economic growth, the Federal Reserve's monetary policy normalization is beginning to impact certain sectors of the economy. Housing activity and home price appreciation is beginning to slow from the significant increase in mortgage rates over the last year **(Chart 1)**. Housing is typically one of the first sectors to feel the impact of rising interest rates and typically leads a broader economic slowdown by approximately twelve to eighteen months.

At this late stage in the economic cycle, the two primary threats to sustained economic growth and rising equity markets is further monetary policy normalization by global central banks or sustained pressure on global supply chains from trade tariffs. In order for U.S. equity markets to remain attractive it is critical that the Federal Reserve allows sufficient time for capital markets to adjust to higher interest rates and declining liquidity before continuing further with any material monetary policy normalization.

Interest rates continued to gradually rise in the third quarter with the bellwether 10-year Treasury note rising 20 basis points to 3.06%. Since the beginning of the year, the 10-year Treasury yield has risen 65 basis points.

The Federal Reserve followed through with its well telegraphed "normalization" of the federal funds rate with its third quarter point increase of 2018. The rate stands at 2.25%, with another quarter point increase expected at the December meeting **(Chart 2)**.

Credit risk premiums narrowed in the quarter to 111 basis points, allowing the investment grade credit sector to recoup all of the underperformance versus U.S. Treasuries that occurred in the first half of the year. Municipal bond yields followed U.S. Treasury yields higher in the quarter but year-to-date remain one of the best performing fixed income sectors.

Chart 1

U.S. 30-Year Fixed Avg Mortgage Rate

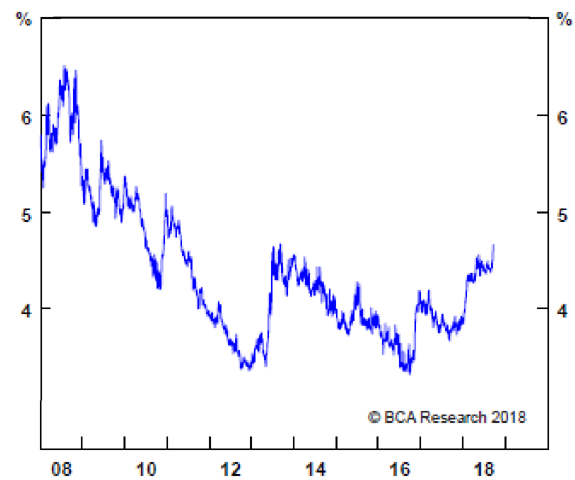
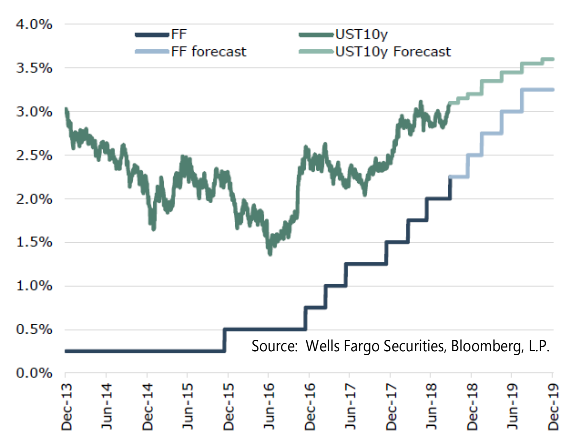


Chart 2

Federal Funds Rate and U.S. 10-Year Yield



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The unemployment rate remains below 4% and the year-to-date average non-farm payroll gains are running at 207,000 per month. That is stronger than the average monthly gain in 2017 (182,000 per month) and in 2016 (195,000 per month).

While we expect GDP growth to slow in 2019 to trend levels of 2.0-2.5%, the tax reductions and other measures passed in late 2017 have stimulated economic growth this year. Second quarter GDP growth was 4.2%, the highest quarterly rate in four years. Most of the major inflation readings watched closely by the Federal Reserve seem well behaved with core CPI and core PCE readings in the 2.1%-2.2% range.