Think
FINANCIAL PLANNING

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Quarterly Market Update

Presented by **Think Financial Planning** **thinkbank.com**

A mixed September but strong quarter for U.S. stocks

September started with some volatility, but it ended on a positive note for most U.S. markets, capping off a strong third quarter. The Dow Jones Industrial Average (DJIA) led the way for the month with a return of 1.97 percent, and the S&P 500 followed with a 0.57-percent return. But the Nasdaq Composite could not overcome the early declines, finishing the month down 0.70 percent. Despite its poor performance in September, the Nasdaq did end the quarter largely in line with its peers; it returned 7.41 percent for the quarter compared with 7.71 percent for the S&P 500 and 9.63 percent for the DJIA.

These solid returns were supported by strong fundamentals. Per FactSet, as of quarter-end, the estimated third-quarter earnings growth rate for the S&P 500 was 19.3 percent. This would be the third-highest quarterly earnings growth rate since early 2011 and would come on top of a 25-percent growth rate in the second quarter. Ultimately, fundamentals drive long-term market performance. So, the strong expected earnings growth is worth our attention. From a technical perspective, all three indices were well above their 200-day moving averages for the month and the quarter, which indicates the trend remains positive.

Internationally, the results were more mixed. Concerns around a slowdown in global trade and weakening emerging market currencies caused volatility. For developed markets, the MSCI EAFE Index gained 0.87 percent in September and 1.35 percent for the quarter, despite periods of heavy volatility. The MSCI Emerging Markets Index didn't fare as well, losing 0.50 percent for the month and 0.95 percent for the quarter on fears of a currency crisis and trade worries. Both indices remained below their 200-day moving averages, suggesting investors remain wary of the perceived higher risks outside the U.S.

Fixed income also had a challenging month but managed to post a gain for the quarter. The Bloomberg Barclays Aggregate Bond Index declined by 0.64 percent for the month. For the quarter, however, the index eked out a small gain of 0.02 percent. These lackluster results were driven by rising rates, which negatively affect bond prices, with the 10-year U.S. Treasury yield going from 2.87 percent to 3.05 percent during the quarter. Rates were driven up by signs of rising inflation as well as Federal Reserve (Fed) action. The Fed hiked rates in September and is expected to do so again in December. High-yield bonds, which are typically less influenced by interest rate movements, had a stronger month and quarter, returning 0.56 percent and 2.40 percent, respectively.

Economic expansion inspires confidence

The economic news for the quarter was substantially positive. High confidence levels were matched by strong spending growth for both businesses and consumers. In one surprising development, the Conference Board Consumer Confidence Index spiked to an 18-year high in September. This index is well above the levels seen in the mid-2000s and sits near the all-time highs set in the late 1990s and early 2000s.

Consumers were not alone when it came to improving confidence for the month. After declining in July, both the Institute for Supply Management (ISM) Manufacturing and ISM Nonmanufacturing indices bounced back significantly in August. The rise in the ISM Manufacturing index—to a 14-year high—was especially notable and showed that manufacturers remain quite confident in the ongoing economic expansion despite headwinds such as a strong dollar and trade concerns.

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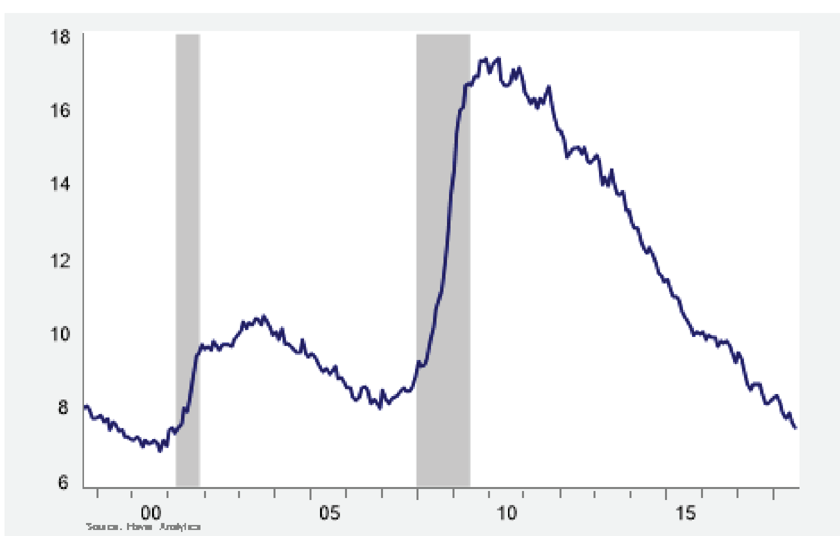
Rising confidence leads to higher spending

Although these high levels of confidence are encouraging, a willingness to spend does not mean much without a similar uptick in the ability to spend. Fortunately, a combination of strong job growth and rising wage growth helped on that front. Stronger-than-anticipated wage growth in August took the annual rate to a nine-year high. This increase, combined with the 201,000 new jobs that were added in August, pushed consumer spending power and kept the labor market strong. The unemployment rate remained at 3.9 percent, a multiyear low, whereas the more comprehensive underemployment rate fell to a 17-year low (see Figure 1).

Figure 1. U-6 Underemployment, 1998–2018



Given the rising willingness and ability to spend, retail sales continued to grow in August. This came on top of growth in July that was larger than expected. Overall, personal consumption for the third quarter appears to be close to matching the strong 3.8-percent pace of the second quarter. In turn, this could lead to another quarter of gross domestic product growth of more than 3 percent.

Businesses also did their part to boost spending. Durable goods orders for August rose by 4.5 percent, against expectations for 2-percent growth. This growth was driven in large part by a rise in aircraft orders. Although this measure of business investment can be volatile, this result is encouraging given a decline of 1.7 percent in July. Core orders growth was smaller but steadier, suggesting that even outside of transportation business, investment continues to improve.

With both consumers and business confident and spending, we seem to be in a virtuous cycle. Higher confidence causes higher spending, which in turn leads to faster growth and even higher confidence. This scenario is typical of a mature economic cycle.

Risks are real but not pressing

As good as things are, risks remain, as international markets showed during the quarter. The most visible concern, economically, is the growing confrontation on trade between the U.S. and China. Here in the U.S., however, fears of a trade cliff—driven by tariffs and trade barriers—have been replaced by the realization that the impact may be more like a slowly rising headwind. Although there has been real economic damage abroad, the U.S. economy and markets appear to be taking the increasing risk in stride. The announcement at the end of the month of an agreement on a revised trade deal with Mexico and Canada should also help blunt the negative effects of the ongoing U.S.-China confrontation, at least for now.

The other major risk factor is political, with the upcoming midterm elections in November. There may be some short-term volatility around the time of the elections, but fundamentally, they should not derail the strength of the economy. There are two possible outcomes here. In one, the Republicans retain control, which is likely to be considered positive for the economy. In the other, we have a divided government—which has also historically been considered a positive. Overall, while politics are certainly worth paying attention to, their direct impact on the markets is likely to be muted for the time being.

Beyond politics, economic risks appear to be well contained. Although there is a slowdown in housing, it is a slow process and may be moderating, as lower timber prices contributed to better-than-expected home builder confidence and housing starts. These results were a healthy development for the housing market, as low supply in new homes has played a part in disappointing sales. Other economic indicators remain positive.

Solid start for Q4, potential headwinds ahead

The start of the fourth quarter looks solid. The economic fundamentals are strong and should be able to withstand periods of short-term volatility. Confidence continues to be high and seems resilient in the face of political uncertainty.

At the same time, with pending elections and everything else going on, we may well see market volatility before the end of the year. Just because consumers and businesses have been confident in the face of potential headwinds so far does not guarantee that they will remain so. Therefore, despite the good news, we have to stay aware of risk and remember that a well-diversified portfolio that aligns financial goals and time lines remains the best way to get where you're trying to go.

All information according to Bloomberg, unless stated otherwise.

Disclosure: Certain sections of this commentary contain forward-looking statements based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Nasdaq Composite Index measures the performance of all issues listed in the Nasdaq Stock Market, except for rights, warrants, units, and convertible debentures. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Bloomberg Barclays Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Bloomberg Barclays government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Bloomberg Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

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