# “Mounting Risks”
## Market Commentary – October 2018

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**The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 4.2% in the second quarter of 2018.** This is up from the advance estimate of 4.1% and the same as the second estimate. On September 26, the Federal Open Market Committee (FOMC) released its revised economic projections. It sees GDP growth of 3.1% in 2018, 2.5% in 2019, 2.0% in 2020, 1.8% in 2021, and 1.8% in the “longer run” (beyond 2021). The forecast for 2018 was raised from 2.8% and 2019 was nudged up from 2.4%. The Fed does not seem convinced that the strength in economic growth recently observed will be sustained.

**As expected, on September 26, the FOMC raised its target range for the federal funds rate to 2.0% to 2.25%.** This was the eighth 25 basis point increase since December 2015. By the end of 2018, the FOMC sees a federal funds rate of 2.4%, which implies one more hike in 2018. It also projects the federal funds rate at 3.1% in 2019 and 3.4% in 2020, which would be accomplished by three 25 basis point rate hikes in 2019 and one 25 basis point increase in 2020. Interestingly, the FOMC sees the federal funds rate in the “longer run” at 3.0%. In terms of balance sheet, total assets as of July 2018 stood at $4.278 trillion, down $188 billion from a year earlier. The cumulative effects of quantitative easing are being unwound, as promised. The next FOMC decision on monetary policy is scheduled for November 8.

**Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market.** The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $167.33, which implies a price-to-earnings (P/E) ratio of 17.4 with the S&P 500 at 2,914. The earnings yield (E/P) of 5.74% represents attractive value relative to the 10-year U.S. Treasury note yield of 3.06%. The 10-year Treasury yield jumped 21 basis points over the past month. Should this trend continue, which seems likely given the direction of the federal funds rate, higher interest rates will become problematic for stock valuations.

**The S&P 500 uptrend, in a pattern of higher highs and higher lows, remained intact last month.** The index hit an intraday high of 2,940 on September 21 and remains above its 50-day moving average. Both the 50-day and 200-day moving averages are rising at steady clips, which is characteristic of an uptrend. Areas of support should be around 2,870 (January high and 50-day moving average) and 2,790 (old resistance in February, March, and June). A material decline on high volume would put the continuation of this uptrend in jeopardy.

**Risks are mounting as the gap between growth and value stocks is widening.** What follows is our familiar review of major index returns (without dividends) from 1/1/2018 to 9/30/2018: +19.3% Nasdaq 100; +18.6% S&P 600 Small Cap Growth; +16.6% Nasdaq Composite; +16.1% S&P 500 Large Cap Growth; +9.0% S&P 500; +8.5% S&P 600 Small Cap Value; +7.9% S&P 400 Mid Cap Growth; +7.0% Dow Jones Industrial; +4.5% S&P 400 Mid Cap Value; +1.2% S&P 500 Large Cap Value. The short-term outperformance of growth over value is staggering, but investors would be wise to not draw the conclusion that value investing is an inferior strategy – quite the contrary. Passive investing through index funds and Exchange Traded Funds (ETFs) are making the problem worse, which may lead to a massive correction.

**While some investors get hung up on market index returns, what really matters is whether an investor is achieving their individual goals.** By definition, “individual goals” are tailored to each investor. Two common goals include building for retirement and also trying to stay retired without having to go back to work. Investors’ focus should be on making incremental progress toward their goals, while keeping mind that progress often involves taking “two steps forward and one step back”. It is the temporary setbacks that create opportunities for those with a plan. We utilize a balance between stocks and cash to help plan for market moves to both the upside and downside.