3rd Quarter 2018: Quarterly Recap and Near-term Outlook

J.P. Morgan Asset Management Chief Global Strategist, Dr. David Kelly, CFA recently said "the most serious problem with populist politics is that it is not serious." In today's bitterly divided landscape, those are brave words from an investment industry heavy-weight.

Global Portfolios under Populist Regimes

Perhaps it is old-fashioned of me to believe, but clients will quickly view ours as a useless profession if, in fear of offending political sensibility, we appear unable to discern fact from spin, are unwilling to make high-conviction calls, and we avoid uncomfortable topics. Our jobs, as investment professionals, necessarily include absorbing, evaluating, and incorporating political risk into our opinions, outlooks, and actions. I applaud Dr. Kelly for his honesty. Populist politics is a significant investment issue, and it must be examined honestly and objectively.

Today's global economy is, in effect, one, single, enormously complex, feed-back loop. It is constantly seeking equilibrium in response to actions taken by all players on the world stage. As powerful a force as the United States, the European Union, China, or any emerging economy might be, countervailing factors outside the control of any one economy necessarily work against populist agendas. The interconnectedness of global trade, supply chains, financing sources, interest rates, and currency translations, insures that countervailing forces will extract heavy penalties from short-term, idealogical, maneuvers against the modern global infrastructure.

Dr. Kelly knows this. I know this. Any economic or investment professional worth the price of advice knows this. While any, if not every, political administration might be focused on short-term gain - getting reelected - industry professionals understand that short-term agendas are not serious, effective, long-term, policy prescriptions. Pandering to election cycle outcomes never work out as promised, and history tells us that it leaves the electorate worse off for the effort. For Lake Jericho and our clients, with an investment thesis built upon continued global growth, populist regimes, protectionist regimes particularly, present significant challenges for our long-term strategies.

Q3 Quarterly Recap

At the end of Q3, the Q1 correction in stocks was a distant memory. U.S. stocks hit new highs as corporate earnings, helped by the Tax Cut and Jobs Act windfall, continued to exceed expectations. Both consumer and business confidence improved, as data on job growth and economic activity continued to delight.

The soft spot, domestically, was bond market returns, which continued to feel pressure from rising interest rates. The slaughter in bonds that some predict is no where to be found, as the move higher in interest rates

has been relatively slow, steady, and well broadcast. Aside from a few jolts, price pressures are modest, and are being offset by increasing yields from newly issued short- and intermediate-term, high-quality, bonds.

International equity markets, particularly emerging markets, were a different story. Uncertainty surrounding the never-ending Brexit negotiations, a slowing E.U., a strengthening U.S. dollar, fear that emerging market countries might struggle to pay what is largely U.S. dollar-denominated debt, competition for investment dollars as U.S. yields continue to rise, and protectionist trade tensions have dampened demand for international stocks. The current divergence between U.S. equity and international equity performance is among the widest in decades and has negatively impacted client performance during 2018.

- The S&P 500® Index finished Q3 with a total return of 7.71%, for a 2018 year-to-date return of 10.56%.
- The more concentrated Dow Jones Industrial Average surged during Q3 with a total return of 9.63%, for a year-to-date return of 8.83%.
- The technology and consumer-cyclical heavy NASDAQ Composite Index lagged during Q3, with a total return of 7.41%. With a year-to-date return of 17.48%, the NASDAQ remains the leader.
- After leading their large-company counterparts for much of 2018, small- and mid-sized U.S. companies reversed course significantly during Q3. In the end, the Russell 2500™ Index lagged with a total return of 4.70%, with a year-to-date return of 10.41%. Small- and mid-sized U.S. companies are less affected by the increasing threat of tariffs and trade-wars as less of their earnings depend upon overseas transactions. Their reversal during Q3 was taken as an early-warning indicator that other concerns about the U.S. market are beginning to weigh on sentiment.
- International developed market portfolios, as measured by the MSCI World (ex-U.S.) Investable Market Index, finished Q3 with a total return of only 0.41%, serving to marginally reduce the year-to-date loss of -3.81%. International emerging markets, as measured by the MSCI Emerging Markets Investable Market Index, finished Q3 with a loss of -2.37%, leaving the index with a year-to-date loss of -10.04%. As we regularly remind readers, effective diversification means that, at any given time, there will be a part of your portfolio you will likely despise. Investors still benefit from an internationally diversified strategy as broad global exposure protects long-term stock investors from long, drawn-out bear markets in any one country or region. One need only look to the decade following 2001, a period in which U.S. returns were essentially flat, to see that international allocations saved most investor portfolios from a decade of zero growth.
- Bond markets, in the face of rising global interest rates, have provided little shelter for investors. Interest rates and bond prices are inversely related, so as interest rates increase, bond prices fall. The Bloomberg Barclays U.S. Aggregate Bond Index finished Q3 with a total return of 0.02%, leaving the year-to-date loss of -1.60%.

Most Lake Jericho client portfolios are globally diversified, balanced, strategies that incorporate combinations of the various markets detailed above. Clients have asked that we reduce granularity of data in the Quarterly Commentary, and instead provide easier-to-discern, independent, benchmarks to help improve understanding of relative portfolio performance versus like-managed portfolios. To this end, we now present Morningstar, Inc. Target Risk Portfolio Series of benchmarks for performance comparison. That series is presented in the table atop the next page.

Near-term Outlook

I am much later than usual to publish this quarter's *Outlook*. Being so does provide the benefit of hindsight into the full October experience. The vantage point provides clear insight into what is shaping up as the predominant market theme as we close out 2018. Q3 was the type of market that I like to see: investment decisions focused on the fundamentals of corporate earnings in a low inflation environment. Q4 quickly

Morningstar, Inc. Target Risk* Portfolio Series

Benchmark Comparisons For All Periods Ending September 30, 2018

Target Risk Portfolio	Q3 2018	YTD 2018	1 Year	3 Year Total Return	5 Year Total Return
Conservative	0.90%	0.05%	1.46%	12.36%	16.32%
Moderately Conservative	1.82%	1.28%	3.91%	21.44%	27.39%
Moderate	2.52%	2.20%	6.02%	30.22%	37.07%
Moderately Aggressive	3.27%	3.25%	8.32%	39.59%	47.14%
Aggressive	3.91%	4.39%	10.40%	47.61%	55.71%

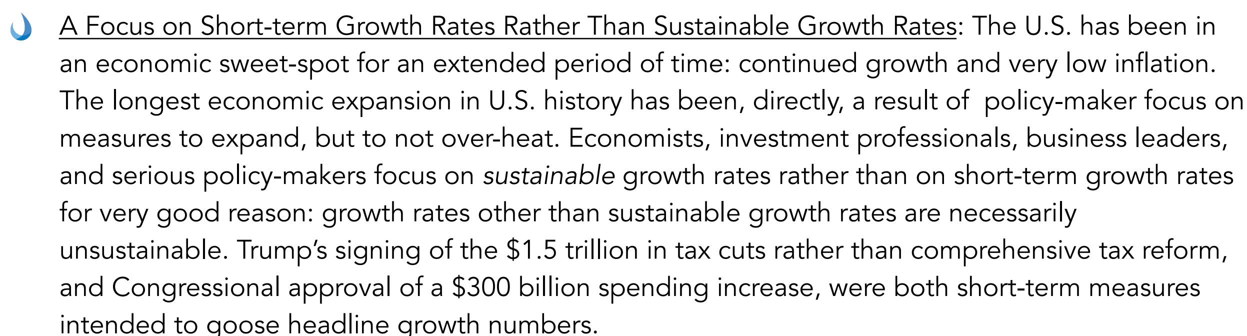
* The Morningstar Target Risk Index family is designed to meet the needs of investors who would like to maintain a target level of equity exposure through a portfolio diversified across domestic, international, and emerging market equities, bonds and inflation-hedged instruments. The Morningstar Conservative Target Risk Index seeks approximately 20% exposure to global equity markets. The Moderately Conservative Index seeks approximately 40% exposure to global equity markets.. The Moderate Index seeks approximately 60% exposure to global equity markets. The Moderately Aggressive Index seeks approximately 80% exposure to global equity markets. The Aggressive Index seeks approximately 95% exposure to global equity markets. Benchmarks are constructed with no management fees, and with no transaction costs, while Lake Jericho portfolio performance is actual performance, net of all fees, including investment management, administration and transaction expenses.

turned into the type of market that I hate to see: investment decisions driven by algorithms focused on anticipated market psychology rather than on objective reality.

While, directionally, October's sell-off might be founded on valid concerns, the magnitude of the sell-off suggests a disconnect from reality. Yes, in this earnings season we did start to hear softer guidance for corporate earnings. And yes, about 35% of earnings guidance did mention concerns or direct impacts from trade and tariffs. So yes, it is increasingly difficult to see the same upside trajectory for markets to which investors have become accustomed. However, by most measures the U.S. economy is strong. Economic output continues to grow, both domestically and abroad. Unemployment is at multi-decade lows. Businesses and consumers continue to shown confidence. The iM Business Cycle Index does not indicate a downturn or recession in the US economy in the near term. On the contrary, the US economy remains robust.

However, after nearly two years of uncharacteristically complacent markets, robust earnings momentum, and relatively low inflation worries, attention has turned to what could be the coming bill for the decade of cheap money, the temporary high of tax cuts, and unbridled federal spending. For any late-cycle economy, cycle, that peak momentum has passed, that earnings growth is slowing, that inflation is creeping higher, and that interest rates must increase is typical, and well-studied. What is atypical, and new territory for a late-cycle economy, is the territory in which the U.S. now finds itself from the populist economic agenda undertaken by the Trump administration and Senate/House leadership; record fiscal spending, record budget deficits, record debt issuance, and rising industry jitters that tactics regarding global trade and tariffs have been misguided. Fear and potentiality do not equate to certain outcomes, of course. But what is certain, however, is that, without exception, the *consequences* of similar populist measures have always been very different than the *rationale* for initiating those measures.

The following five points detail the economic and market influences we are watching most closely, that will guide our investment and allocation decisions/recommendations for the balance of 2018 and into 2019.



- A Focus on Short-term Growth Rates Rather Than Sustainable Growth Rates: The U.S. has been in an economic sweet-spot for an extended period of time: continued growth and very low inflation. The longest economic expansion in U.S. history has been, directly, a result of policy-maker focus on measures to expand, but to not over-heat. Economists, investment professionals, business leaders, and serious policy-makers focus on *sustainable* growth rates rather than on short-term growth rates for very good reason: growth rates other than sustainable growth rates are necessarily unsustainable. Trump's signing of the $1.5 trillion in tax cuts rather than comprehensive tax reform, and Congressional approval of a $300 billion spending increase, were both short-term measures intended to goose headline growth numbers.

- National Debt: Increased government spending during a recession is a time-tested method to lift shrinking economies out of a funk. Increased government spending during the peak of an economic cycle, when government should be using peak revenues to reduce that prior debt, is a long-theorized recipe for stagflation. The Treasury is boosting sales of bonds to finance the surging budget deficit. The federal deficit grew to a six-year high of $779 billion in the 12 months ending September 30, Trump's first full fiscal year in office. The U.S. Treasury Department reports borrowing this year will more than double 2017's need, at $1.34 trillion. The Congressional Budget Office, a nonpartisan arm of Congress, forecasts government spending will outweigh revenue by $973 billion in fiscal 2019 and more than $1 trillion the next year.
- Trade and Tariffs. We hold no doubt, or resistance, to the idea that structural deficiencies exist between the U.S. and some trading partners. We fully support addressing those deficiencies, and acknowledge that the best time to do so is during a time of economic strength. Our concern, and why we think the administration tactics misguided, is that efforts thus far are largely tilted towards "old economy" industry sectors such as steel, aluminum, coal, and heavy manufacturing. As a modern service economy, we believe efforts should be primarily tilted towards "new economy" issues such as smart infrastructure, A.I., quantum computing, and biotechnology.
- Interest Rates: The Federal Reserve's FOMC has raised its benchmark interest rate three times this year, and is expected to hike one more time in December. The FOMC has been determined to stay ahead of inflation, and has signaled a willingness to keep raising rates to keep it in check, despite criticism from Trump. Market participants are just a determined to incorporate inflation fears and market risks into rates. Trump's criticism of the Fed is largely misplaced, as it is the market that "votes" on the level of rates through daily market action. Rising rates affect consumer and business willingness to borrow, and increases costs to U.S. taxpayers to support the swelling national debt.
- Dollar Strength: One outcome of higher interest rates that few discuss, is the impact upon currency values, and what can become a snowball effect further choking economic growth. When interest rates in the U.S. are higher, relatively-speaking, than other secure sovereign debt, then owning U.S. debt will become more popular. To buy U.S.debt, one must first buy U.S. dollars, hence the dollar value will rise. The problem with a strengthening dollar is that, while it might mean that people and companies in the U.S. can buy more foreign goods, it makes OUR goods more expensive for others to buy. And is this not the exact problem that populist agendas are supposedly working against?

We remain watchful and ready to respond should we see signs on the horizon sufficiently impactful to change our near term outlook. As always, I am available at any time, any day of the week, to discuss specific portfolio performance questions. Until then, be well, enjoy the rest of your week, and thank you!

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