OmniStar financial group

Market Perspectives

A Glance at How the World Affects You

October 1, 2018

U.S. stocks ended the week slightly lower after reaching new all-time highs last week, with the S&P 500 Index dropping 0.5%. Materials, financials and consumer staples were among the biggest detractors, while telecom, health care and technology moved higher. U.S. Treasury prices and the dollar also advanced and oil prices ended the week up 3% amid growing concerns over tightening supply as a result of U.S. sanctions on exports from Iran.

Vicissitudes in the market should not come as a surprise, equity prices simply don't move in linear fashion. However, we are entering the fourth quarter (when markets typically post the strongest returns of the year). In theory, investors can breathe a sigh of relief during this time of year. We are not postulating a linear move higher heading into year-end, but we have analyzed data collected on S&P 500 performance from 1980-2017. The way we see it, the final quarter of the year has generated average gains of 4.59%, compared to gains of 2.34%, 2.67% and 0.3% for 1Q, 2Q and 3Q, respectively.

Looking at the percentage of "wins", the index proved successful 82% of the time, or four years out of five. That is a solid, if not reliable, track record. Nevertheless, fourth quarter has seen its share ponderous results. For example, in 1987, which included Black Friday, stocks fell 23% during the period; in 2008, they sold off 18% after the collapse of Lehman Brothers and the U.S. economy plunged into recession. As recently as 2012, stocks slid 1% in the final quarter to end a flat year. Still, we view this quarter as one that will go in the "win" column. The current fundamentals (low interest rates, rising GDP, solid earnings per share growth, and a stable dollar) are positive indicators for stocks. Emerging risks should not be underestimated and we will be watching closely as the bull market heads toward a tenth year.

A Look at Last Week

- The Federal Reserve delivered a mixed bag. As expected, the Federal Reserve raised rates 0.25% to a target range of 2.00% to 2.25%. However, the Fed's removal of the word "accommodative" from its statement drew greater attention from investors, causing some to speculate that the Fed is nearing its neutral rate. However, Chairman Powell noted the change in language doesn't impact the likely path of policy.

- U.S. trade negotiations continue to be in the spotlight. Following a prospective deal with Canada, trade issues between the U.S. and most of the world appear generally positive. China, of course, is the exception and that relationship can only be construed as one that is quickly deteriorating.

- Inflation appears well contained, but that won't last forever. Business owners could begin raising prices to compensate for wage hikes and higher prices on inventory as a result of the developing tariff war. We anticipate moderate inflation growth. However, too much inflation into 2019 may require the Fed to intercede. On a positive note, the Fed recently raised its GDP growth prospects for 2018 to 3.1%.

- Interest rates remain low and we don't believe they will challenge the strength of equity prices. Said another way, we are confident in the stock market until interest rates are high enough to slow the overall economy. The benchmark 10-year Treasury yield has only recently moved above 3.00%. We believe rates can move another 1.00% before warranting cause for concern.

Looking forward, our reasons for optimism include solid economic growth despite trade wars. Corporate fundamentals are healthy and price to earnings is reasonable. Stocks are priced on valuations, but they trade based on supply and demand. At this point, the net supply for stocks continues to shrink, thereby providing some tailwind stock prices. Finally, lower tax rates should also continue insulating markets from severe sell-offs.

Our position as a money manager is fully invested. However, we realize that our optimism comes with risk. Therefore, the following outlines our reasons for caution. Growth in foreign territory is mixed and the U.S – China relationship is worsening. Given new tariffs, some inflation, the eventual rise in interest rates and inventory pricing pressures, there is plenty on which to focus. Rounding out our list is global politics and U.S. midterm elections.

The equities backdrop remains positive

In closing, we turn our attention back to corporate fundamentals which remain strong. We will soon find out if third quarter earnings reveal any immediate concerns or near-term problems. Investors and analysts are targeting forward earnings around $178 per share in 2019 which give us a price-earnings ratio (P/E) of 17, a very reasonable number. However, these assumptions don't provide much room for error. For now, however, equities do not face enormous downside potential, and we think equities continue to provide greater value relative to fixed assets.

Best Regards,
Phillip L. Clark, RFC
President & CEO