SARSI LLC

Third Quarter 2018 Market Newsletter Summary

- US stocks are positive for the year, but non-US stocks have not kept up because of lackluster economic growth abroad, rising US interest rates and a strong dollar.
- The US economy and corporate profitability are strong and expected to stay strong. One area of weakness in the economy is housing, which is losing steam but still growing.
- Reasons to worry about the health of the bull market include its age, rising interest rates, valuation and midterm elections.
- Developed economies outside the US are slowing down but leading indicators point to a recovery. Emerging market economies and markets are experiencing bouts of volatility.
- Investors should balance fear and greed. A diversified portfolio can help.

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Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	7.71%	10.56%	17.90%	17.31%	13.95%
S&P Mid Cap 400	3.86%	7.49%	14.21%	15.68%	11.91%
S&P Small Cap 600	4.71%	14.54%	19.08%	19.41%	13.32%
MSCI Emerging Markets	-0.95%	-7.39%	-0.44%	12.77%	3.99%
MSCI EAFE	0.21%	-0.98%	3.25%	9.77%	4.90%
Investment Grade Credit (C0A0)	0.84%	-2.20%	-1.11%	3.14%	3.55%
Non-Investment Grade Credit (H0A0)	2.42%	2.50%	2.92%	5.54%	5.51%
Bloomberg Commodity Index Total Return	-2.02%	-2.03%	2.59%	-0.12%	-7.31%
Dollar Index (DXY)	0.70%	3.27%	2.21%	-0.42%	3.47%
Vanguard Total Bond Market Index (VBMFX)	0.01%	1.68%	-1.30%	1.18%	1.98%
10 Yr Rate	3.06% 09/30/2018	2.40% 12/31/2017	2.33% 09/30/2017	2.06% 09/30/2015	2.61% 09/30/2013

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 10/5/2018			
	Latest Release	Recent Trend	Notes
Non Farm Employment	134,000	Positive	Although the number of jobs added was fewer than expected, the jobs report was very strong. Last month's number was revised up by 35% and unemployment ticked down to 3.7% the best reading in almost 50 years. Wage inflation seems steady at 2.8% year over year.
Weekly Claims for Unemployment Insurance	207,000	Positive	Claims reflect a very strong employment situation in the economy. The 4 week average is the lowest in 45 years.
ISM Manufacturing Index (Number over 50 points to growth)	59.8	Positive	Manufacturing activity is moderating a bit (The index is down from 61.3 last month) but still very strong.
ISM Non Manufacturing Index (Over 50 points to growth)	61.6	Positive	Strong employment and business activity led the non manufacturing index to the highest level since it was created in 2008.
Consumer Prices (Month over month change)	0.2%	Positive	Lower medical and apparel costs led to consumer inflation to be contained in August. Year over year inflation is 2.7% headline and 2.2% without food and energy.

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	Latest Release	Recent Trend	Notes
Producer Prices (Month over month change)	-0.1%	Positive	Unlike comsumer inflation and despite tariff pressures, producer prices edged down at the headline and core (without food and energy).
Retail Sales (Month over month change)	0.1%	Positive	Retail sales was below expected and weak primarily because of weak auto sales. However, last month's number was revised upwards and the trend over the last few months has been positive.
Consumer Confidence (Conference Board)	138.4	Positive	Consumer confidence shot up to an 18 year high.
Durable Goods (Month over month change)	4.5%	Positive	Aircraft sales led to a big upswing in durable goods orders. Core capital good (Non defense ex-aircraft) was up only 0.1% which is down 0.5% from the last reading but was preceded by a string of strong numbers.
Industrial Production (Month over month change)	0.4%	Positive	The individual components of this report were varied, but the overall number is reasonably strong and the year over year trend is upward.
Capacity Utilization	78.1%	Positive	Capacity utilization has been inching upwards but is still below the 'normal level' of 80%.
Housing Starts	1.282MM	Negative	Housing starts came in higher than expected but forward looking indicator (permits) was weak.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.1%	Negative	Home price increase have been tepid for some time now. Year over year increase was 5.9% which is the softest since August last year.
GDP (Real, Annualized)	4.2%	Positive	Residential investments hurt a bit, net exports helped a lot to give us a strong second quarter 2018 GDP estimate.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

The stark difference between the performance of US stocks versus non-US stocks earlier this year was accentuated further in the third quarter. While US stocks of all sizes rallied strongly, non-US stocks, especially emerging market stocks, could not keep up. US stocks are up over 10% for the year as of the end of the third quarter, while non-US stocks are down for the year.

Interest rates in the US rose and interest rate sensitive bonds fell (The price of bonds has an inverse relationship with interest rates, all else being equal). The price of credit sensitive bonds, both investment grade and non-investment grade, rose during the quarter helped by a strong economy and corporate profits. Year to date, investment grade bonds, which are more sensitive to interest rates, are down.

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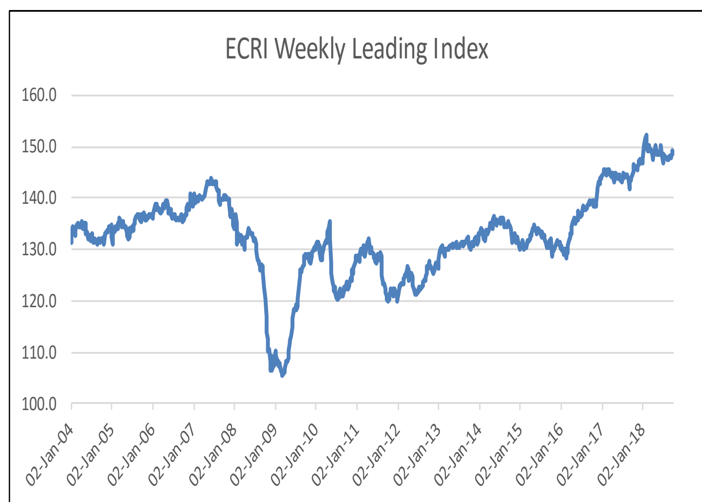
In early October, as we write this newsletter, US stocks have joined non-US stocks and are falling, spooked by rising interest rates. A correction during a secular bull market can be a good thing if the economy remains strong. Similarly, rising interest rates are not necessarily bad if they are rising because of a strengthening economy and not because of a spike in inflation.

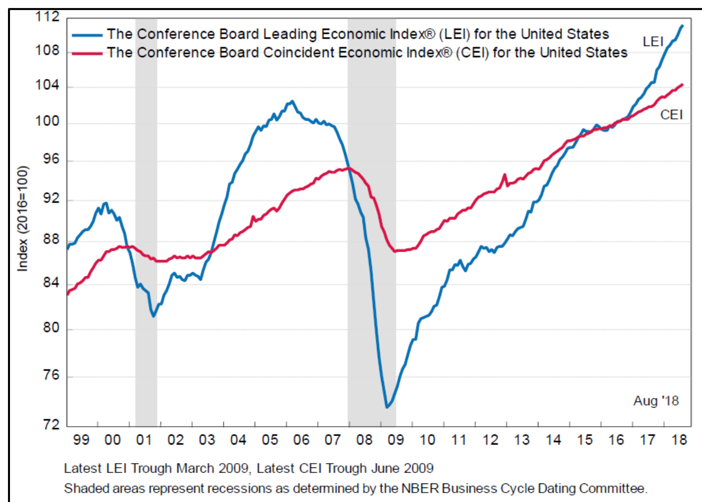
As seen in the table above, the US economy is in very good shape. Housing data has been moderating a bit, but home prices are still growing and are up almost 6% from a year ago. Home construction activity has moderated because of lower demand for housing and capacity constraints. Demand has weakened because higher mortgage rates and changes to tax laws have made housing less affordable. Lack of available labor and high material costs are hurting home builders and causing capacity constraints. Other areas of the economy including the consumer and business sectors are solid. Forward looking indicators such as the ECRI weekly leading index and the conference board's leading economic index, suggest that the strength in the US economy will continue. (Fig 1 and Fig 2)

Fig 1: ECRI Weekly Leading Indicator



Source: ECRI, Sarsi

Fig 2: Conference Board Leading Economic Index



Source: Conference Board

The US Federal Reserve (Fed) increased interest rates for a third time this year by 0.25%, to a range of 2-2.25%. This is the seventh quarter point increase this cycle and the Fed is expected to increase rates by another quarter point in December followed by three rate hikes in 2019. In comments made during the press conference, the Fed chairman Jerome Powell said that the rate increase reflects their confidence in the US economy, which is experiencing "a remarkably positive set of economic circumstances," and that "there is no reason to think this cycle can't continue for quite some time, effectively indefinitely." As mentioned earlier, an increase in interest rates by itself is not necessarily bad for the markets if it is accompanied by a strong(er) economy without rapidly increasing inflation. In the past, the US economy slipped into a recession only after the Fed stopped increasing interest rates and the affect of higher rates had percolated through the economy and slowed it down. Based on the comments by the Fed chairman, it seems we are still some time away from that point. Inflation is slowly but surely increasing but is not flashing red. Wage inflation for example, is 2.8% and is not a concern until it hits 4%. Higher tariffs can cause inflation; however, the strength of the US dollar should counter that to some extent (A stronger dollar makes imports cheaper offsetting higher tariffs). Interestingly, fears of an inverted yield curve that gripped the markets (and investors) has been replaced with fears of increasing interest rates, confirming the schizophrenic nature of the markets.

A big concern is centered around how long this expansion has gone on – It is the second longest on record and will become the longest in nine months. However, as seen in Fig 3 this is also the shallowest economic recovery ever and as seen in Fig

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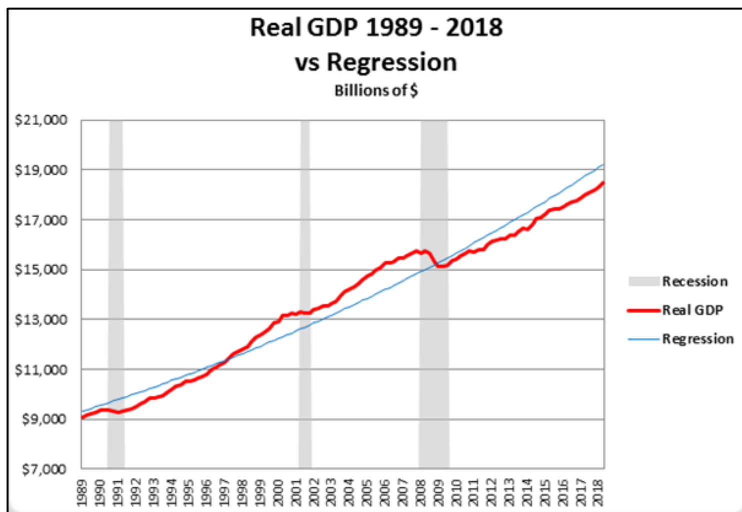
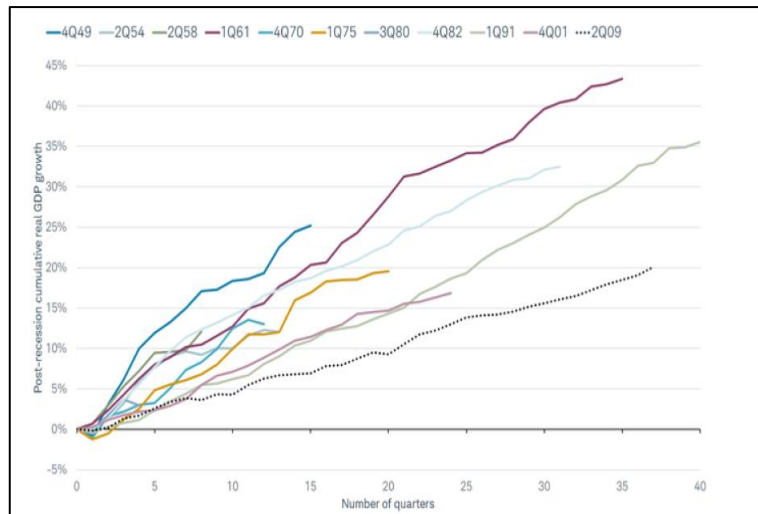
4, the economy is still growing below long-term trend. While, that is by itself not a reason why we won't see a recession soon, it is a valid counter argument to the length of the expansion being the reason for an impending recession. If magnitude (and not length of time) of economic growth is the yardstick by which to measure the possibility of a recession, then there is still sometime before the next one. Interestingly, the below trend growth is also cited as evidence by those in the 'all's not well camp' illustrating the fact that divergent views are what make markets.

Fig 3: US GDP growth versus long term trend



Source: Harris Associates

Fig 4: Current expansion compared to previous ones



Source: Charles Schwab, BEA, Factset as of June 30, 2018

Corporate earnings, which has been called mother's milk for stocks, continues to be strong. According to Factset, companies in the S&P 500 index reported an increase in earnings of 25% in the second quarter, the highest growth since the third quarter of 2010. 80% of the companies exceeded expectations. The momentum in earnings growth is expected to continue in the third quarter when earnings are expected to increase by 20%. The US dollar has strengthened significantly this year and since over 40% of the revenues of companies in the S&P 500 come from foreign countries, this could be a headwind (When revenues in foreign currencies are converted to a strengthening dollar, the revenue in dollar is smaller unless foreign currency exposures are hedged as many companies do). In fact, the strengthening dollar was cited as a bigger concern than increasing tariffs by most of the companies. If third quarter earnings grow as expected despite these headwinds, that would provide a strong support to US stock prices.

If you are looking for reasons to worry, as usual you will find plenty. There are significant risks facing the US economy and the stock market. By all indications, we are in the late stages of the economic cycle and there is the possibility that the bull market that started in 2009 may not have much room to run. (Nobody can forecast how much room left to run, as we said in our last letter). Increasing interest rates may curtail economic growth and make stocks less attractive in comparison to other asset classes such as bonds. Higher rates will also be a headwind for corporate profitability by increasing the debt servicing expense of companies that have collectively raised considerable amount of debt to take advantage of record low interest rates. Stock valuations while not frothy are not as cheap as they were a few years ago. Based on their price earnings ratio (Price/Earnings), stocks are a tad over their 25-year average. The Trump administration's hard negotiating tactics with our trading partners using tariffs for leverage could depress world trade and affect US growth. The US picked some low hanging fruits by structuring a new trade agreement with our neighbors, Canada and Mexico. It is also possible that some sort of a deal will be struck with the European Union which has significant trade with the US. However, discussions with China could be drawn out and negatively impact world trade. As of now, the Chinese markets and economy have been affected (negatively)more than the US markets and economy, but the contagion could well hit US shores if the negotiations get bitter and long drawn.

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The US midterm elections in November is another wild card. Historically, US markets have performed well post the midterm elections especially in the third year of a US president's term, as the incumbent stimulates the economy and consumer confidence. However, in the current bitterly divided political arena, the two major parties can split the two houses of Congress in any number of ways each with a different effect on US stocks. Historically though, markets tend to do well when there is a gridlock scenario.

Outside the US, economic growth has become un-synchronized. The IMF recently cut its global economic growth forecast to 3.7% for both 2018 and 2019, down from 3.9% earlier. In Europe, economic indicators have come in below expectations (Fig 5) although the index of leading economic indicator shows that growth could pick up. Trade wars and turbulence in emerging markets have caused pockets of risks in the area. However, earnings momentum and economic momentum remain positive. A weaker Euro against the US dollar will also be a tailwind to corporate earnings as European companies get a substantial portion of their revenues from abroad.

Fig 5: Citigroup Economic Surprise Index

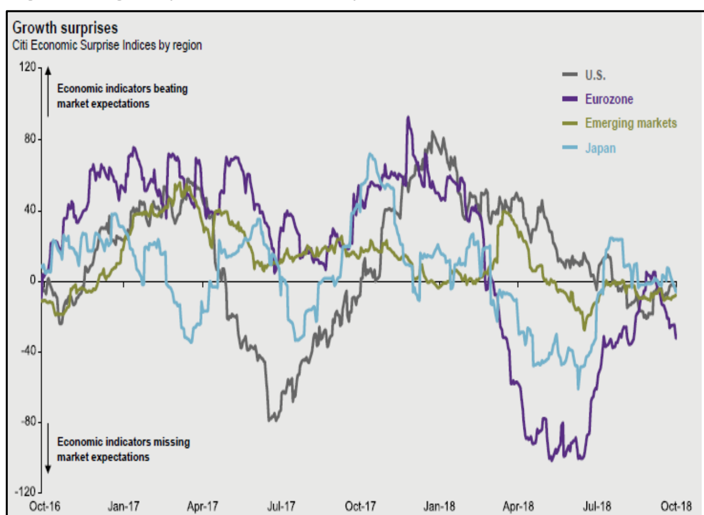
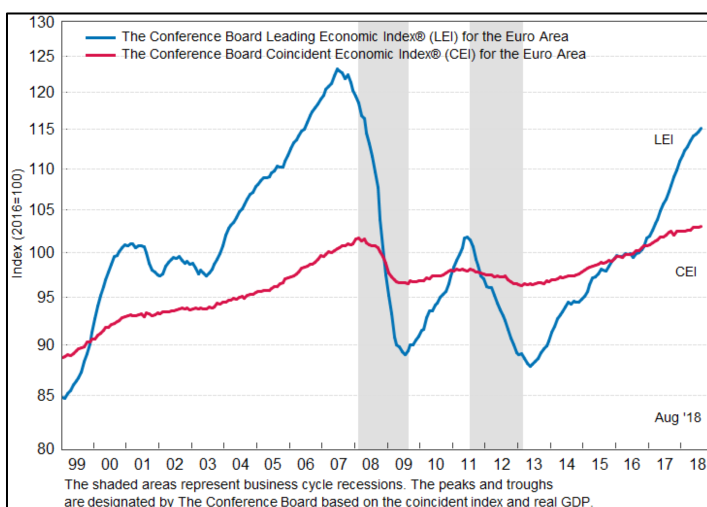


Fig 6: Euro area Leading Economic Indicator



Global purchasing manager's index have moderated recently, but still are above 50 in all regions, reflecting growth in manufacturing. In Emerging markets, there have been pockets of turbulence especially in weaker economies such as Turkey and Argentina, (Both of which took corrective steps recently) and other countries such as India and Indonesia. However, as discussed in previous letters these countries are in better shape than in the past and are collectively still growing. Financial assets in these countries, however, are likely to remain under pressure because of its inefficiency and the perception that it is riskier, made worse by adverse geopolitical headlines.

Valuation of non-US stocks have become more attractive because of the recent weakness and are below their 25-year average.

Overall, it seems the positives outweigh the negatives. Strong economic activity and healthy corporate profit growth, relatively benign inflation/interest rates and less than euphoric investors make it unlikely that a recession or a bear market is around the corner. However, investing is about balancing fear and greed and it behooves investors to be invested in a thoughtful, diversified manner.

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