Economic & Market Quarterly

Fall 2018

This summary is provided by BMT Wealth Management.

Domestic Economic Expansion Takes Center Stage

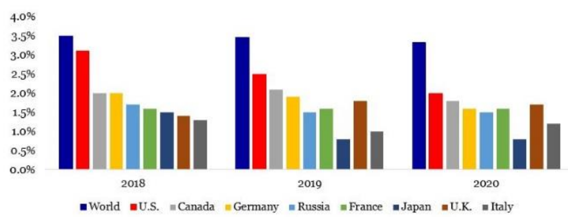
U.S. Real GDP registered very strong +4.2% quarter-over-quarter growth (+2.9% year-over-year growth) in the second calendar quarter of 2018. Third-quarter estimates for GDP growth are quite robust, with a +4.1% quarter-over-quarter forecast from the Federal Reserve Bank of Atlanta, for example.

Since late 2016, economic growth in the United States has been accelerating, in part due to the prospect of lower corporate and individual income tax rates. Employment growth has been steady, as the civilian unemployment rate declined to 3.7% in September, the lowest level since December 1969.

Wage growth, which has been slow to pick up despite the strong gains in employment, came in at a 2.8% annual increase in September. With hiring now running ahead of growth in the labor force, we would expect to see an acceleration in wages in the months ahead and into 2019.

The graph below depicts the strong forecast for U.S. economic growth (red bar), which lies in contrast to the projected growth rates for other industrialized countries (to the right of the red bar). Projected world GDP growth (dark blue bar at the left) is driven higher by faster projected growth rates in emerging markets.

Real GDP Forecasts
Y/Y %



Source: Strategas Research

Geography Dictates Returns Yet Again

The continued buoyancy of the U.S. economy, and the resulting strength in corporate earnings, created a very favorable environment for domestic equity markets during the most recent quarter.

This is evidenced by the S&P 500 Index, which powered higher by 7.71% during the three-month period, for its best quarterly showing in almost five years. The advance more than doubled the return posted by the Index for the first six months of the year and has the Index higher by 10.56% through the end of September. Of note, the S&P hit an all-time closing high on Sept. 20.

Small-cap stocks, as measured by the Russell 2000 Index, generated a lesser return, advancing 3.58% during the three-month period. However, those stocks had produced outsized returns during the first half of 2018, so the Index of small-cap stocks still finds itself ahead of the

S&P 500 in 2018, with a nine-month return of 11.51%.

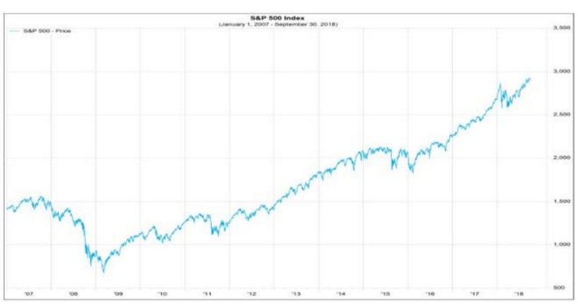
Geography continues to be an extremely important factor when it comes to equity market returns, with non-U.S. markets badly lagging domestic returns. Within the developed markets, the MSCI EAFE Index moved higher by just 1.35% during the quarter, which still leaves the Index in the red (-1.43%) in 2018.

However, those results actually look rather good when compared to emerging markets equities, which declined for the second quarter in a row, albeit at a much-reduced pace from the prior quarter. For the first nine months of 2018, the MSCI EM Index has slumped by -7.68%.

As noted above, the S&P 500 Index closed at an all-time high on Sept. 20, ending the day at 2,930.75. As we approach the ten-year anniversary of its Great Recession closing low of 676.53 (March 9, 2009), it is interesting to step back and look at the aggregate advance in this Index.

The chart below reflects the performance of the S&P 500 Index from the outset of 2007 through the quarter just ended. The chart shows the relative calm of 2007, the storm brought on by the Great Recession, and the sustained recovery since March 2009.

S&P 500 Index:
1/1/2007 through 9/30/2018



Source: FactSet, Inc.

The average annual return for the S&P 500 for this almost 12-year period is over 8.5%. While that is lower than its average over the past 50 years (+10.15%), it is still impressive, given the declines suffered roughly 10 years ago (it lost more than -45% from the beginning of 2007 to the closing low).

Further, while the recent drawdown in stock prices has clearly been painful (the S&P 500 Index was down -4.97% from Oct. 1 through Oct. 12), the average annual returns from the end of 2006 through the close on Oct. 12, 2018, still stand at just under 8.1% per year.

Fixed Income: Higher Yields

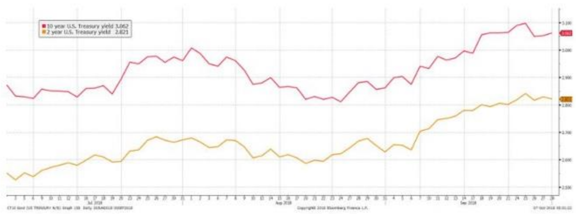
The U.S. Treasury yield curve continued to flatten during the third quarter, as U.S. Treasury yields increased across the yield curve. The two-year and 10-year U.S. Treasury yields jumped 29 basis points (0.29%) and 20 basis points (0.20%), respectively, and ended the quarter at 2.82% and 3.06%. Short-term U.S. Treasury yields have been moving higher, coinciding with the rising federal funds target range.

The U.S. Federal Reserve (the Fed) raised the target range 25 basis points (0.25%) at the Sept. 25-26 FOMC meeting to a range of 2.00% to 2.25%. It also revised higher its economic growth outlook in 2018 from 2.8% to 3.1%.

During the post-meeting press conference, Fed Chairman Jerome Powell provided an upbeat assessment of the U.S. economy and indicated that he expects the Fed will continue to gradually raise the target range over the next couple of years.

Investor expectations for higher interest rates, combined with subdued inflation, led to an additional 9 basis points (0.09%) of curve flattening this past quarter (the curve is the difference between the two-year and 10-year U.S. Treasury yields).

Two-Year U.S. Treasury Yield (Gold Line) and 10-Year U.S. Treasury Yield (Red Line): 7/2/2018 through 9/28/2018



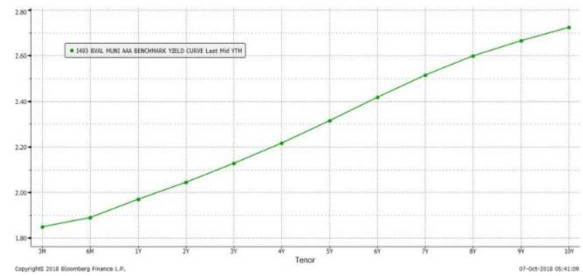
Source: Bloomberg Finance L.P.

Interestingly, inflation expectations have remained well anchored to the Fed's inflation objective of 2.0% annualized inflation. Ten-year breakeven yields, a common reference for inflation expectations that refers to annualized expected inflation over a 10-year time period, ended the quarter at 2.15%, modestly above the Fed's target level. Low inflation expectations have contributed to the flattening of the yield curve.

In the third quarter, the Bloomberg Barclays U.S. Intermediate Government Credit Index increased a modest 21 basis points (0.21%). Investors favored U.S. corporate bonds over U.S. government securities, as risk aversion subsided. U.S. credit returned 0.73% during the quarter, while U.S. government securities ended the period down -0.11%. Overall, credit spreads tightened during the quarter.

Regarding the tax-free market, municipal bonds ended the quarter in the red, with the Bloomberg Barclays Municipal Aa+ 1-10Yr Index dropping 15 basis points (0.15%). Municipal bond yields increased across the yield curve, although the shape of the curve (two-year through 10-year) remained steeper relative to U.S. Treasury yields. The difference between the 10-year and two-year BVAL Municipal Bond AAA yields was roughly 65 basis points (0.65%).

BVAL Municipal Bond AAA Benchmark Curve As of 10/5/2018



Source: Bloomberg Finance L.P.

As we enter the final leg of the year, we see value in short to intermediate maturities with a bias toward credit. Current economic growth should continue to support corporate bonds, while expected higher interest rates lead us to a more cautious view on duration risk.

Challenges of Late Business Cycle Investing and Our Outlook Going Forward

As the business cycle matures and economic data pertaining to the labor market, business confidence, consumer spending, and aggregate demand for products and services continues to show no visible signs of abating, we often are asked, "Is this as good as it gets? What's next for the financial markets?"

We keep these questions front of mind and do wonder whether the recent surge in economic activity and corporate profits places them at, or close to, peak levels. In other words, when will financial markets, especially those tied to higher-risk assets (i.e., stocks), start reflecting a less sanguine macroeconomic environment?

While no business or market cycle perfectly replicates those of prior periods, we do take comfort in the fact that some conditions that have preceded the last eight recessions are not currently in place. For example, we have yet to see a sustained rise in high-yield bond spreads or an inverted yield curve (both of which would indicate tighter credit conditions), falling corporate profit margins, elevated inflation levels, deceleration in The Conference Board Leading Economic Index, or plummeting consumer confidence.

Although we would not assign a high probability of a recession over the next six to 12 months, we would not be surprised to see stock market volatility rise as equities adjust to an environment of higher interest rates, or to see prices rise as the effects of tariff and trade-war rhetoric weigh on company outlooks.

Late January 2018 marked the end of a period of nearly 400 trading days when the market did not decline more than 5%. That was one of the least volatile market environments in the last 60 years.

Since that time, even though U.S. stocks have risen thus far this year, we have already had one 10% correction during the first quarter of 2018, with the first two weeks of the fourth quarter witnessing a 4.97% pullback from third-quarter-end levels.

While we are optimistic about the economy and still think equities are more attractive than bonds, we cannot overstate the diversification benefits of high-quality fixed income securities, especially for investors who have greater sensitivity to market volatility.

Ernest E. Cecilia, CFA
Chief Investment Officer
610.254.2030 | ececilia@bmtc.com

Andrew G. Keefer, CFA, CFP®
Director of Equity Research
717.520.5684 | akeefer@bmtc.com

James T. Barnes, CFA, CIPM
Director of Fixed Income
610.254.2012 | jbarnes@bmtc.com

Anthony G. Natale, CFA
Director of Strategic Research
610.254.2005 | anatale@bmtc.com

BMT Wealth Management
bmtc.com/wealth