To Our Clients and Friends:

We are pleased to bring you our report for the third quarter of 2018.

While the markets have struggled a bit during the first few days of October, let’s not forget that the S&P 500 just had its best quarter since 2013, so a little consolidation and profit-taking is not a big surprise. The widely followed index of the 500 largest U.S. companies soared 7.7%, is now up 10.5% for the year and almost 18% over the last 12 months. The MSCI World ex-USA Index (including dividends) had a modest gain of 1.4% for the quarter, but not enough to overcome its loss for 2018, which now stands at -1.4%. Bonds (along with many interest-rate sensitive stocks) were a victim of rising short-term interest rates. The Bloomberg Barclays U.S. Aggregate Bond Index posted flat returns for the quarter and is down -1.6% year-to-date and -1.22% over the last 12 months, respectively.

So does a blockbuster quarter, sensational news headlines and the fact we are now in October mean that the market retreats over the past couple of days are going to continue? There is a lot of noise in the media these days – even more than normal it seems – much of which the media wants you to worry about (after all, bad news sells, as the saying goes). We are not “selling” anything but perspective, so it is important that things that never make it to the media are brought out for your consideration.

Let’s first recall a few basics: Equity market returns are based on earnings. Earnings are based on revenues and expenses, including interest payments. Revenues are a function of demand and prices. Companies need workers to generate revenues and must pay competitive wages to attract and retain them. Companies typically pay out a portion of their earnings to shareholders. How much is paid out is what makes stocks more or less attractive when compared to other investments. Let’s take a look at one of these factors in light of the current (and anticipated) state of the economy and what the media is saying about both.

**Interest rates.** Short term interest rates are set by the Federal Reserve. The Fed recently made good on its stated intent to continue to raise interest rates to more “normal” levels and indicated that it is prepared to keep raising them until its employment and inflation targets are reached. Higher rates raise the cost of doing business, encourage saving (vs. spending) and are designed to cool off what is seen as a robust – and perhaps overheating - economy. If the Fed raises rates too much and too fast, such that it significantly raises the cost of doing business, market returns over such a short period, whatever month it happens to be.

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1 One particular exception to this trend is utilities, which have been surging of late, perhaps indicative of a so-called “flight to quality”.

2 The so-called “October Effect” is a theory that stocks tend to decline during the month of October. The effect is considered mainly to be a psychological expectation rather than an actual phenomenon as most statistics go against the theory, despite some significant historical stock market events having happened in October. We discourage anyone from focusing on equity

3 The U.S. Federal Reserve was created in 1913 to set monetary policy. One of its key mandates is to “maintain orderly economic growth and price stability” through the (usually) positively correlated variables of employment and inflation.

4 The U.S. economy grew at a brisk 4.2% pace in the second quarter, the fastest in nearly 4 years. The Atlanta Federal Reserve is forecasting 3rd quarter GDP growth of 4.1%.
earnings – and stock prices – will be adversely affected. Furthermore, higher rates make relatively high equity market valuations harder to justify and have the potential to make fixed income securities relatively attractive when compared to equities. Reduced demand for equities means lower prices, all else being equal. Despite a few dire and well-aired predictions, we believe that the Fed is very aware of the impact its decisions have on the markets and, while avoiding market disruption is not one of its stated goals, we believe that it will move gradually and predictably, two things the markets are looking for. While it is of course possible the Fed will over-hike, we do not think it will suffocate the U.S. economy by tightening too much or too fast. And, now that it has raised the Fed Funds Rate from essentially 0% to 2.25%, there is room to lower rates if and when the economy shows signs of distress.

Unemployment. Today the DOL’s Bureau of Labor Statistics announced that September nonfarm payroll employment increased by 134,000, and that the unemployment rate dropped to 3.7%, the lowest level since 1969. While job growth missed expectations (185,000) many believe that the severe weather experienced by much of the country explains at least some of the shortfall. Low unemployment has the potential for wage inflation, which would raise the cost of doing business and theoretically reduce earnings and payouts. So far, however, significant wage growth has been absent. Provided wage growth does not heat up to the point where it significantly affects earnings, what is essentially “full employment” means that robust economy has more room to run.

Trade. Tariffs have garnered a lot of headline space lately. Tariffs are designed to protect the country that imposes them from what it sees as unfair (usually artificially low prices) trade practices of the country on which they are imposed. The news is full of stories about either (a) how high foreign (usually Chinese) imposed tariffs on U.S. produced goods have made them more expensive, have reduced foreign demand and cut into domestic companies’ revenues and/or (b) how U.S. tariffs have increased U.S. companies’ cost of producing goods, either of which can adversely affect profits. What is far less publicized is that (a) the tariffs on Chinese imports represent only about 1% of America’s economy and (b) those tariffs are effectively a tax of ~13% of the affected imports, meaning the actual impact on the U.S. economy is only about 0.17% of GDP. What is also rarely noted is that the U.S. has recently agreed to new trading terms with Canada and Mexico, the U.S.’s second and third largest trading partners, which together make up almost ½ of all U.S. trade. Also lost in the noise is the fact that with China, exports are only ~¾ of total trade, whereas with Canada and Mexico (and our 4th and 5th largest trading partners, Japan and Germany), exports are closer to ½.

How these and other factors are going to play out and ultimately impact the equity markets is anyone’s guess. However, based on what we know now, despite some yellow flags, there has been solid economic and earnings data and signs that both should generally continue. With the 3rd quarter marking more than 115 months of generally rising stock prices, the longest bull market in history, it is easy to be tempted by complacency, which must be avoided. Do a self-examination – try to gain and keep

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5 Also recall that the DOL has a history of “revising” prior month’s jobs figures the following month, sometimes significantly. August’s job gains were recently revised upward by 69,000, 1/3 higher than initially reported!

6 September year over year wage growth was approximately 2.8%, according to Yahoo Finance.


8 But not by much: Total trade with China in 2017 was ~$700 billion, while Canada and Mexico were right behind at $6.8 billion and $6.2 billion, respectively. Source: FactSet.

9 Id.
a good dose of perspective and rationality, and call us if you need help with either.

On a personal note, we welcome Laura Corbiani, CFP® to MCA. Laura joined us this summer. She brings years of financial and investment services to the team. Laura’s focus will be advising and assisting with both retirement plans and wealth management clients. We look forward to introducing you to Laura in person.

Laura Corbiani, CFP®

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