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Forza Investment Advisory, LLC

Strengthening Our Clients' Financial Lives

FROM THE DESK OF BOB CENTRELLA, CFA: ***October 5, 2018***

2018 Q3 Summary & Outlook

Well it was an interesting summer weather-wise, news-wise and market-wise. "Why's" that you say? Well the weather was full of rain, heat and humidity. And it seemed like every weekend was rain. The news was full of talk on trade, supreme court nominations, earnings, interest rates and a lot of BS, while the stock market was full of gains generating the best quarterly return in 5 years. Once again, the adage of "Sell in May and Go Away" would have left you a lot poorer if you followed the advice. For the 3rd quarter, the US equity market rock and rolled its way to a nice gain as the S&P 500 returned 7.65% (10.36% YTD) and the Dow Jones Average 9.52% (8.5% YTD) estimated total return. But that was the only place to be. International markets weren't as fortunate with the MSCI World index only returning .93% (-3% YTD) while bonds fell as the Barclays Bond Aggregate dropped .09% (-1.75% YTD) as the Fed increased short term rates. Recently the yield on the 10-Yr UST crossed 3% and with this move up in interest rates and the recent market advance, we could be set up for a stock pause near-term and so far in early October stocks are slumping a bit. Hopefully the start of earnings season and some solid numbers will give investors reasons to buy again.

During the quarter, large caps outperformed by a wide margin as the Russell 2000 SmallCap index climbed 3.56% (10.5% YTD) while the S&P 400 Midcap index rose 3.91% (6.3% YTD). This divergence in performance had some interesting implications for portfolio performance. In terms of equity performance for a diversified investor there are really 4 major types of investment categories that make up a portfolio – Large Cap, Mid-Cap, Small-Cap and International. There are many sub-categories of these but those are the 4 major ones. Generally, an investor will hold some of each of those major categories to diversify risk, with Large cap being the biggest portion in a typical portfolio. So, for the quarter (and YTD) a diversified portfolio returned less than a large cap portfolio which held only the S&P 500 or the Dow stocks as investors crowd into large caps.

Below is a list of major asset classes and their price change (not total return) for Q3.

Asset Class	***Q2-18 %***	***Asset Class***	***Q2-18 %***
Dow Transports	10.00%	Stoxx 600 EU	.86%
DJIA (Dow)	9.01	Euro Stoxx	.36
Nasdaq 100	8.33	Corp Bond	.31
Nikkei 225	8.14	S&P RE	-.02
S&P 500	7.20	Vang Intl Bond	-.31
Nasdaq Composite	7.14	German DAX	-.48
Swiss Market	5.56	Vang Tot Bond	-.62
SmallCap 600	4.38	Nymex Crude Oil	-1.21
S&P Midcap 400	3.48	FTSE 100	-1.66
Russell 2000	3.26	20yr UST	-3.66
CAC 40 (France)	3.19	MIB (Italy)	-4.23
Nat Gas	2.87	Gold	-4.78
WSJ Dollar index	1.90	Coffee	-8.12
Hi Yield Cp Bond	1.60	Lean Hogs	-24.98
Taiwan	1.56	Argentine Peso	-29.93

In the 3rd quarter, large cap stocks ruled as Apple rose 22% and became the first $1 Trillion market cap company. Amazon, not to be outdone briefly rose above $1 Trillion as well but finished the quarter with a gain of 17.8% and just under the magic number. Microsoft rose 16% and is closing in on $900 Billion cap while Alphabet (Google) "only" rose about 7%. Other FAANG stocks, Facebook and Netflix actually declined -15% and -4.4%. Among sectors Healthcare stocks led the quarter rising 13% overall as consistent earnings and attractive valuations garnered investors to buy the group. Industrials rose 7.6%, Services +6.2%, Consumer Goods +4.8% and Technology +4.6%. Weaker sectors included Utilities (+.7%) as rates rose, Materials/Energy +3.2% and Financials +3.5%. So, looking at sector performance you can see that S&P and Dow gains were driven by a concentrated number of large stocks.

STOCKS – THE NEW WALL OF WORRY

As an investor, we like good news as it tends to drive stocks higher. But there is always an ever-changing "wall of worry" that investors fret about and generally puts pressure on stocks until it is embedded in investors' minds and forward thinking. So here is what I consider the current wall of worry or market headwinds we face going forward:

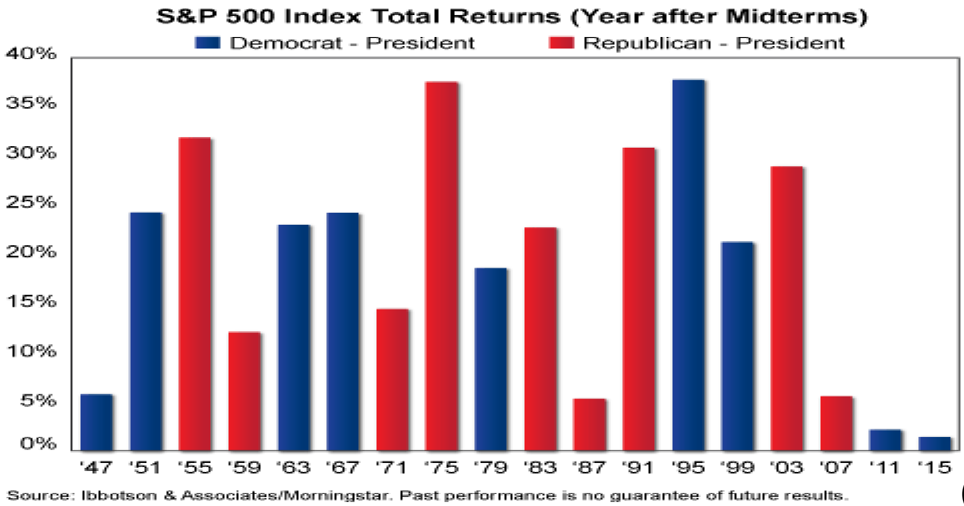
- Interest rates are moving higher as the Fed raised rates for the 3rd time this year and signaled more to come. The 10-yr UST crossed 3% and seems there to stay.
- The Fed is unwinding its balance sheet allowing $50 Billion a month to roll off further pressuring bond yields
- Earnings gains are peaking but as I show below the comps are getting tougher. Q3 earnings season is about to start in earnest and October generally brings a bumpy road for stocks
- The midterm election brings political uncertainty (see chart on following page)
- On the trade front we got some positive news with the new Canada/Mexico/US agreement, but tariffs are still a concern and China and Europe deals need to be done
- Italy's budget deficit projection is worrisome to the EU and there is also gaining talk of an Italian exit from the Euro. (Italian word for exit is Uscita - pronounced "ooh-sheetah"). So that would be an O-Scita!

Speaking of earnings, Q3 earnings announcements are about to start this week and for the next several. Earnings have been very strong due to the corporate tax cuts and a vibrant economy. GDP growth was 2.2% in Q1, 4.2% in Q2, and Q3 is estimated at 4.4%. The economy is humming! This has helped earnings rise to the tune of 25% in both Q1 and Q2 with Q3 estimated at 20% and Q4 at 17.5%. However, in 2019 the comparisons get dicey and earnings growth drops to a more normalized rate of 7.2% in Q1 and 7.5% in Q2. This deceleration in earnings growth could certainly limit stock gains as the market tends to grow with earnings (especially if interest rates continue to rise). These tough year-over-year comps will be the talk of strategists, economists and investors as we head to 2019. It's still early to project expectations for 2019 but market gains similar to earnings gains is a good start.

In terms of valuation the S&P 500 12-month forward PE ratio (Price to Earnings) is 16.7x compared to the 5-yr historical average of 16.3 and the 10-year average of 14.5. Because earnings have risen 25% the last 2 quarters, the market is actually cheaper than it was at the start of the year when stocks sold at 18.5x forward earnings even though the S&P is up about 10% through September. So, I think overall valuation is still at an attractive level.

Although the strategy has underperformed somewhat in the first 9-months due to the previously discussed concentrated gains, I continue to like a diversified approach to investing for the long term. I recommend exposure to most sectors and prefer healthcare, technology, services and financials along with some consumer goods and industrial stocks. I'd be underweight energy, utilities and REITS. On the oil front, the price of WTI has risen to $75ish in a range of $70-$76 for now. Energy stocks have traded with oil and will likely continue to do so and be volatile. Finally, I continue to like Mid and Small cap stocks as part of a portfolio although they too are sensitive to rising rates.

Regarding the midterm election and stocks, here is an interesting chart:



(R='55,59,71,75,83,87,91,03,07)

As indicated above, <u>the S&P has generated a positive return in 18 of the last 18 midterm elections</u> the calendar year following. The average gain was 19.13% while the range was 1.38% to 37.43%. So, the smart money would say that stocks should be up in 2019, and they could be up double digits.

BONDS

The Fed recently raised rates for the 3rd time this year and odds are that a fourth may occur in December as well as several more in 2019. This has finally caused the 10-year UST yield to rise above 3%, something I've been predicting for about 3 years now! The 10-year bond now yields about 3.25%, highest since 2011. This compares to the yield on the S&P 500 of about 1.85%. All of a sudden, the yield difference between the two is more material, a higher hurdle rate for stocks. The 30-year bond also has moved closer to 3.5% yield. In prior letters I've talked about how these rates are still ridiculously low compared to history with a 10-year UST never experiencing a 3% yield until the last 10 years. But there is a new horde of young money managers that never before experienced rising markets with 3%+ treasury bond yields. So, this "dance" will occur over the next year as these younger managers get used to the somewhat higher bond yields and adjust their thinking. Us seasoned managers have "been there done that", so our job is to educate these youngsters that the market doesn't crash because bond yields are above 3%! I mean really, a 3% return over 10 years is not very enticing. Having said that, this shouldn't be taken lightly, and we still need solid earnings to help drive stocks higher. If the 10-yr establishes a new trading range of 3.1%-3.3%, then this should be absorbed by investors in due time. I do think that if the 10-yr were to move to above 3.5%, this could be tougher for stocks moving forward.

In terms of bond strategy, I continue to remain cautious on owning any bonds beyond a few years maturity and favor owning bonds less than a year and reinvesting as they mature. With yields above 2% on 1-yr paper and rates still rising, I prefer these short-term bonds and would stay away from longer maturity bonds and from passively managed long-term bond funds. But next year there could be some interesting investment choices if rates continue to rise. Floating rate bonds are also attractive as rates reset higher.

INTERNATIONAL

The ex-US economy is growing but not as fast as the US and there are pockets of weakness. The trade deal with Mexico and Canada has taken some of the tension away in North America but now all eyes are on what happens with Europe and especially China. China's economic growth has "slowed" to 6-7% which although still strong compared to elsewhere it is a deceleration. China stocks are in a bear market as fears of a trade war with the US is in play unless China comes to the table. In Europe, Italy is garnering all the attention and not for its art, great wines and food. Italian bond yields are spiking to the highest level in 4 years as the new government has declared it will borrow more for 2 years and the deficit is likely to rise. Europe policymakers are not happy and a fear is rising that it could cause problems for the country's banks and renew financial strains in the eurozone. Although fears of Italy leaving the EU appear overblown, the Italian political situation is unstable, the economy has been stuck at very low/no growth and something needs to be done.

Regarding foreign stocks, emerging markets have gotten whacked due to higher rates and a stronger dollar. Elsewhere, global stocks have been underperforming vs the US. Very few are up YTD with the Japan Nikkei's 6% gain being one of the stronger. I continue to be cautious near-term but still recommend some exposure to international stocks. I again limit emerging market exposure though as these stocks are sensitive to US interest rates and the dollar.

ECONOMY

As mentioned earlier the US economy is expected to have grown 4.4% in Q3. Unemployment is now at 3.7%, the lowest since 1969 and employers are actually having a hard time filling positions with qualified workers although the participation rate remained at 62.7%. The ISM Manufacturing index is near a 14-month high at 59.8 (50 means positive growth) and the Service index is at a 20 year high at 61.6, the 2nd highest level ever. Wages are rising and disposable income is up 5.3% the past year. On the inflation front, core inflation is up about 2% the past year, right at the fed's target. The only somewhat weak spot is on the housing front. The rise in rates may be having an effect on home sales as they have declined slightly, and new permits are also down a bit from previous month. However, new home sales for the first 8 months of the year are up 6.8%. Love him or hate him, Trump has this economy humming.

The Fed raised rates for a 3rd time this year in September and could raise again in December. Chairman Powell indicated that monetary policy was still accommodative and should at least be neutral. As such, expectations are for another 3-4 hikes next year. If that happens, then we should see higher rates across the yield curve – or there will be a severe inversion. An inversion would certainly not be good for Financial stocks or the market. And higher rates again must be absorbed by investors as bonds get compared to stocks. Higher rates could also raise borrowing costs for companies. If for instance there are another .75% of moves next year and the 10-year UST rises to near 4%, then I can certainly see stocks having a harder time moving significantly higher unless earnings growth is still near 10%.

SUMMARY & OUTLOOK

In summary, we still prefer equities over bonds but think a slight pause over the recent wall of worry is occurring. This is typical when there is a void of earnings news similar to what we are in right now. But that could change in a few days. All attention will be focused on what companies report and say. One potential earnings headwind is currency. The stronger dollar may cause companies to adjust forward guidance downward.

Forza's recommendation remains consistent with how we started the year – we still like equities, are cautious on bonds but would maintain both in the overall allocation of assets for balanced portfolios. On a fundamental basis, we prefer equities to bonds and would have limited exposure to international stocks. Post-election, I am a little concerned if Democrats win both House and Senate. This is not baked into stocks and would cause a short-term selloff in my opinion. I think investors are prepared for a split in House and Senate. I would get more cautious on equities if this occurs as talk of impeachment and a rollback of tax reform and regulations could cause a big downturn in equities and more focus on negative than positive. Eventually this would pass but it would still cause me to rethink allocation for 2019-2020.

Fee free to give a call to discuss. Enjoy the Fall!

Bob