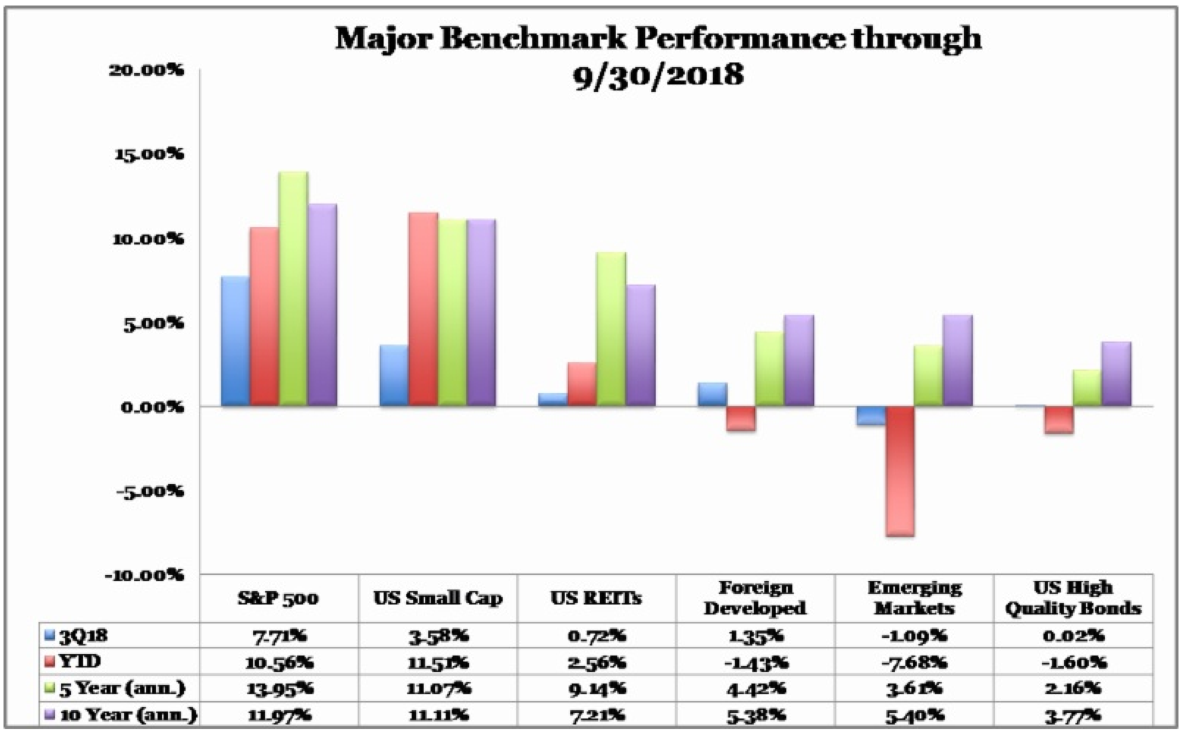
integral financial solutions

2018 Third Quarter Market Outlook

After a very rocky first half of 2018, the US equity market picked up steam in the 3rd quarter, hitting multiple highs. This is noteworthy, considering we are over 9 years into the current expansion.

Diversified portfolios benefited from strong US equity exposure, but it was not across the board. The bulk of the positive performance came from the Technology and Healthcare sectors. Other sectors were flat to negative. A positive US stock market return was offset by weak bond and international equity performance. We will discuss this in more detail below.



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds
3Q18	7.71%	3.58%	0.72%	1.35%	-1.09%	0.02%
YTD	10.56%	11.51%	2.56%	-1.43%	-7.68%	-1.60%
5 Year (ann.)	13.95%	11.07%	9.14%	4.42%	3.61%	2.16%
10 Year (ann.)	11.97%	11.11%	7.21%	5.38%	5.40%	3.77%

Third Quarter Observations

Despite sunny skies for the US stock market in the 3rd quarter, we continue to worry about tariffs and a looming trade war. Additionally, Brexit is still undecided, and emerging markets struggle while global leaders squabble. *As of 10/11/18, the US stock market has suffered six consecutive days of declines, culminating with the Dow Jones dropping by over 800 points on 10/10 and on its way to end lower on 10/11. Tech stocks have led the drop.*

On a recent call, J.P. Morgan's chief economist provided a good analogy on how we should position our portfolios 9 years into an expansion: *"we should both fix the roof while the sun is still shining AND make hay."[1]* Put another way, we want to profit from markets that are going up, but not put all our eggs in one basket, as a recession will invariably occur at some point in the future. We especially like this advice, as it can be tempting to chase investments that are *currently* doing well and outperforming the market.

While core fixed income (bonds) returns are presently weak, flat performance certainly does not indicate that a bubble has burst. In fact, both corporate bonds and municipal bonds were appreciating until Federal Reserve started raising interest rates in December 2016, at which point returns began to flatten.

Since the Fed expects to raise rates once more in 2018 (and up to three times in 2019), we don't expect bond prices to appreciate until 2020. However, if an investor is in low maturity funds (of the type that IFS favors in our portfolios) with low turnover (i.e. most bonds are held to maturity), they should not be overly concerned with relatively flat bond performance. Once the Fed stops raising rates, not only will investors enjoy higher income, but also increasing market value of the underlying bonds. Additionally, this may all coincide with the start of a recession, when bonds should help act as a safeguard for losses in a portfolio.

Click on this link for a good article from Vanguard on how rising rates affect various investments.

While economic numbers, (especially in the US), continue to be very strong, there is cause for caution. Tax reform is temporarily propping up growth. GDP hit a whopping 4.2% in the past quarter large due to a spike in exports scheduled before the tariffs were due to hit. In the coming quarters, growth is expected to average 3%, partly from tariffs and partly from future effects of the increased deficit.

The role that tariffs may have on future market performance is unclear, but uncertainty has resulted in widespread volatility in world equity markets this past year. Right now, there are potential tariffs on $200B of Chinese imports on a range of products. There is the possibility that President Trump will impose tariffs on all $500B of Chinese goods, which would heighten any such effects on the markets.

The earliest markets to suffer from the tariffs have been international equities (particularly emerging markets). While it's tempting to abandon international stocks, it's important to remember that this asset class handily outperformed US stocks in the 1990's and 2000's. If we maintain a long-term outlook and consider the favorable valuations of international equities, we can justify their inclusion in a diverse portfolio.

Looking Forward

Some clients have asked us "why is my portfolio trailing the tech sector?"
Our clients already have exposure to tech stocks within the mutual funds they own. When the tech sector tanks, as it did in March 2000 (and intermittently since then), our clients will be much better positioned to recover, due to diversification. While some tech exposure is OK, we do not believe in chasing returns, (especially so long into what is about to become the longest expansion in US history).

That leads to another question: "Are US equities overvalued?"
We would argue a handful of high-flying tech stocks are. As many of you who own individual tech positions know, we are strongly in favor of paring back those positions to prevent concentrated holdings that will adversely affect your bottom line when there is a market downturn/correction. As of 10/11, we would argue the S&P 500 is not overvalued.

What Are We Doing?

The next question that may come from clients is "what we should do to better position our portfolios?"
With year-end approaching, we are making sure portfolios are as tax efficient as they can possibly be -that means tax loss harvesting and discussing charitable giving, either with cash or appreciated shares. We maintain very tax efficient portfolios, which helps our clients' bottom lines, a fact not widely reported in the financial press.

Last year, many investors in actively managed funds (as opposed to the passive funds that we favor) were hit with significant tax bills (capital gains distributions) that took a significant percentage out of their net returns. Our passive fund distributions continue to be on the low side.

We also urge our clients to maintain a long-term outlook, to visualize their portfolio in different market environments, including recession.

This discussion is tied in with our other services which we discuss below.

Comprehensive Financial Planning and Investment Management

We use conservative assumptions in financial plans to allow for flat or negative market environments. You may hear friends /colleagues brag about how their tech-heavy portfolios are outperforming this year (although definitely not this week), but bear this in mind: this market in many ways is reminiscent of the late ‘90’s when a few tech companies were outperforming. Many of those same tech companies, having lost value precipitously, have yet to re-reach their March 2000 highs.

We very much represent the tortoise (vs. the hare) in our approach, as we have encountered too many undiversified hare portfolios that have yet to recover from either 2000 or 2008.

We will be reaching out to our clients in the coming months but encourage any of you to contact us any time.

Janet and Barry

[1] https://www.businessinsider.com/stocks-how-you-can-prepare-for-next-bear-market-2018-9

Sources: Dimensional Fund Advisors (DFA), PIMCO, JP Morgan, Morningstar, New York Times, Schwab, Vanguard, Wall Street Journal.
