HIGHTOWER
WESTCHESTER

Q3 2018 Market Commentary

The third quarter proved to be strong for domestic stocks with the major benchmark indices showing robust gains, led by the large cap stocks of the Dow Jones Industrial Average and the S&P 500. The technology-heavy Nasdaq continued its strong showing while the small cap stocks of the Russell 2000 posted moderate quarterly gains. Corporate earnings continued to soar on the heels of corporate tax cuts, consumer spending, and global growth. These factors were enough to quell investor concerns over the continuing saga that is the back-and-forth trade tariffs between the United States (U.S.) and China, but for how long?

Toward the end of September, a new round of reciprocal tariffs between the U.S. and China kicked in as it appears neither economic giant is ready to give in to the other. The U.S. imposed an additional $200 billion in tariffs on Chinese goods, prompting China to assess $60 billion worth of tariffs on U.S. products. This follows each country's initial volley of $50 billion in tariffs on their respective imports. As a result, the benchmark indexes produced a mixed bag of returns for the month.

Prices for 10-year Treasury bonds dropped by the end of the quarter, pushing yields higher by 0.20% to 3.05%. Brent Crude oil prices continued their push higher and closed the quarter at about $82.72 per barrel by the end of September, $5.28 per barrel higher than the price at the close of the second quarter.[1] Gold closed the quarter at roughly $1,195, noticeably lower than its $1,254 price at the end of June.[1]

In September, U.S. consumer confidence hit its highest level since 2000, while the monthly average of initial jobless claims fell to the lowest level since 1969.[1] Wage growth rose to the highest level since 2009, supporting retail sales growth of over 7% year on year.[1] Also, the National Federation of Independent Business's survey showed that small businesses were the most optimistic they've been since the survey began in 1974. Against this remarkably strong growth backdrop it's not surprising that U.S. equities have delivered attractive returns.

New home sales declined in July for the third time in four months. They are now at their slowest pace since October 2017.[2] According to the National Association of Home Builders Housing Market Index, "builders face headwinds from softening demand, especially in the sales expectation and traffic of prospective buyer's components. In addition, pricing to cover material and labor cost increases has been challenging." The median sale price of a single-family home is up 6.3% year-over-year while there has been a 0.67% rise in mortgage rates over the one-year period. [2] With existing home prices continuing to outpace income growth, real estate began to subtract from overall growth in the third quarter.

Inflationary pressures have remained weak while consumer spending continues to be strong. Prices for consumer goods and services rose only 0.1% in August, the same mark reached in July.[1] Core consumer prices, a tracker of inflationary trends, showed no increase following July's 0.2% gain.[1] Core prices (excluding food and energy) have increased 2.0% over the last 12 months.[1]

ASSET CLASS AND STYLE RETURNS IN LOCAL CURRENCY

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	3Q 2018
MSCI EM 33.6%	Global Agg 4.8%	MSCI EM 62.8%	REITS 27.6%	REITS 7.3%	REITS 20.1%	Small cap 35.8%	REITS 27.1%	Growth 6.5%	Value 15.1%	MSCI EM 31.0%	Growth 11.8%	Growth 6.2%
Cmdty 16.2%	Cmdty -35.6%	Small cap 40.8%	Small cap 24.4%	Global Agg 5.6%	Small cap 18.4%	Value 29.7%	Growth 11.5%	Small cap 2.8%	Small cap 14.5%	Growth 24.5%	DM Equities 7.1%	DM Equities 5.4%
Growth 10.5%	REITS -37.3%	Growth 29.4%	Cmdty 16.8%	Value -4.9%	MSCI EM 17.4%	DM Equities 29.6%	DM Equities 10.4%	DM Equities 2.6%	Cmdty 11.8%	Small cap 19.1%	Small cap 6.4%	Value 4.6%
Global Agg 9.5%	Value -37.7%	REITS 27.4%	MSCI EM 14.4%	DM Equities -5.0%	Growth 16.5%	Growth 29.5%	Value 9.2%	REITS 2.3%	MSCI EM 10.1%	DM Equities 19.1%	Value 2.3%	Small cap 2.5%
DM Equities 5.2%	DM Equities -38.3%	DM Equities 26.5%	Growth 12.7%	Growth -5.1%	DM Equities 16.4%	MSCI EM 3.8%	Small cap 6.7%	Value -1.2%	DM Equities 9.6%	Value 14.1%	REITs 1.8%	REITs 0.7%
Value -0.0%	Growth -39.0%	Value 23.6%	DM Equities 10.6%	Small cap -8.7%	Value 16.3%	REITS 3.2%	MSCI EM 5.6%	Global Agg -3.2%	REITs 9.3%	REITs 9.3%	Cmdty -2.0%	MSCI EM 0.1%
Small cap -3.8%	Small cap -40.4%	Cmdty 18.9%	Value 8.4%	MSCI EM -12.5%	Global Agg 4.3%	Global Agg -2.6%	Global Agg 0.6%	MSCI EM -5.4%	Growth 4.4%	Global Agg 7.4%	Global Agg -2.4%	Global Agg -0.9%
REITS -17.8%	MSCI EM -45.7%	Global Agg 6.9%	Global Agg 5.5%	Cmdty -13.3%	Cmdty -1.1%	Cmdty -9.5%	Cmdty -17.0%	Cmdty -24.7%	Global Agg 2.1%	Cmdty 1.7%	MSCI EM -2.6%	Cmdty -2.0%

Source: Barclays, Bloomberg, FactSet, FTSE, MSCI, J.P. Morgan Asset Management. DM Equities: MSCI World; REITs: FTSE NAREIT All REITs; Cmdty: Bloomberg UBS Commodity Index; Global Agg: Barclays Global Aggregate; Growth: MSCI World Growth; Value: MSCI World Value; Small cap: MSCI World Small Cap. All indices are total return in local currency. Data as of 30 September 2018.

Emerging market (EM) equities have been weighed down by a slowdown in the pace of Chinese credit growth, fears over the vulnerability of some economies to tighter U.S. monetary policy and concerns about the potential impact of global trade tensions. China has successfully slowed the pace of non-bank credit growth but, faced with the external headwind of U.S. tariffs, the authorities are now easing policy to support domestic growth, while maintaining regulatory pressure on shadow lending. This should provide some support for those EM countries that depend on Chinese demand.

On the other hand, the EM economies that are most reliant on external funding are finding the tightening in U.S. monetary policy challenging. As the Federal Reserve (Fed) continues to raise rates and unwind its balance sheet, EM countries with large dollar-denominated debts and significant, or widening, current account or fiscal deficits may continue to struggle. Higher oil prices are not helpful in this context for those EM economies that are large oil importers, particularly those whose currencies have fallen sharply, further increasing the cost of imports in local currency terms. The tightening in interest rates that some economies have been forced into to defend their currencies and control inflation will prove a drag on growth.

UK equities have been hurt by fears of a no-deal Brexit. Interestingly, the inverse correlation between the pound and UK equities has broken down recently. Perhaps, as the deadline for a deal edges closer, investors are becoming less willing to view the possibility of a no-deal Brexit as a positive for the stock market, even with the sterling weakness that would accompany such an outcome.

WORLD STOCK MARKET RETURNS IN LOCAL CURRENCY

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	3Q 2018
MSCI Asia ex Japan 38.0%	UK FTSE 100 -28.3%	MSCI Asia ex Japan 67.2%	MSCI Asia ex Japan 15.6%	US S&P 500 2.1%	Japan TOPIX 20.9%	Japan TOPIX 54.4%	US S&P 500 13.7%	Japan TOPIX 12.1%	UK FTSE 100 19.1%	MSCI Asia ex Japan 35.9%	US S&P 500 10.6%	US S&P 500 7.7%
MSCI EM 33.6%	US S&P 500 -37.0%	MSCI EM 62.8%	US S&P 500 15.1%	UK FTSE 100 -2.2%	MSCI Europe ex UK 20.0%	US S&P 500 32.4%	Japan TOPIX 10.3%	MSCI Europe ex UK 9.1%	US S&P 500 12.0%	MSCI EM 31.0%	Japan TOPIX 2.0%	Japan TOPIX 5.9%
UK FTSE 100 7.4%	Japan TOPIX -40.6%	MSCI Europe ex UK 29.0%	MSCI EM 14.4%	MSCI Europe ex UK -12.1%	MSCI Asia ex Japan 19.7%	MSCI Europe ex UK 24.2%	MSCI Asia ex Japan 7.7%	US S&P 500 1.4%	MSCI EM 10.1%	Japan TOPIX 22.2%	MSCI Europe ex UK 1.4%	MSCI Europe ex UK 1.9%
MSCI Europe ex UK 6.6%	MSCI Europe ex UK -42.7%	UK FTSE 100 27.3%	UK FTSE 100 12.6%	MSCI EM -12.5%	MSCI EM 17.4%	UK FTSE 100 18.7%	MSCI Europe ex UK 7.4%	UK FTSE 100 -1.3%	MSCI Asia ex Japan 6.4%	US S&P 500 21.8%	UK FTSE 100 1.0%	MSCI EM 0.1%
US S&P 500 5.5%	MSCI EM -45.7%	US S&P 500 26.5%	MSCI Europe ex UK 5.1%	MSCI Asia ex Japan -14.6%	US S&P 500 16.0%	MSCI Asia ex Japan 6.2%	MSCI EM 5.6%	MSCI Asia ex Japan -5.3%	MSCI Europe ex UK 3.2%	MSCI Europe ex UK 14.5%	MSCI EM -2.6%	UK FTSE 100 -0.7%
Japan TOPIX -11.1%	MSCI Asia ex Japan -47.7%	Japan TOPIX 7.6%	Japan TOPIX 1.0%	Japan TOPIX -17.0%	UK FTSE 100 10.0%	MSCI EM 3.8%	UK FTSE 100 0.7%	MSCI EM -5.4%	Japan TOPIX 0.3%	UK FTSE 100 11.9%	MSCI Asia ex Japan -3.5%	MSCI Asia ex Japan -0.9%

Source: FactSet, FTSE, MSCI, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. All indices are total return in local currency. Data as of 30 September 2018.

Fixed income returns have been uninspiring, with high yield credit outperforming government bonds. Against a backdrop of strong growth, rising inflation and rising interest rates in the U.S., it is notable that, while unexciting, fixed income returns haven't been as bad as some might have predicted. Year to date, EM debt has been the clear underperformer although it should be noted that the worst performing EM credits make up a small part of the index. Looking ahead, we believe investors should focus on liquidity within fixed income markets and be aware of elevated leverage in U.S. investment grade credit.

The Federal Open Market Committee met in late September and raised the target rate range 0.25% to 2.00%-2.25%. This is the highest rate since April 2008. There is also the likelihood that another 0.25% increase is on tap for December, with the possibility of three more hikes coming next year.

Municipal bond supply rebounded to $32.6 billion in August, which represents a 20% increase from July and one of the highest issuance months of 2018. It is important to note that new-money issuance volume has increased significantly as a proportion of total issuance. Despite the higher month-over-month supply figure, year-to-date issuance of $224.6 billion is still 15% lower than the same period in 2017.

FIXED INCOME SECTOR RETURNS IN LOCAL CURRENCY

2011	2012	2013	2014	2015	2016	2017	YTD	3Q 2018
IL 10.2%	Euro HY 23.3%	Euro HY 8.8%	Euro Treas. 13.1%	Euro Treas. 1.6%	US HY 17.5%	EM Debt 9.3%	US HY 2.5%	US HY 2.4%
US Treas. 9.8%	EM Debt 18.5%	US HY 7.4%	EM Debt 5.5%	EM Debt 1.2%	EM Debt 10.2%	Global IG 9.1%	Euro HY 0.1%	EM Debt 1.9%
EM Debt 8.5%	US HY 15.5%	Euro Treas. 2.2%	Euro HY 5.5%	US Treas. 0.8%	Euro HY 10.1%	IL 8.7%	Euro Treas. -0.5%	Euro HY 1.7%
US HY 4.4%	Global IG 11.2%	Global IG 0.3%	US Treas. 5.1%	Euro HY 0.5%	Global IG 4.3%	US HY 7.5%	US Treas. -1.7%	Global IG 0.4%
Global IG 4.3%	Euro Treas. 11.0%	US Treas. -2.7%	IL 3.4%	Global IG -3.6%	IL 3.9%	Euro HY 6.1%	Global IG -2.8%	US Treas. -0.6%
Euro Treas. 3.4%	IL 8.5%	IL -3.2%	Global IG 3.1%	US HY -4.6%	Euro Treas. 3.2%	US Treas. 2.3%	IL -3.3%	Euro Treas. -1.0%
Euro HY -1.1%	US Treas. 2.0%	EM Debt -6.6%	US HY 2.5%	IL -5.0%	US Treas. 1.0%	Euro Treas. 0.2%	EM Debt -3.5%	IL -1.6%

Source: Barclays, BofA/Merrill Lynch, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. IL: Barclays Global Inflation-Linked; Euro Treas: Barclays Euro Aggregate Government - Treasury; US Treas: Barclays US Aggregate Government - Treasury; Global IG: Barclays Global Aggregate - Corporates; US HY: BofA/Merrill Lynch US HY Constrained; Euro HY: BofA/Merrill Lynch Euro Non-Financial HY Constrained; EM Debt: J.P. Morgan EMBIG. All indices are total return in local currency. Data as of 30 September 2018.

The most obvious near-term risk to the global economy is the potential for a further escalation in trade tariffs emanating from the U.S., and the subsequent retaliation. So far, the U.S. is imposing tariffs on about $250 billion of imports from China, and China has retaliated with tariffs on about $110 billion of U.S. exports to China. The tariff rate is scheduled to increase in January if a deal cannot be reached and an escalation to imposing tariffs on all of China's exports to the U.S. has been threatened. The worst-case scenario could prove a meaningful drag on global growth at the same time as pushing prices higher. However, the trade negotiations haven't been all bad news, with a new NAFTA deal and a cooling in threats to impose tariffs on U.S. auto imports.

The conversation has died down recently, but for a few days the financial news headlines were plentiful with the 10-year anniversary of Lehman Brothers filing for bankruptcy. That fateful day back on September 14, 2008, depending on how you look at it, changed the world, at least for some time. Many would argue that we are still attempting to work our way out of it!

The economy enjoyed robust growth during the second quarter, according to the gross domestic product. Will growth approach 4.0% in the last quarter of the year? If consumer spending continues to expand as it did during the summer months, economic expansion could equal or surpass third-quarter growth rate. Looking ahead, the next earnings season has snuck up on us. Earnings seasons have been wellsprings for the bulls this year and there are probably a lot of investors counting on history repeating itself.

Overall, global growth remains positive but less synchronized than last year. For now, the U.S. stands out as the clear leader in terms of growth. In the near term, the main risk appears to be that the trade conflict will escalate and weigh on business and consumer sentiment. So far there are some signs that this may be happening outside the U.S., but the U.S. itself has remained resilient. The extent to which the U.S. and the rest of the world can withstand the impact of the latest round of tariffs and any further escalation will be key for the outlook and unfortunately remains uncertain.

With that said, increased market volatility is very possible, as has been the case throughout the year. As always, a well-diversified portfolio matched to your risk tolerance remains the best way to meet your financial goals over the long term. Despite plenty of noise emanating from Washington, we continue to stay true to our process of building diversified portfolios around multiple time horizons, while garnering ideas on and off Wall Street. Not everything that we hold as diversifiers will work at any one given time, but we hope that our diversification will pay in times of market turbulence.

To discuss this commentary further, please contact us at 914-825-8630. hightowerwestchester.com

[1] *FactSet financial data and analytics. www.factset.com*

[2] *https://www.embracehomeloans.com/blog/quarterly-real-estate-market-update-q3-2018/*