The Cobblestone Advisor

Investment Brief

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COBBLESTONE
CAPITAL ADVISORS

Surge in Growth Pushes Stocks to New Highs

The third quarter of 2018 saw U.S. stock markets surge to record highs, spurred on by surprisingly strong economic data. U.S. large cap stocks led the way, with the S&P 500 increasing +7.7%. The broader U.S. market is now up +10.6% through September 30th and has rebounded +13.9% from the April 2018 lows. On August 21st, the current bull market, which began in the depths of the 2009 financial crisis, surpassed the bull market of the 1990s to become the longest in history (3,509 days and counting as of this writing).

The economic growth that is fueling this recent market move higher is even stronger than was expected at the start of the year and has far reaching impacts on companies, workers and consumers. When 2018 began, the consensus among economists was that U.S. real GDP growth would be approximately 2% for the full year. While the first quarter reading was around that level at 2.2% year-over-year, the second quarter came in much stronger than expected at 4.2% (the strongest quarter since 2014). Economists now expect that GDP growth was over 3% for the third quarter and have ratcheted up expectations for the full year 2018 to around 3%.The impact of this increase in growth is profound. Corporate profits continue to make new highs, with S&P 500 earnings expected to be up 23% in 2018. Companies, flush with cash, are increasing dividends and stock buybacks as well as spending heavily on both capital investments and human resources. Unemployment hit 3.7% in September, the lowest rate since 1969, and the total number of open jobs continues to exceed the total number of unemployed. At the same time, average hourly earnings for U.S. consumers are growing fast enough to boost consumer spending, but not yet fast enough to be overly concerning as it relates to the potential impact on inflation. As a result, confidence abounds, which can lead to a self-perpetuating cycle of even more hiring and more spending.

Wither Diversification?

While some alternative asset classes—namely private investments and other differentiated, less liquid alternatives—have complemented U.S. stocks and been additive to the overall performance of balanced investment portfolios, more traditional sources of diversification have had the opposite effect recently.

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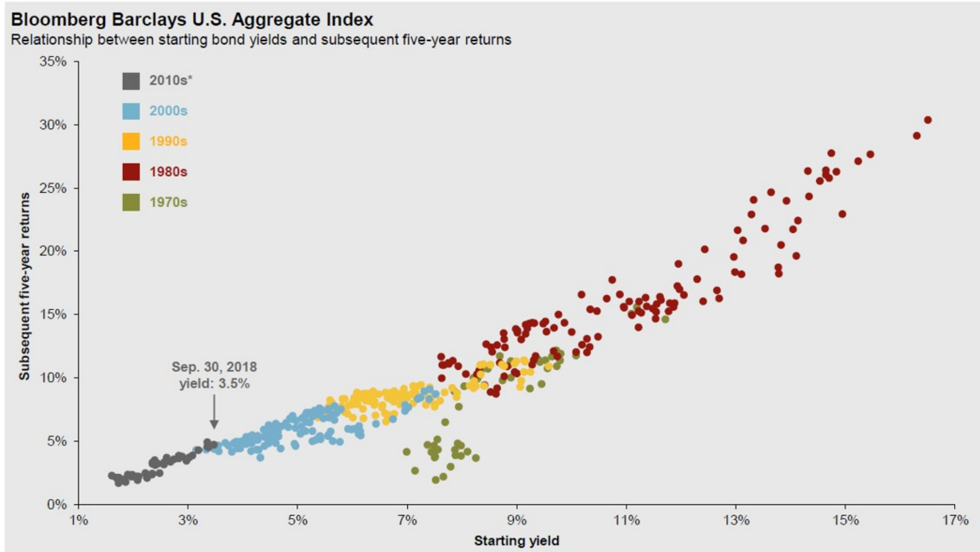
Total Return Ending 9/30/2018				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
MSCI All Country World Index	4.28%	3.83%	9.77%	13.36%	8.64%	8.16%
Russell 3000 Stock Index	7.12%	10.57%	17.58%	17.03%	13.42%	11.97%
S&P 500 Stock Index	7.71%	10.56%	17.91%	17.26%	13.90%	11.93%
Russell 2000 (Small Cap Stocks)	3.58%	11.51%	15.24%	17.07%	11.04%	11.08%
MSCI EAFE (International Stocks)	1.35%	-1.43%	2.74%	9.21%	4.40%	5.36%
MSCI EMF (Emerging Markets)	-1.09%	-7.68%	-0.81%	12.33%	3.60%	5.39%
Barclays US Aggregate Index	0.02%	-1.60%	-1.22%	1.31%	2.15%	3.76%
FTSE NAREIT All Equity REITs	0.50%	1.78%	4.31%	8.94%	9.54%	7.74%
Consumer Price Index			2.7%	1.9%	1.6%	1.5%

International markets continue to lag, primarily emerging market stocks, which were down -1.1% in the third quarter and are now lagging U.S. stocks by over 18% in 2018 (-7.7% vs. +10.6%). Further, as the chart at the bottom of this page shows, the returns of U.S. and international stocks have been diverging for quite some time now. They recovered in lockstep at the beginning of the expansion, but the U.S. markets began to meaningfully outperform in mid-2011.

Higher Bond Yields, Better Future Returns?



Source: Bloomberg Barclays, FactSet, J.P. Morgan Asset Management. *2010s are from January 2010 to September 2013. R^2 for bond yields and subsequent five-year returns is 86%. Past performance is not indicative of comparable future results. *Guide to the Markets – U.S.* Data are as of September 30, 2018.

There are many reasons for this divergence, some of which are clearly geopolitical (most recent examples include the crisis in Turkey and the threat of a trade war with China). However, from a purely economic standpoint, two contributing causes stand out. First, this seven-year period has largely been one in which the U.S. dollar has been strong (up over 25% on a trade-weighted basis). Second, U.S. real GDP growth has outpaced the rest of the world by approximately 1.5% annualized over that period. While these conditions have persisted longer than expected, they should be mean-reverting over time. If so, this divergence likely will reverse.

Likewise, bonds, usually among the most stable asset classes, are down –1.6% through September 30th and are on track to post negative returns for only the fourth year since 1989. Fortunately the math here is a lot simpler. As the chart above shows, one of the strongest predictors of long-term return for bonds is the starting yield of those bonds. So, while rising interest rates may lead to disappointing returns as rates normalize, they are also cause for better expected returns from fixed income in the future.

Unusual Persistence of International Stock Divergence

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

Nobel prize winning economist Harry Markowitz once famously called diversification "the only free lunch in investing". While the recent period has been frustrating in this regard, we have no reason to believe the benefits of diversification no longer apply. So we will remain seated at the lunch counter, patiently waiting for our free meal to arrive.