LPL RESEARCH

MARKET INSIGHT QUARTERLY

October 11 2018

# THIRD QUARTER 2018 IN REVIEW

## STOCKS, RATES RISE AS ECONOMIC GROWTH BOOSTS RISK APPETITE

- **U.S. economy posts fastest growth since 2014.** Gross domestic product (GDP) grew 4.2% in the second quarter, its strongest growth since the third quarter of 2014. The increase in GDP was fueled by a pickup in consumer spending and a surge in exports (ahead of tariffs that were imposed in July). Economists surveyed by Bloomberg expect growth to moderate: Their median projection is for 2.9% GDP growth in 2018, implying a 2.7% growth rate for the second half of the year.

  Third-quarter reports reflected an improving domestic economy and manageable inflationary pressures, even as the impact of tariffs started to creep in. Growth in nonfarm payrolls and an unemployment rate near an 18-year low pointed to a solid labor market, while wage growth climbed to its fastest pace of the cycle in August. Pricing and wage pressures remain relatively subdued (compared to previous tightening cycles), so modestly accelerating wages are a tailwind for spending and growth. Subdued inflationary pressures also reinforce the Federal Reserve's (Fed) approach to gradually raising rates, which was confirmed in the Fed's September meeting. The Institute for Supply Management's Purchasing Managers Index rose to its highest reading of the expansion as an influx of domestic new orders boosted

**1 Q3 2018 AT A GLANCE**

| | Q3 2018 |
|---|---|
| GDP* | 3.0% |
| S&P 500 Index | 7.7% |
| Bloomberg Barclays Aggregate Bond Index | 0.02% |
| Bloomberg Commodity Index | -2.02% |

Source: LPL Research, Bloomberg, FactSet 09/30/18

*Bloomberg consensus as of September 30, 2018.

Figures for S&P 500 Index, Bloomberg Barclays Aggregate Bond Index, and Bloomberg Commodity Index are total returns from 06/30/18–09/30/18 (Q3).

All indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment.

Please note: All return figures are as of September 30, 2018, unless otherwise stated.

Past performance is not indicative of future results.

The economic forecasts set forth in the presentation may not develop as predicted.

manufacturing activity. However, data showed increasingly disruptive supply chain constraints, and U.S. firms noted labor shortages, rising input costs, and uncertainty around tariff implications in several economic surveys. Overall, leading indicators pointed to low odds of a recession over the next 12 months.

- **The S&P 500 Index returned 7.7% during the quarter, its best quarterly gain since the fourth quarter of 2013.** It was also a historically calm market with no 1% moves in either direction. Driven mostly by strong economic and earnings growth in the U.S., the performance was particularly impressive given the tariffs and trade tensions, in addition to fears of emerging markets (EM) contagion, rising interest rates, and the policy risk associated with the upcoming midterm elections.

  In terms of market leadership, large caps beat small caps as the Russell 2000 Index returned 3.6%. Strength in globally focused large caps was encouraging amid trade tensions. Growth beat value, driven by solid technology and consumer discretionary sector gains and underperformance by the value-heavy energy sector, building on growth's big 2018 lead. U.S. stocks continued to outpace international equities, buoyed by strong domestic economic and earnings growth. Growth in major overseas economies has slowed and pockets of stress in EM drove some global investor rotation into U.S. markets, which led to lackluster returns for international developed and EM equities. The MSCI EAFE Index returned 1.4%, while the MSCI EM Index lost 1.0%.

- **Longer term rates surge amid wage growth, increased risk appetite.** Rates across the yield curve rose in the quarter as the 10-year Treasury yield reached a high of 3.10% September 25. Longer term yields were weighed down for most of the quarter amid currency-market turmoil and trade worries. However, rates benefitted from an acceleration in wage growth in August and a renewed appetite for risk at the end of last month. September 18, the 10-year yield jumped the most since May after the U.S. threatened to raise the rate on $200 billion in tariffs if no deal is reached by the end of the year, encouraging investors that a U.S.-China trade agreement would be reached by then. The curve flattened further, as the spread between the 2-year and 10-year yields fell to 24 basis points through the end of the quarter.

  Rates' move higher last quarter weighed on high-quality fixed income. The Bloomberg Barclays Aggregate Bond Index ended the quarter unchanged, while Treasuries dropped 0.6% and mortgage-backed securities slid 0.1%. Investment-grade corporates underperformed, rising 0.9% in the quarter. Economically sensitive, lower credit quality sectors were boosted by strong equity market performance. High yield climbed 2.4%, its biggest quarterly gain since the first quarter of 2017, while bank loans gained 2.1%. EM debt rose 1.9%, even as the region's currency turmoil intensified in July and August, and trade tensions escalated. Unhedged foreign bonds were the worst performer, declining 2.2% as pronounced U. S. dollar strength was a headwind on returns.

- **Long/short managers underperform by the worst margin since 2011.** Despite negative performance in both July and September, the HFRX Systematic Diversified CTA Index led all quarterly alternative investment returns with a gain of 1.2%, which was driven by a strong 2.7% return in August. Long equity and energy-related positioning supported returns. As measured by the HFRX Equity Hedge Index, long/short equity managers disappointed during the quarter, with a loss of 1.1%, underperforming the S&P 500 by 8.6%. This represented the worst period of

See page 4 for list of indexes used to represent the referenced asset classes.



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relative performance since the fourth quarter of 2011. A sell-off in momentum-related holdings and in EM equities led to losses in long books.

- **Metals and oil weigh on commodity prices.** Commodities were negative for the third quarter. The Bloomberg Commodity Index fell 2% with losses in metals and oil offsetting gains in natural gas. Crude oil prices fell sharply to start the quarter and then staged a comeback amid the anticipation of tightening global supply from Iran sanctions. Oil finished the quarter down just slightly. Copper fell during the quarter, likely hurt by a stronger U.S. dollar and fears of a trade-related slowdown in China. Precious metals, also hurt by a strong dollar, declined sharply. U.S. trade negotiations fueled intra-month volatility in agriculture prices. The Bloomberg Commodity Index was down 2% year to date through the end of September. ■

## A LOOK FORWARD

We expect low double-digit total returns for the S&P 500 in 2018, driven by strong earnings growth thanks to a combination of steady economic growth and tax cuts. As noted in our *Midyear Outlook 2018: The Plot Thickens,* with fiscal incentives in place, we expect steady economic growth and stock market gains may continue through 2018 and beyond. We forecast 3.8% global GDP growth in 2018, thanks to new fiscal policies and improved business vitality. We expect the U.S. economy to remain a primary driver, with potential GDP growth of 3.0% for the year, while Europe and Japan may lag.

U.S. stock market fundamentals remain positive, in our view. Our 2018 S&P 500 earnings forecast of $155 per share, a 17% annual increase, may prove conservative. We acknowledge the potential for increased volatility along the way, as we are in the later stages of the economic cycle and factors such as rising interest rates, trade tensions, geopolitical uncertainty, and upcoming midterm elections can raise investors' concerns. Fourth quarters of midterm election years have historically been good for stocks.

Periods of stock market volatility have resulted in temporary "flights to quality" where investors seek safe-haven assets like U.S. Treasury bonds,* highlighting the diversification benefits of high-quality fixed income within a well-balanced portfolio. However, we continue to believe the long-term fundamental drivers including economic growth, deficit spending, rising inflationary pressures, and expectations of future Fed rate hikes may push bond yields higher through year end. ■

* U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. They are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Please see our *Midyear Outlook 2018: The Plot Thickens* publication for additional descriptions and disclosures.

## 2 HEALTHCARE STOCKS WERE STRONGEST SECTOR

S&P 500 Sector Performance, Ranked by Third Quarter Returns

| Sector | Q3 2018 |
|---|---|
| Healthcare | 14.5% |
| Industrials | 10.0% |
| Telecom | 9.9% |
| Technology | 8.8% |
| Consumer Discretionary | 8.2% |
| S&P 500 | 7.7% |
| Consumer Staples | 5.7% |
| Financials | 4.4% |
| Utilities | 2.4% |
| Real Estate | 1.1% |
| Energy | 0.6% |
| Materials | 0.4% |

## 3 U.S. LARGE CAPS BOOSTED S&P 500 RETURNS

Domestic & International Asset Class Performance, Ranked by Third Quarter Returns

| Asset Class | Q3 2018 |
|---|---|
| Large Growth | 9.2% |
| S&P 500 | 7.7% |
| Mid Growth | 7.6% |
| Russell 3000 | 7.1% |
| Large Value | 5.7% |
| Small Growth | 5.5% |
| Mid Value | 3.3% |
| Small Value | 1.6% |
| Large Foreign | 1.4% |
| Emerging Markets | -1.0% |

## 4 ECONOMICALLY SENSITIVE BONDS AND EM DEBT OUTPERFORMED

Bond Market Performance, Ranked by Third Quarter Returns

| Sector | Q3 2018 |
|---|---|
| High-Yield Corporates | 2.40% |
| Bank Loans | 2.05% |
| EM Debt | 1.87% |
| Investment-Grade Corporates | 0.89% |
| High-Yield Munis | 0.76% |
| Barclays U.S. Aggregate | 0.02% |
| MBS | -0.12% |
| Munis | -0.15% |
| Foreign Bonds (Hedged) | -0.55% |
| U.S. Treasuries | -0.59% |
| TIPS | -0.82% |
| Preferred Stocks | -1.61% |
| Foreign Bonds (Unhedged) | -2.19% |

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

Bond Market Asset Class Indexes: Foreign Bonds (hedged) – Citigroup Non-U.S. World Government Bond Index Hedged for Currency; Preferred Securities – Merrill Lynch Preferred Stock Hybrid Securities Index; Treasury – Bloomberg Barclays U.S. Treasury Index; Mortgage-Backed Securities – Bloomberg Barclays U.S. MBS Index; Investment-Grade Corporate – Bloomberg Barclays U.S. Corporate Bond Index; Municipal – Bloomberg Barclays Municipal Bond Index; Municipal High-Yield – Bloomberg Barclays Municipal High Yield Index; TIPS – Bloomberg Barclays Treasury Inflation-Protected Securities Index; Bank Loans – Bloomberg Barclays U.S. High Yield Loan Index; High-Yield – Bloomberg Barclays U.S. Corporate High Yield Index; Emerging Market Debt – JP Morgan Emerging Markets Global Index; Foreign Bonds (unhedged) – Citigroup Non-U.S. World Government Bond Index (unhedged)

Sources: LPL Research, FactSet 09/30/18

All indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

The sectors are represented by the 10 S&P 500 Global Industry Classification Standard (GICS) indexes.

Asset classes based on Russell 1000, Russell 3000 Growth and Value Indexes, Russell 2000, Russell Midcap Index, MSCI EAFE, and MSCI Emerging Markets Index.



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## IMPORTANT DISCLOSURES

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Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

## DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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