CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

October 18, 2018

Financial Markets Commentary 3rd Quarter 2018

Summary

The U.S. stock market posted another strong quarter, rising 7.20%.[i] Once again, however, it was pretty much the "only game in town". International markets were about flat on balance, with developed markets up 1.51% and emerging markets down -2.16%.[ii] Bonds were almost unchanged as the S&P U.S. Aggregate Bond Index rose 0.07%. The question on every investment professional's mind lately is "How long can this divergence last"? Many professionals believe that either foreign stocks have to surge or U.S. stocks need to decline because the performance and valuation gaps between the two are almost historically wide. That said, the trend has been to overweight U.S. stocks and hope the point of transition is both gradual and resolved by foreign stocks rising.

If one was inclined to look for cracks in the armor of the current U.S. stock rally, it would probably be that small and mid-size stocks performed poorly in September. Midcap stocks declined -1.10%[iii] to finish the quarter up 3.48% and small cap stocks were off -3.17% in September to close the quarter with a 4.38% gain. By way of comparison, the S&P 500 was up 0.57% in September and 7.20% for the quarter. See Chart 1. This suggests rising interest rates and tight labor markets might be beginning to have an effect, because one would expect smaller companies to have higher borrowing costs on average than larger ones, and less ability to "offshore" their labor.

Chart

International stocks continue to be hurt by the strong dollar, especially in those countries with high dollar-denominated debt and/or higher oil prices due to the Iran sanctions (remember that globally oil is priced in dollars, so a 20% increase in oil prices plus a 10% stronger dollar means oil costs 32% more in local currencies). In addition, the Chinese-American trade war is clearly hurting the Chinese market and both Brexit and the new Italian government are currently weighing down European stocks. Short of the U.S. capitulating on its tough trade stance, it is hard to see what would trigger a bull market in foreign stocks even though they appear to be cheap in comparison.

Bonds performed well earlier in the summer, but they sold off sharply in September (-0.48%) as it became clear that interest rate pressures were building.[iv] Less interest rate sensitive segments of the bond market, such as floating rate loans and high yield debt, managed to gain over one percent on the quarter. High quality municipal and treasury bonds each gave up less than one percent.

Activity

There wasn't that much to do in July and August as the dominant bullish trend from the second quarter carried over. Bonds yield remained steady and the dollar declined a bit, allowing stocks to continue their upward march. In September, as we approached the day (September 26th) when we expected the Federal Reserve to raise interest rates, markets got nervous. We recognized the potential danger in this environment and began to reach out to our more conservative clients about getting even more defensive.

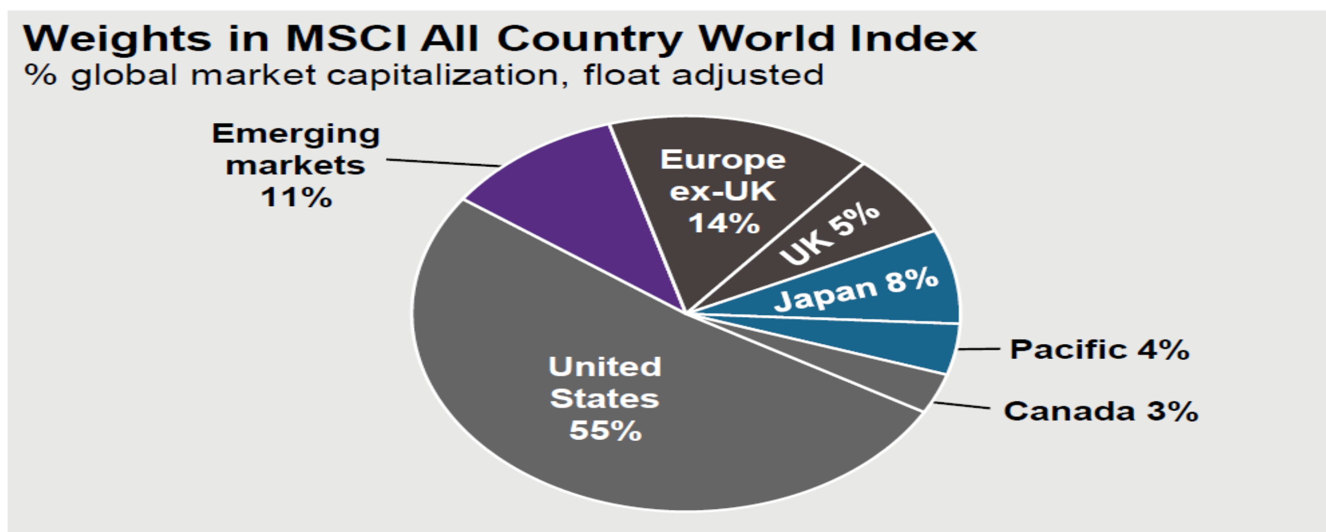
Outlook

Since the end of the quarter we already know that strong economic reports on October 3rd and 5th helped push long term interest rates to their highest levels since 2011, and that stocks everywhere buckled under the pressure. So far U.S. stocks have given back a little more than foreign stocks, but nothing has emerged unscathed (save gold, which has trimmed its year-to-date loss from -8% at the start of October to under -6% as of this writing). At this point, potential catalysts exist for both a run at 3000 on the S&P 500 (again, involving a significant reduction in trade friction with China leading to a stronger Renmindi (Chinese currency) and lower oil prices) and, alternatively, a continuation of the current sell-off (an escalation of the trade conflict leading to more dollar strength and less global economic activity). If we had to guess it would be that in the next month or so a deal gets made that both sides can declare victory on, and markets rally (led by emerging markets). We suppose you could call us cautiously optimistic.

Commentary – In defense of Foreign Investing

What is the right amount of a portfolio to invest overseas? A purely neutral policy would put about 45% of one's equity portfolio overseas because that approximates the foreign slice of global stock market capitalization. Chart 1 from JP Morgan shows us the global market breakdown, by capitalization (or the value of the market as determined by aggregate stock share prices multiplied by stock shares outstanding). But wait, why should we be neutral? Foreign stocks offer currency risk. Their economies are, for the most part, not as robust. Their accounting systems are not as transparent. Their overall profitability trails ours. It would seem therefore that the international weighting should be quite a bit lower than 45%, but how much lower? This is probably the biggest challenge in portfolio management right now.

Chart 2



Source: JP Morgan 4Q18 Guide to the Market

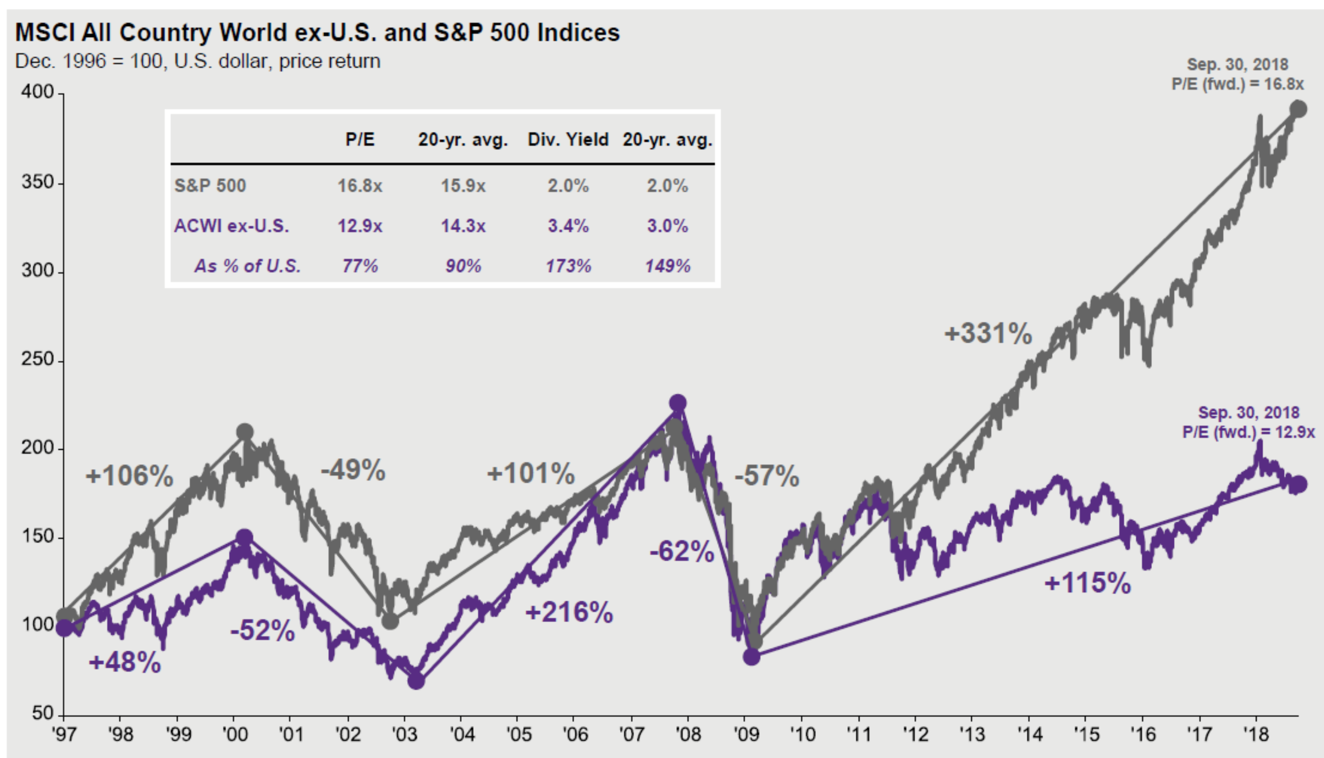
The implications are large; according to Morningstar, US stocks have a 10-year average annualized return of 11.97% through September 30th. This would be the return on the equity portion of your portfolio if it had no international stock exposure. If you divided equity exposure by capitalization like global stock indices do[v], your annualized return would fall to about 9%. If you held a two-thirds domestic, one-third foreign exposure (as the average investment advisor does according to TD Ameritrade), your return would improve to about 9.8%. Tactically underweighting foreign stocks to just one-fourth of total equity exposure improved the return to 10.32%.

Is all this to argue that foreign stocks are a drag on returns and therefore should be excluded from portfolios? Certainly not. Our investment careers have included two periods in which foreign stocks dramatically outperformed U.S. stocks. The first was from 1985 through 1990, and the second from 2003 through 2007. Broadly speaking, one would have done better in foreign stocks from 1985 through 1994 and

2000 through 2009, so the periods of strong U.S. outperformance were 1995 through 1999 and 2010 through the present. The current period is very long by historical standards, which is why so many market pundits predicted the strong performance of foreign stocks in 2017 marked the beginning of a new era. It is rare, however, that the majority would successfully predict a major secular change – and it obviously didn't happen in this case either. That said, inevitably it will happen at some point. If one waits until that point is obvious to all, they will likely miss out on a significant amount of gains.

Chart 3 below illustrates why many professionals have been expecting foreign stocks to outperform. Historically there has been high correlation between foreign and domestic stocks, and the performance gap has never been particularly wide. Until now. As the chart shows, the U.S. has historically traded at a price-to-earnings premium to foreign markets of 1.6 times on average. That premium is 3.9x today. Maybe you can argue our economic stability and military strength warrant a greater premium than 1.6x, but 3.9x seems rather extreme.

Chart 3



	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	16.8x	15.9x	2.0%	2.0%
ACWI ex-U.S.	12.9x	14.3x	3.4%	3.0%
As % of U.S.	*77%*	*90%*	*173%*	*149%*

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan
Asset Management

Source: JP Morgan 4Q18 Guide to the Market

On a global basis, non-U.S. stocks are 45% of total stock market capitalization. Tactically, we have always been under-weight foreign stocks by that measure. Depending on your risk tolerance, an average portfolio we manage is roughly 24% invested in non-U.S. companies. As such, our portfolios clearly reflect the turmoil many foreign countries are experiencing. Yet we feel it is a mistake to write them off completely even though they have been a drag on performance this year.

Overall foreign markets are significantly cheaper than ours and the growth rate of foreign economies is higher. Our policies (tariffs, taxation) have contributed to their difficulties in many cases, but it is foolish to believe that they can't or won't adapt. As investors, we should hope that they do, because the U.S. stock market is not likely to duplicate its 11.97% ten-year average over the next ten years.

Eric C. Graber, President

952-926-3000

Mark A. Carlton, CFA, Trademark Financial Management

Consultant to Capital Strategies Financial Corporation

952-358-3395

---

[i] As measured by the S&P 500, Source: S&P Dow Jones Index Dashboard, September 28, 2018

[ii] As measured by the S&P Developed Ex-U.S. BMI and S&P Emerging BMI. Source: S&P Dow Jones Index Dashboard, September 28, 2018

[iii] S&P Global Index Dashboard,9/28/18 is the source for both quarterly and year-to-date U.S. stock and bond returns.

[iv] As measured by the S&P U.S. Aggregate Bond Index. Source: S&P Dow Jones Index Dashboard, September 28, 2018

[v] Approximately 55% US, 34% developed foreign and 11% emerging markets (per JPMorgan and MSCI).