Investment Update

December 2018 Review and Outlook

Domestic equity markets rose in November, with the S&P 500 up 2.04% for the month. The international developed equity markets declined slightly, with the MSCI EAFE Index down 0.11% in November. Global financial markets continued to be volatile throughout November and into early December as investors lowered expectations for economic and corporate earnings growth in 2019. Despite the volatility, overall economic data continue to demonstrate a stable domestic economy. The markets also have been concerned that rising inflation and interest rates may lead to more aggressive action by the Federal Reserve, which may raise interest rates more quickly than the financial markets expect. What's more, there is ongoing concern that tariffs proposed by President Trump may ignite a trade war with major U.S. trade partners such as China.

Overall, the domestic economy is benefitting from a healthy labor market, accelerating growth in consumer spending and a healthy manufacturing sector. In the overseas economies, recent economic data continue to suggest that economic growth in Europe, Japan and China is moderating.

The midterm elections concluded with the expected result of Democrats assuming control of the House of Representatives and Republicans retaining control of the Senate. The domestic equity market has historically rallied after midterm elections into year-end, as a major source of uncertainty is removed. The S&P 500 has been up in the 12 months following every midterm election since 1950.

Fixed-income investments rose 0.45% in November, as measured by Barclays Intermediate Government Credit Index. The yield on 10-year Treasury notes closed at 3.01%, down 0.14% from 3.15% at the end of October. The yield on the 10-year Treasury note is up 0.60% since year-end 2017, when it yielded 2.41%. Overall, the domestic economy continues to grow moderately.

Here is our economic and financial-market perspective:

Volatility – Volatility remained elevated in the financial markets in November. Volatility may remain at these elevated levels due to the uncertainty regarding economic growth, corporate earnings growth, tariffs and monetary policy.

Corporate Profits – Third quarter earnings per share for companies in the S&P 500 increased about 26%, up from the second quarter's 24.8% increase. Fourth quarter earnings are expected to increase about 14% year-over-year. Corporations are benefiting from lower tax rates this year due to the tax-reform bill and a more favorable regulatory environment. Corporate earnings are a key driver of stock prices.

Interest Rates – We expect the Federal Reserve to raise rates by 25 basis points at its December meeting, depending on economic data at that time. The Federal Reserve has indicated that short-term interest rates are close to their neutral rate.

Consumer Confidence and Spending – Consumer confidence, as measured by the Conference Board, fell modestly in November to 135.7, down from 137.9 in October. Recent reports on consumer confidence continue to be the highest in 18 years and not far from the all-time high of 144.7, reached in 2000. Higher consumer confidence bodes well for the domestic economic outlook.

Economic Growth – U.S. gross domestic product (GDP) growth in the third quarter grew at a 3.5% annual rate, less than the second quarter's 4.2% increase. Economic growth in the third quarter reflected higher (4%) consumer spending and greater corporate profits due to the tax-cuts implemented earlier this year.

Employment – The most recent official unemployment rate remained at 3.7% in October. Unemployment is the lowest since December 1969, when the unemployment rate was 3.5%. The longer term employment-growth trend has been at healthy levels, reflecting a strong economy.

Housing – Housing data continue to be mixed and may suggest this important sector of the economy is slowing. Pending home sales declined 2.6% in October while housing starts increased 1.5%. Sales of existing homes increased 1.4% in the most recent report, the first increase in six months. Mortgage rates have increased since year-end 2017 and bear watching to see if higher lending rates dampen housing activity.

Economic and Financial Market Outlook

Economy – The U.S. economy continues to grow and is in solid shape, and inflation remains at historically low levels. The largest uncertainty is proposed tariffs, especially with China. Housing, as well as auto sales, and durable goods orders bear watching as activity has declined. Consumer spending and sentiment have been a bright spot for the domestic economy in 2018. Economic activity has been moderating overseas. The reduction in tax rates and a reduced regulatory burden have positively impacted economic activity in 2018.

Financial Markets – We expect markets will continue to be volatile, as investors expect lower economic and corporate earnings growth in 2019 as well as continued higher interest rates and uncertainty regarding tariffs. Historically, when Congress has been divided with a Republican-led Senate and a Democrat-led House, along with a Republican President, the S&P 500 has had an average annual return of 15.7% since 1950, although there is no guarantee these past results will occur in the future. We continue to be bullish over the longer term despite increased uncertainty in the short term.

Sources: Federated Investors, The Wall Street Journal, CNBC.com, FactSet, MainStreet Advisors, The Conference Board, The University of Michigan, JP Morgan Asset Management, Thomson Reuters.