

Overview

The steady U.S. recovery from the global financial crisis is one of the longest economic expansions in American history, and the markets continue to test new highs. The tax cuts helped boost both consumer and business investment spending throughout the year. U.S. GDP grew at close to 4% annualized in the second quarter and the markets have reacted favorably to indicators that the U.S. economy continues to gain steam. Unemployment is at its lowest level in nearly two decades and manufacturing continues to grow at robust levels. We remain confident that the U.S. economy will continue to expand over the next few quarters, but are cognizant that we are in the later stage of the economic cycle. We continue to monitor risks that may negatively impact the global markets including the ongoing trade and tariff conflict, the impact of higher U.S. rates, moderating international economic growth, and rising geopolitical tensions. As we are in a late-cycle economy, and because we believe risks to the markets have increased, we continue to emphasize that investing in a broadly diversified portfolio is prudent and key to limiting the overall risk of the portfolio.

Domestic Equities

U.S. equity markets rallied in the third quarter with the S&P 500 returning 10.56% and small cap stocks returning 11.51% through the end of September. Although mostly positive across the board, the dispersion in equity returns has been significant with growth stocks outperforming value stocks by 12.85% year-to-date. Technology stocks (historically growth stocks) were the best performing sector returning 20.18% while consumer staples stocks (historically value stocks) were the worst performing sector down -3.3%. Although we can't predict exactly when, we believe the valuation gap between value stocks and growth stocks has become very stretched and a rotation back to value is likely. Historically, Fed rate hikes and rising bond yields have been good for value stocks and we anticipate that these factors will support value stocks over the next few quarters.

A main driver of returns for U.S. equities has been robust corporate profits growth, with operating earnings per share of S&P 500 companies rising by 27% year-over-year. Barring an intensifying trade war, or an unexpected external shock to the financial system, we expect stock prices to continue to be supported this year by tax reform, increased profit margins, and healthy economic growth in the fourth quarter.

International Equities

After a strong 2017, international developed and emerging market equities have significantly underperformed their U.S. counterparts this year and are down -7.68% and -1.43% respectively. The underperformance in emerging market equities can be largely attributed to a series of headwinds including a strengthening dollar and rising U.S. interest rates, moderating global growth in certain countries including China, increased trade tensions, and country-specific economic and political turmoil in nations such as Argentina, Venezuela and Turkey. Despite these concerns, we continue to believe that the long-term case for investing in emerging markets remains intact. Even with the recent slowdown, emerging markets have higher economic growth rates

when compared to developed markets, favorable demographics, low debt levels, and strong corporate earnings growth potential.

In international developed markets, concerns over the weakening of synchronized, global growth have also weighed on these markets. However, earnings expectations remain positive in many international markets and monetary policy remains relatively accommodative. Despite some interruptions this year, we believe that economic growth should remain relatively healthy in both developed and emerging economies over the next few quarters. We remain confident that international equities will benefit the portfolios by providing diversification within the equity exposure of a portfolio that should lower the overall risk and improve returns over the long run. Additionally, from a valuation perspective, international developed and emerging markets are now even less expensive and, in our view, more attractive than they were in the beginning of the year.

Fixed Income

The Federal Reserve raised the federal funds rates by another 0.25%, to a range between 2% and 2.25% in September and officials signaled that they expect to lift them again later this year. Rising interest rates across the yield curve have negatively impacted the fixed income market throughout much of 2018. Returns were mostly negative across the board with the U.S. Aggregate Index (a measure of investment grade bonds in the U.S) down -1.60%, 30-Year U.S. Treasuries down -6.55%, and municipals down -0.66% through the third quarter. Although most segments of the fixed income market are down year-to-date, there are a few sectors that posted positive returns including floating rate bank loans which returned 2.06% and the 2-Year Treasuries which returned 0.12%. Bank loans have floating rate coupons and typically have low interest rate sensitivity which has led to their outperformance as the Federal Reserve has raised rates eight times over the last three years. With the federal funds set to continue to rise in the U.S., we believe that it is critical to build diversified fixed income portfolios to provide an attractive level of yield while keeping the duration of the portfolios relatively short to mitigate the negative effects of rising inflation and higher interest rates.

Real Estate

U.S. REITs, currently trading at discounts to net asset values (NAV), have been one of the most out of favor segments of the market, but have gained traction over the last few months and are now slightly positive on the year, up 1.58%. The real estate market outside the U.S. has fared less well and is down -3.98% through the third quarter. Despite this relative underperformance, global real estate securities have experienced generally strong cash flow growth over the last few years. REITs are currently trading at earnings multiples near the low end of their five-year range, while broad equity valuations are at cycle highs, representing attractive relative value, in our view. We believe REITs should continue to see improving operating fundamentals in most global markets amid solid economic growth, steady job creation, reasonable new supply levels, and monetary conditions that should remain relatively accommodative.

Conclusion

After a prolonged period of economic growth and easy monetary conditions, investors may question if it's time to take some chips off the table. Although we anticipate that there will be continued economic growth in the U.S. and maintain a favorable outlook for equities, risks appear to be rising which may lead to increased volatility in the fourth quarter. Potential headwinds resulting in increased volatility include higher interest

rates, fading effects from fiscal stimulus, a messy global trade war, and an emerging market currency crisis. The turn in an economic cycle is difficult to predict, but with the prospect of volatility increasing as rates continue to rise and financial conditions tighten, we believe it is prudent to consider reducing the level of risk in the portfolios.

Ferrell Wealth Management portfolios are constructed to provide a balance between growth potential and downside protection; and we continue to monitor your investments to maintain the appropriate risk/reward equilibrium for your unique needs. With Ferrell Wealth Management, “the **F**uture is What **W**e **M**ake of it,” and we truly appreciate your confidence in our ability to navigate towards the most favorable outcome for your financial future. Should you have questions about your portfolio or the current economic environment, please do not hesitate to contact us.

Warmest Regards,
Ferrell Wealth Management