Northport Investment Management, LLC
A Registered Investment Adviser

Market Commentary – 3rd Quarter 2018

It was a positive quarter for U.S. stocks with all three major stock indices advancing. The Dow gained 9.0% in Q3. The S&P 500 appreciated by 7.2%, for its best quarterly performance since the fourth quarter of 2013. Both the Dow and the S&P 500 have risen in 11 of the past 12 quarters. The S&P 500 is now up 9.0% year-to-date (10.6% with dividends). The NASDAQ Composite rose by 7.1% in Q3, for its ninth straight quarterly gain. Despite political turmoil at home and abroad, U.S stocks set record highs in Q3, encouraged by solid economic fundamentals. International equities continue to lag (developed markets MSCI EAFE Index +.76% in 3Q 2018, -3.8% year-to-date). Emerging-market stocks have been particularly hurt by global trade tensions (MSCI BRIC Index -5.1% in 3Q 2018, -10.4% year-to-date). Only three of the eleven S&P 500 sectors were negative (essentially flat) in Q3 (Basic Materials -.1%, Energy -.1% and Real Estate -.02%). Healthcare (+14%) and Industrials (+9.5%) performed best in the quarter.

Bonds were broadly lower throughout Q3 2018, driven by expectations surrounding Federal Reserve policy. Longer dated bonds were the weakest. The Fed raised the Fed Funds interest rate by a quarter-point at its September meeting, to a target range of 2.00%-2.25%. This is the third quarter-point increase this year, and now makes eight quarter-point increases since 2015. The Fed's own forecasting continues to show an additional quarter-point rate hike in December, followed by three in 2019, and one in 2020. If this forecast plays out, it will bring the Fed Funds rate to between 3.25% and 3.50% in the current cycle. In comparison, the past 30-year average for Fed Funds is 3.2%, with a high of over 10% in the late 1980s, to nearly zero in 2011. The yield on the benchmark ten-year Treasury note rose from 2.847% to 3.055% during Q3 2018.

We continue to view the rise in interest rates in a broader context, and in a positive light. It is a relatively healthy development which is reflecting the underlying strength in the U.S. economy. The Fed is gradually normalizing interest rates. We are settling into a higher range. This should not be a big headwind for our economy unless the speed and magnitude of the rate hikes increase. This is not our expectation. Borrowing costs are rising, but investors will also earn a higher return on their relatively safer assets.

Stocks are at record highs. As of August 2018, this has now become the longest bull market in history. We are in unchartered territory. The S&P 500 is already up around 10% year-to-date. We are cautiously optimistic. Our caution arises from the potential negatives of global trade conflicts, geopolitical risks, and rising inflation. We are most comforted by the solid foundation that this market advance is built upon. Stock performance is all about earnings, and corporate earnings have been stellar. Revenue growth has also been good, helped by solid consumer spending, driven by the strong job market and high consumer confidence.

S&P 500 earnings were up around 25% in Q2 2018. Can this pace be sustained? Probably not. Even if earnings have peaked, can we continue with more excellent earnings quarters going forward? We think so. Being cautious doesn't mean exiting stocks or timing the market. It is about being prudent, staying disciplined on price, remaining diversified, even if some asset classes are dragging us below the S&P 500 return presently, sticking with a total return emphasis, and pursuing value.

Highly valued stocks and rising interest rates suggest that bonds have become a better investment. We continue to feel that shares of well-established companies with attractive dividend yields are a much better long-term investment than bonds. A ten-year treasury note now pays over 3%, with no risk. Many of our high-quality equities offer a similarly attractive dividend yield. One has to be willing to accept a relatively high level of price volatility with equities, however, we feel the potential for dividend increases and capital appreciation has proven to be well worth the relative risk. Receiving a steady (usually increasing) quarterly income stream alleviates negative short-term share price volatility. We will continue to use bonds for diversification, but we don't foresee a significant near-term asset allocation shift.

I want to mention a change to the presentation of your individual equity portfolio. Effective on Monday, 9/24/18, S&P economic sectors were reshuffled to add the new Communication Services sector. The move involved 23 companies worth around $2.7 trillion in market capitalization. Noteworthy changes include Alphabet (GOOG), Facebook (FB) and Twitter (TWTR) moving from the Technology sector into the new Communication Services classification. The Telecommunications sector was disbanded, with companies such as AT&T (T) and Verizon (VZ) moved into Communication Services. Several companies, including Disney (DIS), Comcast (CMCSA) and Netflix (NFLX), moved from the Consumer Discretionary sector into the new Communication Services sector.

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