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SANDERSON WEALTH MANAGEMENT

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Financial Market Update

2018 certainly has had its ups and downs. The year started with stocks rising week after week and setting new all-time highs along the way. Market sentiment reversed course in late January when U.S. stocks sold off more than 10% in just a few days. When fears subsided, U.S. and emerging market stocks experienced a partial recovery for several weeks, only to fall shortly afterward. By the end of May, U.S., foreign developed, and emerging market stocks were basically even for the year. From there, things began to diverge. With tariffs increasing, tensions rising, and foreign currencies under pressure, U.S. stocks gained value while their foreign counterparts fell from May to September. By quarter end, U.S. stocks stood as the clear outperformer, while emerging market stocks trailed significantly.

Major Asset Class Returns

		Q3 2018	2018
Core Bonds - Taxable	(BBGBARC U.S. Agg)	0.0%	-1.6%
Core Bonds - Municipal	(BBGBARC 5Yr. Muni)	-0.2%	0.1%
Global Stocks (as a whole)	(MSCI AC World)	4.3%	3.8%
U.S. Large Stocks	(S&P 500)	7.7%	10.6%
U.S. Mid Stocks	(S&P MidCap)	3.9%	7.5%
U.S. Small Stocks	(S&P SmallCap)	4.7%	14.5%
Foreign Developed Stocks	(MSCI EAFE)	1.4%	-1.4%
Emerging Market Stocks	(MSCI EM)	-1.1%	-7.7%
Commodities	(Bloomberg Comm)	-2.0%	-2.0%
Real Estate	(DJ Global Select REIT)	-0.2%	1.0%

U.S. Corporate Checkup

In 2017, the U.S. was at a competitive disadvantage with other industrialized nations. At that time our top combined corporate income tax rate was 38.9%, higher than any of our peers and much higher than the 23.7% average of 34 industrialized countries. That is no longer the case. Following the Tax Cuts and Jobs Act, the U.S. is now much more competitive at 25.8%.

The lower U.S. corporate tax rates have provided a shot in the arm for corporate profitability. Earnings per share for large U.S. companies are up significantly this year. Earnings for the first half of the year grew over 20%, and estimates for the third quarter look good as well. Corporate sales are up roughly 10% also. In total, these 2018 gains bring earnings growth to 69% since 2010 and sales growth to 37%. While both numbers represent reasonable growth figures, many question whether they justify the 132% growth that stock prices have achieved during the same time period.

Problems with the S&P 500

With U.S. large company stocks outperforming year to date, many investors are tempted to abandon their diversified portfolios in favor of S&P 500 index funds. The S&P 500, however, is not as diversified as everyone thinks. Sure, it is 500 companies, but the bulk of the index is concentrated in just a few names. Currently, the top 25 holdings represent 36% of the index. In addition, with Apple, Microsoft, Amazon, Google, and Facebook as five of the top six holdings, the index is a bit concentrated in technology. In fact, technology (when adjusted to include both Amazon and Netflix) is now a larger component of the S&P 500 index than the consumer defensive, energy, communication services, utilities, basic materials, and real estate sectors combined.

Are Emerging Economies Dead?

We have heard several reports lately about how certain foreign countries in the developed or emerging world are in trouble fiscally or economically. While this may be true for Argentina and Turkey, as a whole, economic growth is more robust in the emerging world than it is domestically. In fact, total goods and services produced in the U.S. account for less than ¼ of total global output (a figure that the International Monetary Fund only expects to decline in the years to come).

Debt is another factor to consider. As a group, developed country governments carry debt loads in excess of 100% of the size of their economies. The U.S. is no exception, and is projected to exceed 115% by 2022. This can be a cause for concern because when debt exceeds the 90% level it becomes a drain on the economy and reduces economic growth. In contrast, government debt levels of emerging economies are roughly 50%, less than half of the developed world.

Interest Rates

We have seen a general rise in interest rates over the past few years across the globe. The U.S. in particular has seen the interest rate in 10-year government bonds nearly double between September 2016 and September 2018. At quarter end, that rate stood at 3.07%.

Short-term interest rates have also risen in the U.S. from a level of near zero in 2015 to an excess of 2% today, thanks to a series of eight interest rate increases from the Federal Reserve. Three of those increases occurred in this year alone, with one more 0.25% increase likely in December.