Third Quarter 2018 Review

	Close 9/28/18	Total Returns 3rd Quarter	Total Returns 2018 Year-to-Date
Standard & Poor's 500 Index	**2,914**	**+7.71%**	**+10.56%**
Dow Jones Industrial Average	**26,458**	**+9.63%**	**+8.83%**
NASDAQ Composite Index	**8,046**	**+7.74%**	**+17.48%**
Dow Jones Global (ex U.S.)	**253**	**-0.32%**	**-5.21%**
Barclays Aggregate Bond Index	**2,014**	**+0.02%**	**-1.60%**

Currently, for the first time in a decade, investors and savers can earn a higher return on cash deposits than they can on stock dividends. Six-month U.S. Treasury bills, for example, yield over 2.4% compared to the 1.8% dividend yield on the S&P 500 companies. With the stock market reaching all time new highs, does it make sense to take some profits and park the proceeds in cash equivalents that finally pay a visible return? We would highlight a few statistics on the historical performance of stocks, bonds, and cash to begin to address this question. The statistics in the table below are worth reviewing before an investor considers making changes to the allocation of financial assets.

COMPOUND ANNUAL RETURNS

	1926-2017	5-Year Rolling Average		10-Year Rolling Average		20-Year Rolling Average	
		Worst	Best	Worst	Best	Worst	Best
Stocks	10.2	-12.5	28.6	-1.4	20.1	3.1	17.9
Bonds	5.1	0.9	17.0	1.3	13.1	1.7	10.0
Cash	3.4	0.0	11.1	0.2	9.2	0.4	7.7
Inflation	2.9						

These numbers are compiled annually by Yale Professor Emeritus Roger G. Ibbotson. Stocks are the S&P 500 Index, bonds are intermediate U.S. Treasury bonds, and cash is U.S. Treasury bills. Since it covers 92 years from 1926-2017, there are 88 5-year rolling periods, 83 10-year rolling periods, and 73 20-year rolling periods. In the analysis below we will ignore the effect of inflation since they affect each asset class.

So, what can we glean from these historical numbers? For those readers who are unfamiliar with rolling averages, it is simply a process of moving a group of numbers ahead period by period, or year by year in this case. So the 5 year rolling average starts in 1926-1930, followed by 1927-1931, and so on to 2013-2017. The worst 5-year rolling average of negative 12.5% was actually for the period ending in 1932, and the best 5-year rolling average of 28.6% was for the period ending in 1999. **Both worst and best extreme periods stand out because they may actually have been a precursor to what followed. After the worst 5 year rolling period, the market went up 54% in 1933, and after the best 5 year rolling period the market declined for three straight years by over 40% in total.**

To the extent an investor can draw inferences or conclusions from the above table we would highlight the following:

- Based on the column dated 1926-2017, investors with the longest time horizons will likely earn significantly more in stocks than bonds or cash. This is because it is more profitable to be an owner of a business (stockholder) than a lender to a business (bondholder).
- Stocks earn higher returns over time than bonds or cash, but are more volatile (the difference between the worst and the best performance is greater with stocks than bonds). Therefore, an allocation to bonds can reduce the overall volatility of a portfolio.
- Based on the rolling average periods, the longer the investment time horizon the higher the probability that an investor will not lose money in stocks. The "worst" performance for 20 year rolling periods was actually a positive 3.1%.
    - Conversely, the worst rolling average performance for stocks during these 92 years was during the shortest time period of 5 years (negative 12.5%). In other words, you can lose a lot of money in the stock market over a short period of time.

Although, all these figures are not included in the table:

- Looking for extreme periods of performance may be an important clue to future performance based on the performance of subsequent periods (not in table).
- 10 year rolling returns were positive 95% of the periods, and 5 year rolling returns were positive in 86% of the periods.

So, to the extent historical results may be an accurate predictor of future returns, were any of the rolling averages at extremes when we entered 2018?

COMPOUND ANNUAL RETURNS
YEAR ENDING 2017

	5-Year Rolling Average	10-Year Rolling Average	20-Year Rolling Average
Stocks	15.8	8.5	7.2
Bonds	0.9	3.2	4.6
Cash	0.2	0.3	1.9

For bonds the 5-year rolling average return ending in 2017 of 0.9% was the worst of all 88 rolling periods. After a 35 year bull market in bonds that ended in 2016, bonds have been in a "bear" market ever since. The 5-year and 10-year returns on cash are also at extremes as a result of the Federal Reserve's zero interest rate policy that began in 2008 and ended a few years ago. We expect intermediate bond returns will stay under pressure as rates rise but cash returns will improve. Therefore, any allocation to bonds should be into short maturities or cash equivalents.

Projecting Future Bond Yields versus Future Dividend Payouts

Financial history is informative, but markets will be most affected by oncoming events. We began this *Outlook* comparing current cash and bond yields to current dividend yields. However, investors need to estimate and compare future bond yields to future dividend payouts.

- The Federal Reserve is projecting that rates on cash will exceed 3% in 2019 versus the current level of 2.0%-2.25%. They also project higher rates in 2020, perhaps peaking around 3.5%.
- Intermediate bond yields, such as the yield on 10-year U.S. Treasury bond, currently at 3.2%, are harder to predict, but it is plausible that yields could go back to the 4% plus level that preceded the recession in 2008. Could they go over 5%, where they were for 32 straight years from 1968 to 2000? Possibly, but not likely over the next year.
- Dividend payouts, on the other hand, are growing at a fast clip. Over the past five years dividends on the S&P 500 Index companies have grown at a rate of 10%. Thirty years ago companies were not as focused on rewarding shareholders with lavish dividend increases so future dividends were less of a factor in comparing yields. In this period of continued shareholder pressures, investors have to consider how fast dividends are likely to grow. The table below, for example, shows some of the larger dividend increases in 2018:

DIVIDEND INCREASES 2018 vs. 2017 (%)

JPMorgan Chase	43	Blackrock	23
AbbVie	40	Visa	22
Starbucks	26	3M Company	16
TJX Companies	24	Home Depot	16

When we compare the Federal Reserve's projected increases in cash yields of 3.5% to stocks, as the above table indicates, we need to calculate projected dividends because in many cases these increases are significant. Except for the two companies above with 40% dividend increases the other companies have been growing dividends at the listed rate for some time. They are likely to sustain those rates for the foreseeable future. There are signs of growing pressure, to be sure, on public companies to allocate more cash to employees and less to shareholders. This is evidenced by Amazon's recent announcement to increase wages. We think it is too early to call this a new trend, but it may eventually cause companies to slow dividend increases.

Beyond Bond versus Stock Yield Comparisons

The nearly decade-long stock market advance, which is unprecedented going back to 1926, will depend on numerous factors beyond yield comparisons. Although there are many events that historically have caused a bull market in stocks to end, the most likely candidate for a bear market in U.S. stocks has always been an economic recession.

The current economic expansion in the U.S. is one of the longest in modern history, but also the weakest in terms of growth. The economic recovery from the 2008 recession is certainly mature. The majority of economic indicators, albeit not all, in the U.S. are reaching peak levels, which implies an economic slowdown lurks at some point in 2020-2021 timeframe. The clearest signs of peak activity are:

- Auto sales have stalled at historically peak levels of 17.5 million units
- Job growth is slowing
- Consumer and business confidence are at highs
- Manufacturing measures are peaking
- Inflation pressures are mounting
    - Wage gains are in excess of Federal Reserve targets
    - Oil prices are up 50% over the past two years
    - Trade policies are inflationary
    - Housing prices have exceeded the peaks of 2007
- Monetary policy is tightening with higher interest rates

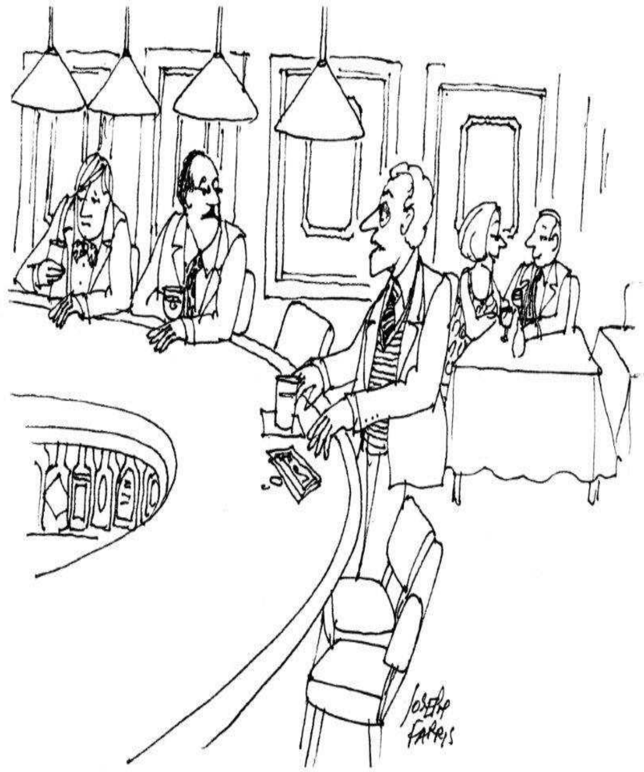
So, with the U.S. stock market at or near its high and the economic recovery at a mature stage, we are looking for signs that the economy actually starts to roll over. So far, it seems that the combination of a healthy U.S. consumer and strong business results are keeping the momentum going. **If we could pinpoint one issue that is most concerning it would be the possible reaction by China to U.S. trade sanctions**.

Summing Up

As a firm we have generally carried relatively high allocations to stocks based on the idea that stockholders with long term time horizons will increase their wealth significantly more with a high allocation to equities than with a balanced allocation including bonds. This varies, of course, depending on each client's time horizon and risk tolerance. There have been periods, such as the early 1980s when bond yields exceeded 15%, during which healthy allocations to bonds made complete sense. Since 2008, when rates rounded off to zero, it made little sense to make a material allocation to bonds. Investors figured this out as time went on, and stocks have produced very strong returns especially in the last six years compared to bonds.

If an investor's time horizon is long, we are maintaining fairly high equity allocations. If there are significant upcoming cash needs, we are in favor of taking some profits and investing in shorter term bonds or cash equivalents. We also think allocating to short term bonds makes sense for portfolios wishing to reduce volatility going forward.

Finally, we would be remiss if we ignored client questions regarding the "political situation." Our brief view on this subject is that by the time we distribute the next *Outlook*, the midterms will obviously be over, Robert Mueller's investigation may be over, and the Iowa Presidential caucus will be only 13 months away. In other words, some more clarity is possible on two scores, but the uncertain political cycle begins anew for 2020. In the meantime, we are more focused on developments in the U.S./China trade standoff than domestic politics.



"I'm a 100% consistent investor. I buy bonds when I should buy stocks and I buy stocks when I should buy bonds."

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