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U.S. Stocks Beat the Rest of the World

Improved economic growth boosted U.S. dollar, driving down gold value

Q3 2018

Main Points

Despite trade war concerns, U.S stocks beat the rest of the world for the second time this year.

Strong U.S. dollar caused precious metals (like gold) and emerging-market stocks to drop in value.

Bonds were weak due to rising inflation concerns and the likelihood of more rate hikes.

Despite trade war concerns that littered the headlines, U.S. stocks came out on top again in the third quarter. **The S&P 500 jumped 7.2% while the Dow Jones Industrial Average gained 9%.**

With tax-cut induced U.S. economic growth outpacing much of the world, and the Federal Reserve's tightening cycle not far enough along to derail it, **U.S. markets were relative winners**.

Commodities struggled in the third quarter. Gold, which performs poorly when the U.S. dollar is strong (shown in the **chart at right**), was the worst performer and sank 4.85%.

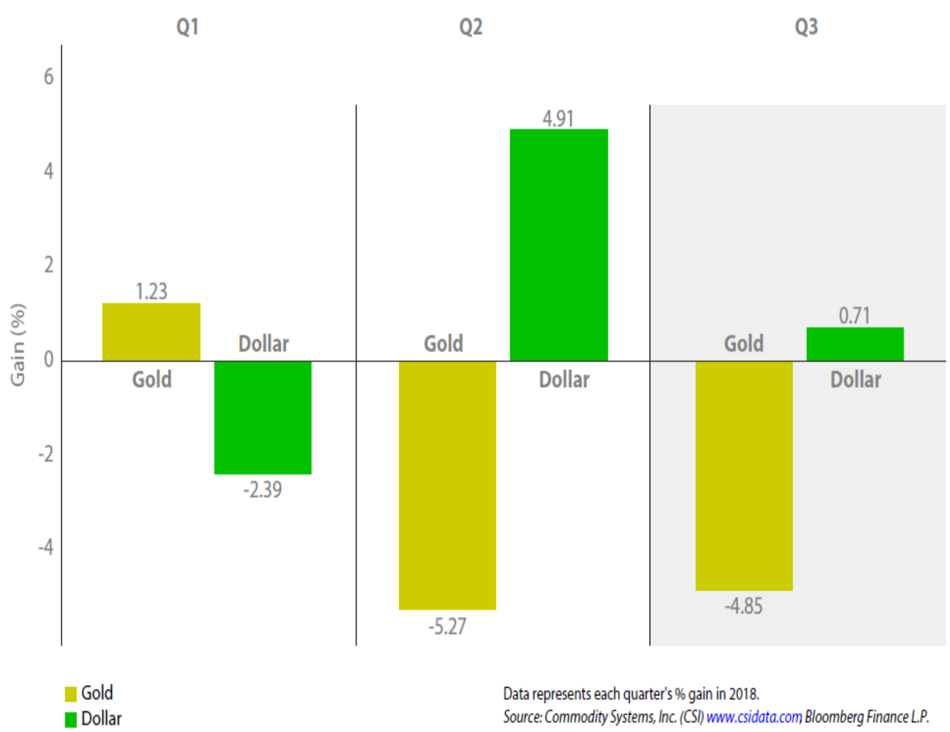
A stronger U.S. dollar also negatively impacted stocks in emerging markets, particularly China. All major regional stock markets lagged the U.S.

Concerns about higher future inflation sparked another sell-off in bonds in September, driving the 10-year US. Treasury yield back towards 3%. As a result, stocks ended up outperforming bonds. Year-to-date, the S&P 500 has outpaced the Barclays Long-Term Treasury Bond Index by over 16%.

With strong economic growth and rising inflation concerns, **Fed rate hikes are expected to continue into 2019**. While higher rates won't necessarily derail stock market performance or the U.S. economy as a whole, it is already having impact on certain sectors of the economy, such as housing. However, while housing has plateaued in the short-term, there is more room for growth in this sector as it's mostly driven by new household formation, employment, and income.

The U.S. stock market is likely to continue to deliver strong returns into 2019, but the strongest market returns typically occur when the moves are global. See if weakness in bonds and foreign stocks spills over to U.S. stocks in the short-term.

U.S. dollar strength hurt gold prices



Data represents each quarter's % gain in 2018.
Source: Commodity Systems, Inc. (CSI) www.csidata.com Bloomberg Finance L.P.

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Stocks

Q3 2018

S&P 500 reached a new all-time high

Main Points

S&P 500 reached a new all-time high, and history suggests gains could continue into 2019.

Sector performance was a roller coaster, oscillating from safer to riskier sectors and industries.

The "communications services" sector launched late in Q3, and includes old and new media.

On September 20, the Dow Jones Industrials Average made its first record high since January, confirming records made in the prior three weeks by the S&P 500, Nasdaq Composite, and small-cap Russell 2000.

While the averages made new highs, it has not been with the same firepower. Not as many stocks have hit new highs as they did back in January. **The stock market is likely to continue to rally into 2019**, but fewer stocks hitting new highs warrants monitoring as it could result in a short-term correction.

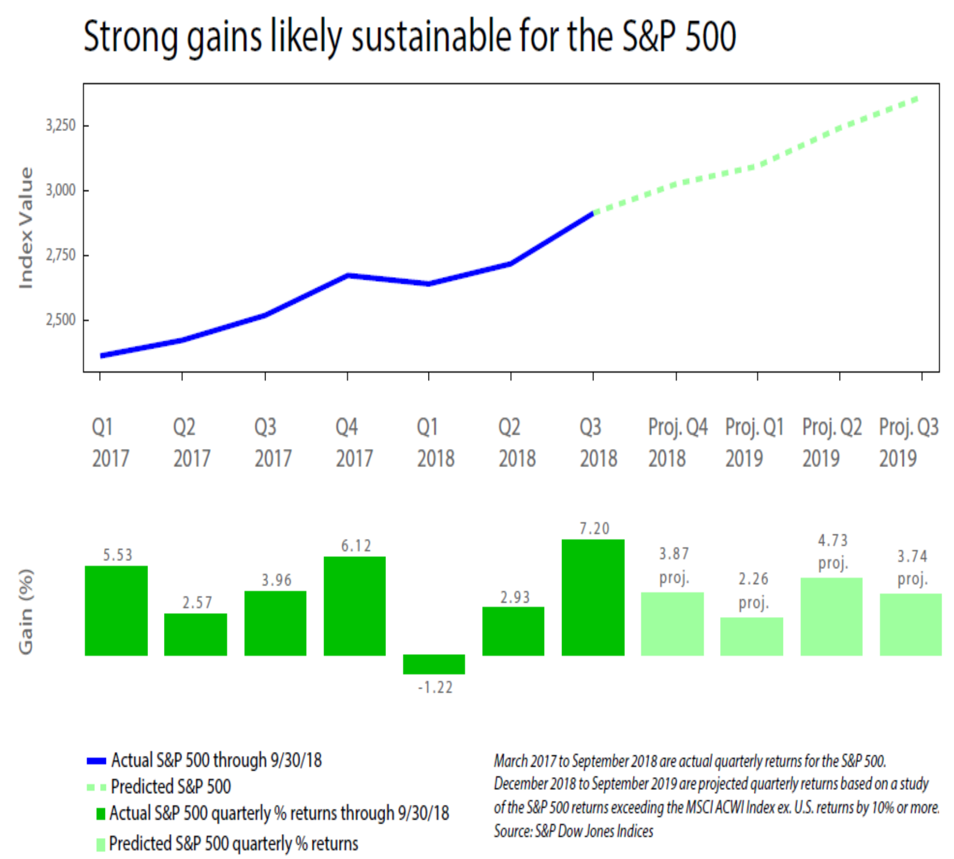
Sectors that show high-growth characteristics—such as health care and technology—dominated in the third quarter. These two particular sectors gained 14% and 12%.

In September, S&P launched the new "communications services" sector, which is made up of media content developers and distributors. With some former tech and media stocks in the mix (like Google), it should be more volatile than the "telecom services" sector it replaced, but less sensitive to interest rates.

On August 24, the S&P 500 hit an all-time high. By the end of the third quarter, the S&P 500 gained nearly 200 points, or 7.2%, reaching 2,914.

According to Ned Davis Research, periods of strong U.S. performance (relative to the world) have typically been followed by further gains up to a year later, as shown by the green bars in the **chart at right**. Corrections after these strong periods also tend to be shallow and short-lived, historically.

Early in the third quarter, safer sectors such as health care and consumer staples outperformed. But by mid-August, investors moved back toward riskier "cyclical" sectors like energy, materials and consumer discretionary. This is a sign that **economic and earnings growth should help fuel market gains into 2019.**



March 2017 to September 2018 are actual quarterly returns for the S&P 500. December 2018 to September 2019 are projected quarterly returns based on a study of the S&P 500 returns exceeding the MSCI ACWI Index ex. U.S. returns by 10% or more. Source: S&P Dow Jones Indices

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Fixed Income

Q3 2018

High-yield corporate bonds continued to outperform

Main Points

High-yield bonds did well due to positive credit conditions and strength in the energy sector.

Long-term Treasury bonds did poorly due to fears of rising inflation and oversupply.

Stronger economic growth and fears of rising inflation suggest rate hikes will continue into 2019.

Higher inflation concerns pushed the 10-year Treasury yield back toward 3%. As yields are inversely related to prices, long-term bonds underperformed. The U.S. Long-term Treasury Bond index lost 2.88%. **Fears of rising inflation in the future and oversupply are likely to continue to drive down long-term Treasury bond returns**.

Commercial mortgage-backed securities (CMBS) were a bright spot in Q3 and had positive returns. CMBS are unique investments, blending fixed income and commercial real estate.

The mortgage portfolio within CMBS is typically diversified, owning loans with different types and locations.

The Fed raised rates in September for the third time in 2018. It is no longer supporting growth with ultra-low interest rates. With wages and oil prices rising, **investors should expect more hikes into 2019.**

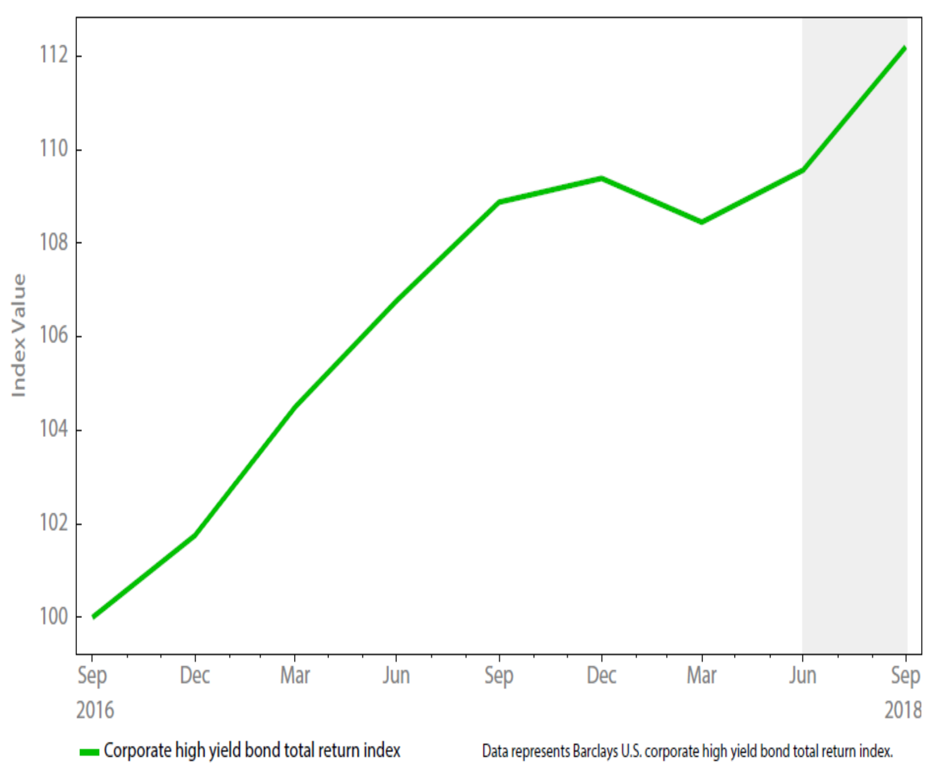
The bottom line: **In Q3, high-yield corporate bonds and CMBS continued to offer greater returns than long-term Treasury bonds.**

Except for U.S. high-yield corporate bonds, **bonds were not a good place to be in the third quarter**. Hurt by a stronger U.S. dollar, the Barclays Global Aggregate, a popular global bond index, lost 74% in the third quarter. The broad U.S. bond index was flat for the quarter.

U.S. high-yield corporate bonds took top honors with a 2.40% total return. As shown in the **chart at right**, high-yield bonds have performed well over the past two years.

In fact, they have outperformed long-term Treasury bonds for most of the time since the end of the Great Recession. Positive credit conditions and strength in the energy sector (where high-yield bonds have more weight than investment-grade corporate bonds) **continue to support high-yield bond outperformance**.

High-yield corporate bonds continued to outperform



Data represents Barclays U.S. corporate high yield bond total return index.
Source: Bloomberg Barclays Indices, data from September 2016 to September 2018

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