LEWIS WEALTH MANAGEMENT

Quarterly Newsletter

3rd Quarter 2018

October 17, 2018

Executive Summary

Markets corrected sharply last week. The causes were mixed, as are the motives of policymakers in Washington.

Fiscal policy has been expansionary (e.g., tax cuts and regulatory easing). Monetary policy has been contractionary (e.g., the Fed raising interest rates).

This year, the U.S. stock market had been focusing on the economic boost provided by the tax cuts and regulatory holiday. Last week, the markets finally paid attention to the Fed rate hikes.

Here are five areas to watch:

1) Fed policy
2) inflation
3) the deficit
4) trade wars and global growth
5) the business cycle

The process of bull and bear markets will march on – indefinitely. Market downturns are a part of the long-term investing experience. But so are the expansions, which dominate and overwhelm the downturns over time.

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Market Data as of September 30, 2018

		YTD 3rd Qtr 2018
U.S. Equities	Russell 3000 ETF	10.42%
International Equities	MSCI EAFE ETF	-1.42%
Emerging Markets Equities	MSCI Emg Mkts ETF	-8.02%
U.S. Bond Market	Barc Agg ETF	-1.64%
U.S. Bond Short Duration	Barc U.S. 1-3 Year ETF	0.14%
Hedging Strategies	Credit Suisse Hedge Fund	1.16%
Commodities	S&P GSCI Comm ETF	11.03%
Real Estate	iShares U.S. Real Estate ETF	1.76%

Markets Corrected

Markets corrected sharply last week and the causes were mixed, as are the motives of policymakers in Washington.

Fiscal policy has been expansionary. Tax cuts and regulatory easing boosted earnings and stock prices for most of the year here in the U.S. (not abroad, however).

Monetary policy has been contractionary. The Federal Reserve has been slowly and steadily increasing interest rates since 2015.

Until last week, markets were basically ignoring the Fed. The markets were happy with the tax cuts and the regulatory holiday. Now, they are coming to terms with the long-term normalization of interest rates by the Fed. The 10-year Treasury bond broke through the 3.00% level and the 30-year mortgages are back above 5.00%. Increasing interest rates mean higher borrowing costs for businesses, consumers, and even our government.

Five Areas of Concern

1. The Federal Reserve

The Fed's mandate is to maximize employment, stabilize prices, and moderate long-term interest rates. Right now, employment is full and prices are relatively stable. The problem is interest rates.

The financial crisis in 2008-2009 was a four-alarm fire. The Fed used every monetary policy tool available to fight the blaze. It lowered short-term interest rates to zero and kept them there for several years. It bought trillions of dollars in bonds in an effort to further lower interest rates. The objective was to encourage investors to buy risk assets (like stocks) and provide low-interest rate credit to businesses, homeowners, and consumers.

Having exhausted all its tools, ***the Fed is relatively unprepared to fight the next fire.*** Since 2015, the Fed has been rebuilding and reloading its monetary policy tool kit. It has been slowly raising short-term interest rates and selling the bonds it bought during the crisis. These moves will not be good for risk assets and borrowers, but they are necessary if the Fed is going to be able to respond to any future economic crisis.

The Federal Reserve is poised to continue to raise rates further as the U.S. economic performance remains strong. It has been telegraphing this to the markets for months. Chairman Powell says these rate increases are "data-dependent," which means that the Fed will continue to monitor the economy closely so it doesn't let rate hikes tip us into a recession. Theoretically, if U.S. economic momentum slows, the Fed could pause further increases, but macroeconomic policy is hardly an exact science.

2. Inflation

Right now, inflation appears to remain benign and within Fed targets. This will make it easier for the Fed to consider pausing further increases. However, if inflation starts to accelerate, the Fed will take this as a sign that the economy is overheating. It will keep raising interest rates to get this under control. This will tend to slow down economic growth and may negatively impact the stock market.

3. The Deficit

The recent tax cuts have blown up the deficit, and this has long-term ramifications for the U.S. economy. According to the Congressional Budget Office, the deficit for fiscal year 2018 will be $793 billion. The deficit for fiscal year 2019 is projected to be $985 billion. We will be financing this deficit in a higher-interest-rate environment. So, our borrowing costs will be higher.

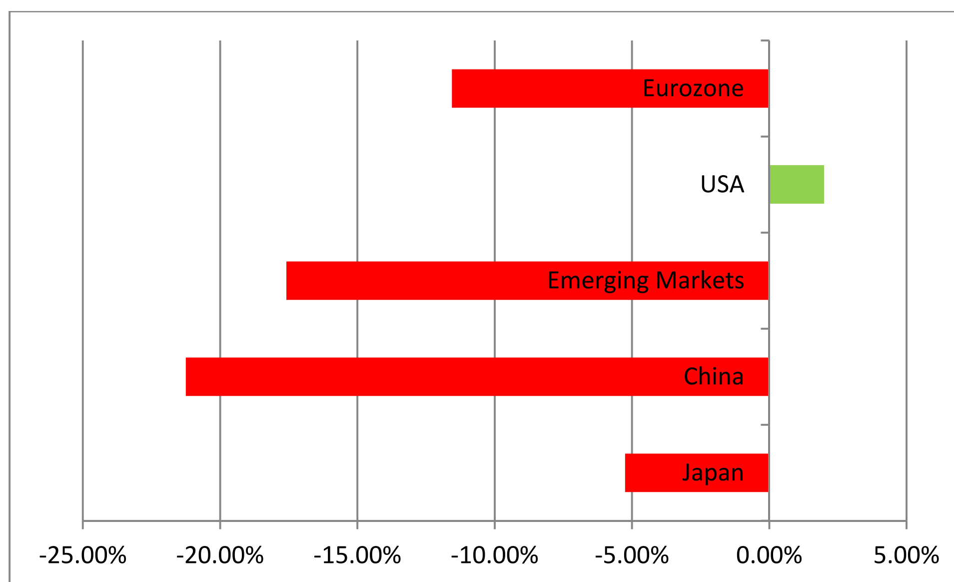
Proponents of the tax cuts argue that the cuts will create economic growth, and this will pay for the cuts. Critics say that the cuts created a temporary "sugar high" that is not sustainable and that the deficit will continue to increase. Time will tell who is right, but most economists say we should be prepared for higher borrowing costs as low-interest rate debt comes due and is refinanced at higher interest rates. This will be a headwind for economic growth.

4. The Trade War with China and Global Growth

We are in a trade war with China, and this is a threat to global growth. Tariffs will be hitting the global markets in the next few months. ***History has shown repeatedly that tariffs hurt economic growth.*** The question is whether punitive tariffs will force the Chinese to trade fairly. If President Trump can negotiate a meaningful trade agreement that would roll back these tariffs, open markets to U.S. exports, and protect U.S. intellectual property, that would be a significant win. If we get bogged down in a long-term trade war with China, it will kill global growth. Also, tariffs will increase prices of imported goods in the U.S., and this would stoke inflation here at home. The Chinese economy is already taking significant hits. Whether this encourages them to negotiate or dig in and fight is yet to be seen. Markets are starting to get jittery the longer this goes on.

As you can see, ***the rest of the world has significantly lagged behind the U.S. this year.***

Price changes of MSCI indexes in 2018 – through October 12, 2018



Source: FactSet, U.S. Stocks Have Been an Anomaly in Global Markets. Not Anymore. *Wall Street Journal*, October 14, 2018.

5. The Business Cycle

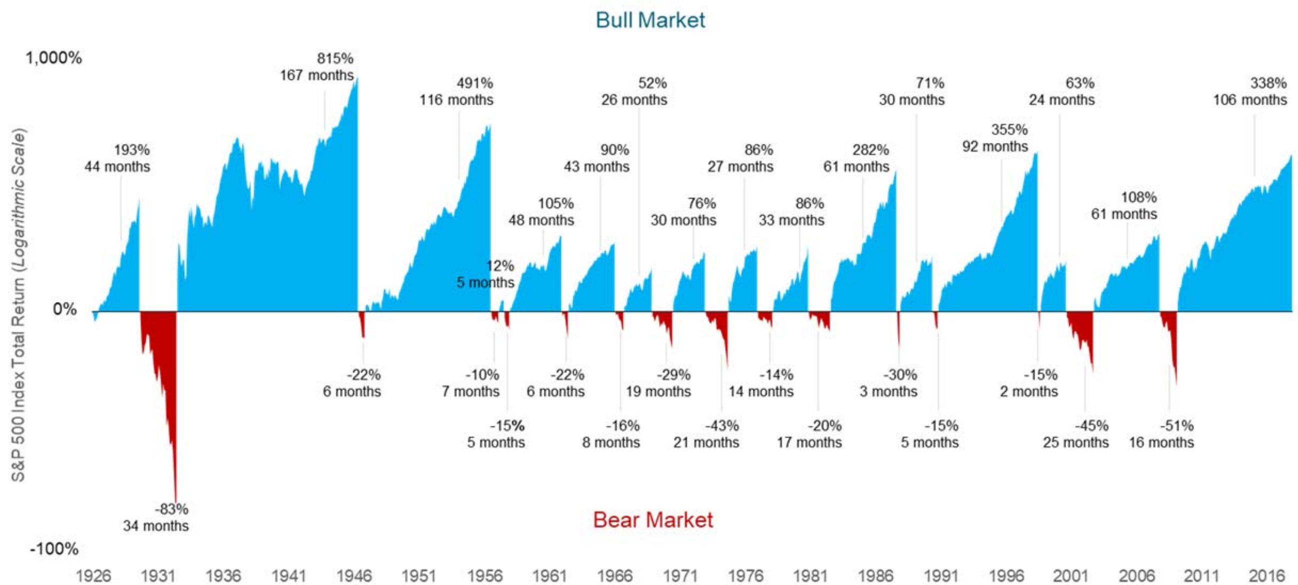
We are currently in the longest economic expansion since World War II. U.S. economic performance remains strong. ***But neither the Fed nor the president can abolish the business cycle – it's bigger than they are.*** The U.S. economy will turn over at some point and our next recession will be here. Most respected economists predict this will happen in the next 1–3 years. No one knows for sure.

Some economists are concerned about how central banks and policymakers will respond to the next financial crisis. Back in 2008-2009, central banks cooperated and tried to coordinate their responses. Policymakers compared notes. They accepted the advice of economists and other experts. However, the world has changed a lot since then. We should not expect the same level of global collaboration and cooperation next time around. It is something to be concerned about, potentially.

The Markets March On

Even so, the process of bull and bear markets will march on – indefinitely. ***As you can see, market downturns are a part of the long-term investing experience. But so are the expansions, which dominate and overwhelm the downturns over time.*** Keep this in mind as we navigate rougher seas ahead.

A History of Market Ups and Downs
S&P 500 Index total returns in USD, January 1926 – December 2017
using a 10% threshold for downturns



Source: Dimensional Fund Advisors.

If you have questions or concerns about your situation, please give us a call at (855) 353-3800.

Thank you,
Austin Lewis

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Source of charts: Dimensional Fund Advisors. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. The S&P data is provided by Standard & Poor's Index Services Group.