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Market Update: October 2018

October was a rough month for investors. Both U.S. and foreign stocks experienced sharp declines, pulling global stock markets down more than 7% for the month. The technology heavy Nasdaq Composite's decline of more than 9% in October was its worst month since 2008.

> **Sharp initial drops are hallmarks of run-of-the-mill corrections, defined by declines of between 10% and 20% in equity prices. Judging by history, this looks like a correction. If history is any guide, the bear market, when it finally comes, will arrive with a whimper, not a roar.**
>
> **Jon Sindreu – WSJ 10/26/18**

The market sell-off was generally attributed to investor concerns over softening global growth, U.S. and China trade tensions, higher interest rates, and a stronger dollar. Year-to-date, U.S. stocks are still hanging on to modest gains, while foreign stocks are suffering double-digit losses.

> **The expectation at the start of the year was this story of synchronized global growth. And it seems like that argument for investing in global equities faded pretty quickly out of the gates.**
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> **Mark Heppenstall, Penn Mutual Asset Management – WSJ 10/29/18**

Nonetheless, the financial news during the month was very positive. U.S. economic growth for the third quarter was robust, and corporate profit growth was solid. Unemployment rates fell to levels not seen since 1969, and consumer confidence reached 18-year highs.

Here are some of the highlights from the U.S. economic front:

- The Commerce Department reported that U.S. GDP grew by 3.5% during the third quarter.
- Eighty percent of S&P 500 companies have reported third quarter profits that exceeded Wall Street estimates ... however, more than one third of the firms have missed revenue projections.
- The Labor Department reported (in the third quarter) that U.S. unemployment levels fell to 3.7% and wages and salaries rose 3.1% from a year earlier.
- The yield on the 10-year U.S. Treasury note reached 3.155%, up from 3.055% at the beginning of the month.

- Rates on 30-year mortgages currently average 4.86% … up nearly a full percentage point from the beginning of the year.
- The WSJ Dollar Index increased by 1.4% for its seventh consecutive monthly gain.

Economic growth outside the U.S. is moderating due to an assortment of dilemmas. China is struggling with trade uncertainties and rising debt, geopolitical concerns (Italy, Saudi Arabia and Turkey) are heating up, emerging markets are suffering from a rising dollar, and the eurozone economy is growing at the slowest pace in two years.

> **The market is asking whether the rest of the world will recouple up to U.S. growth or whether the U.S. will recouple downwards to the rest of the world.**
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> **Neil Dwane, Allianz Global Investors – WSJ 10/31/18**

What is the easiest way to describe the divergence between the U.S. and Europe economies? The Fed is *planning* to raise rates four more times in 2019. The European Central Bank is only *considering* raising rates sometime during the summer of 2019.

I just returned from Charles Schwab's IMPACT® conference in Washington, D.C. With over 5,000 in attendance, the annual conference always offers the best in economic/investment content to practitioners.

So, what was the consensus?

First off, the U.S. economy is still operating on all cylinders. Economists currently see no signs of impending recession. That's the good news. On the other hand, economists have only about 6 months of visibility … at best maybe 9 months. So, the bad news is their insights offer very little guidance for long-term investors.

> **Most of the market's signals … are just statistical noise. People yearn for an explanation for stuff that's often impossible to explain.**
>
> **Campbell Harvey, Research Affiliates – Barron's 11/3/18**

Most of the pundits acknowledged that we are in the late stages of the expansion. Corporate tax cuts and increased government spending (fiscal stimulus) have helped, but the benefits from this *sugar high* will eventually fade. Generally, most are suggesting that a recession will occur sometime in 2020.

Stock values are high, and rising interest rates will put pressure on these high valuations. So, pretty much everyone suggests that investors should expect lower returns in the near-to-intermediate term.

Jeffrey Kleintop, Schwab's chief global strategist, believes that the recent market weakness will soon fade, but over the next six to eighteen months the current economic cycle will peak. At that point, he expects a "garden variety bear market recession" … but not another crisis like the 2008 great recession.

Analysts are also troubled by ongoing U.S. budget deficits and the related impact that debt escalation has on future economic growth.

> **As rates rise, we are on an unsustainable debt path. If I had a magic wand, I would raise taxes and cut entitlement spending.**
>
> **Janet Yellen, Former Fed Chair – Schwab Impact 10/30/18**

Remember, economic growth is simply a function of hours worked and worker productivity. Productivity has been slow for years, as rising entitlement obligations have been crowding out U.S. investment in infrastructure.

> **Entitlements spending is an ever-larger drag on the fiscal budget and private investment. Entitlements are slowing the rate of productivity growth, and that is a critical factor suppressing GDP growth.**
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> **Alan Greenspan – Barron's 10/16/18**

Expect economic growth to slow, and plan on lower rates of return over the next three to five years. Investors should also make sure to have their portfolios properly layered to provide for near-term needs and include certain "shock absorbers" to reduce volatility. Winter may not be coming just yet, but it will arrive at some point. Let's be prepared.

Daniel G. Corrigan, CPA/PFS, CFP®