RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

THIRD QUARTER 2018 MARKET COMMENTARY

October 2018

STATE OF THE MARKETS

Equity markets proved to be resilient in the third quarter, extending gains in the face of headwinds from continued trade negotiations, political uncertainty in Washington, and the upcoming mid-term Congressional elections. U.S. economic and corporate earning fundamentals strengthened in the quarter, lending support for solid equity market returns and higher interest rates.

While the U.S., Canada and Mexico resolved trade negotiations over NAFTA in the quarter, escalating tariff threats continued between the U.S. and China. Equity markets took solace in the fact that the dollar amount of tariffs between the U.S. and China was less than feared, yet no progress was made towards an ultimate resolution. As we have asserted in prior commentaries, we suspect that the U.S. and China politically do not want an extended trade war, however the longer the impasse continues, the harder it will be for either side to make concessions and the more likely that trade uncertainty will weigh on global economic growth.

Despite this uncertainty, as well as the looming Congressional mid-term elections, the U.S. economy continues to steam ahead. U.S. GDP for the second quarter came in at over 4%, beginning to reflect the positive impact of fiscal policy stimulus amid increasing business and consumer confidence in the economy. The labor market remains healthy as the unemployment rate has stabilized at 3.9% and the number of persons employed part-time for economic reasons has fallen by 830,000 this year.

Looking ahead to the end of 2018, we expect election-related uncertainty to lead to some market volatility in the October – November timeframe. The result of the election will have important implications for markets as control of Congress will influence whether further fiscal stimulus to support the economy is enacted and to what extent Democrats can realistically threaten impeachment over election-related collusion claims. However, signs currently point towards Republicans possibly losing control of the House of Representatives, while maintaining control of the Senate, which would lead to more of a stalemate scenario for the second half of the Trump presidency.

Review of the Third Quarter

U.S.-China Trade War Intensifies

In the third quarter, investors continued to fret over developments in trade negotiations between the U.S. and its various foreign trade partners, most importantly China, as trade-related headlines spurred market fluctuations daily. During the quarter, the U.S. imposed new tariffs on $200 billion in Chinese goods in September, causing China to respond with tariffs on an additional $60 billion in American goods. With the U.S. planning to impose additional tariffs – up to the full value of imported Chinese goods – in the coming months if no resolution is reached, a full-blown trade war appears to be upon us between the two largest economies in the world. While the full impact of the tariffs has not filtered through to the hard economic data, the tariffs are expected to dent global and Chinese GDP in 2019 by 0.1% and 0.2%, respectively. Explicitly, President Trump has stated that tariffs are a negotiating tactic to bring trading partners to the negotiating table and reach agreement better trade deals for the U.S. China is the most resistant to this tactic compared to other U.S. trading partners, as President Xi Jingping has taken a hard line towards negotiating with the West to preserve gains from the recent economic liberalization of the communist nation. Further, whereas re-negotiating NAFTA was challenging, at least there was a trade agreement already in place as a starting point. The battle between the U.S. and China is far more open-ended and, therefore, will take much more work to reach an agreement.

The U.S. economy has made great strides in recent years, however the protracted trade uncertainty presents concern for investors about the long-term health of the U.S. and global economy for two main reasons. First, tariffs and protectionist trade policy are inherently anti-growth in a global economy that depends on international trade for the most efficient uses of labor and capital to produce goods. Technology has permitted nations to more easily conduct international trade so that nations with a comparative advantage in labor or capital in the production of a good can trade more effectively with other nations that may have their own advantages in other goods. While the tariff threat may help protect discrete favored industries, the historical record shows that similar past protectionist policies have led to overall lower economic growth in exchange for marginal benefit to these selected industries.

Second, persistent macro-economic uncertainty begins to influence market behavior, as well as business investment, over time. Markets abhor uncertainty. When uncertainty persists over long-term economic growth prospects, short-term economic and corporate profit growth are over-shadowed in investor minds by the potential for dark clouds on the horizon. Businesses will act in the same fashion and may delay or dilute the scale of long-term projects. Thus, there is an eventual indirect real-world impact of extended trade uncertainty that arises due to the chilling effect on economic activity over time. Indeed, markets are currently facing a greater headwind from the fear that the current trade wars will dent economic growth in the future than any actual significant flow through of tariffs to GDP or corporate earnings to date.

Mid-Term Elections Loom

The most significant market moving event of the fourth quarter will likely be the mid-term Congressional elections in November. Current polling, for what it's worth, suggests that the Democrats have momentum in the House of Representatives to pick up several seats and Republicans need to win approximately 30 of the 40 current "toss up" House races to hold onto their majority. In the Senate, the Democrats would need to pick up almost all of the "toss up" races to win the majority. Therefore, the most probable scenario currently is the Democrats winning control of the House with the Republicans maintaining control of the Senate. In this scenario, it is highly unlikely that President Trump could be removed from office through impeachment proceedings, however it is a strong possibility that Democrats will pursue impeachment in the House regardless. The impeachment drama would therefore create a lot of political theater but ultimately would not have significant economic consequences.

More realistically, Democrats would serve as a counter-balance to the Trump economic agenda. Favorably for investors, a split Congress could reduce the extent of trade uncertainty, as all newly negotiated trade deals need to be approved by Congress. Unfavorably for investors, the potential for additional tax cuts would be diminished, yet it is unclear to what extent additional tax cuts would add to economic growth after the initial round of tax cuts already enacted.

Due to the likely scenario outlined above, our opinion is that markets will face some volatility in the run up to the election, before pricing in the probability of a split Congress result and heading higher to close 2018. Historical data can lend some support for market strength in the wake of the election heading into 2019. Historically, markets tend to generate the highest returns in the third year of a presidency. Further, markets tend to weaken in the run-up to a major election, as uncertainty over the outcome abounds, and then recovers strongly in the aftermath. Therefore, it is possible if not likely that we could see a market rally after the election through the end of 2018 and into 2019.

As noted in prior commentaries, however, we feel that the U.S. economic cycle is getting somewhat long in the tooth and a focus on financial planning is important at this stage to ensure that client asset allocations, particularly for retiree investors, are appropriate for the possibility of an economic downturn in the next 2 – 4 years. We feel that the U.S. can continue to grow over the next 2 – 4 years as corporate earnings and business investment continue to respond to fiscal stimulus measures that have been sorely lacking since the Great Recession. Additionally, foreign developed economies are currently in an earlier stage of recovery and the U.S. can benefit from global economic strength. Tactically, value strategies such as RDM's large cap value equity strategy should benefit from the late economic cycle as market data indicates that growth stocks are currently expensive in historical context in comparison to value stocks, which statistically tends to precede a market rotation towards value stocks. Finally, the Federal Reserve is attempting to steer the economy towards a "soft landing" with monetary policy when and if a downturn occurs, rather than the panicked financial crisis that ensued during the Great Recession.

Nevertheless, for long-term investors, it is always prudent to not attempt short-term market timing or invest based on predictions of the moment a downturn will occur. It is simply too difficult to predict the markets over short timeframes with any consistency. For example, many market bears have predicted the end of the bull market over the past ten years and investors would have been greatly harmed by adjusting their investment strategy to such headline-grabbing prognostications. Rather, we recommend ensuring adequate capital buffers are available for cash needs as the economic expansion and bull market ages so investors can wait out any downturn and deploy capital for opportunistic long-term value investing at that time.

As usual, we welcome all comments and suggestions.