THE BOSTON FAMILY OFFICE

Investment Update

Third Quarter 2018

Registering its strongest quarterly gain in almost five years, the S&P 500 closed up 7%, just short of record highs set in the final days of September. Though overshadowed by their larger peers, the smaller capitalization companies in the S&P 600 were up 4%, good by any other measure. International markets continue to perform poorly both on a relative and absolute basis, partially due to a strong dollar, as well as less sanguine growth prospects in developed markets, and the apparent effects of the trade dispute with the US on the Chinese market.

Shorter-term Treasury yields inched closer to that of the 10-year Treasury, but yields also increased across the entire maturity curve and now all offer an attractive income alternative to stocks. For the first time in ten years, even a 1-month Treasury yields more than the S&P 500's 1.9% dividend payout. While all things being equal rising Treasury rates should suppress stock valuations, the perception so far is that they are increasing for the "right" reasons, which are also supportive of stock prices, primarily expectations for better economic growth to come.

Equity Markets (Total Return)	Q3'18	YTD
Dow Jones Industrials	9.6%	20.8%
S&P 500	7.7%	17.9%
S&P Mid-Cap	3.9%	14.2%
S&P Small-Cap	4.7%	19.1%
MSCI All-Country World	4.4%	10.3%
MSCI Foreign Developed Markets	1.4%	2.7%
MSCI Foreign Emerging Markets	-0.9%	-0.4%
US Bond Markets	**Q3'18**	**YTD**
Barclays US Govt/Credit Intermediate	0.2%	-1.0%
Barclays US Govt/Credit Long	-0.5%	-2.7%
BAML Municipal Intermediate	0.0%	0.7%

The Fed also raised its benchmark interest rate again late in September. Ever since it started doing so in late 2015, there has been much debate about whether the expansion was too fragile to handle higher rates, but there is no question that the Fed now has a reasonable amount of flexibility should lower rates be needed in the future. At the same time, higher rates do not appear to be materially affecting the economic expansion, even if only because of the offsetting tailwind from the 2017 tax cuts. Chairman Powell made it very clear that the Fed is open to pausing expected rate hikes next year should economic conditions warrant, and will base its decisions on actual data rather than preconceived notions about how things will play out from here.

The economy the Fed can observe today is generally strong with few signs of accelerating inflation. Consumer confidence is higher than it has been since the beginning of the century, unemployment is under 4%, and wages are finally starting to increase after years of stagnation. There are roughly as many job openings as there are unemployed people, so while those individuals no doubt are suffering, many likely remain out of work because of a skills mismatch, rather than because the economy is failing to create jobs.

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As well as domestic stocks have done in 2018, earnings have increased even more resulting in lower price/earnings ratios and what we think are reasonable valuations. The corporate tax cuts enacted at the end of 2017 helped S&P 500 earnings to increase around 20% or more year-over-year throughout 2018. This is a one-time tailwind to be sure, but earnings are also expected to grow approximately 10% next year, fueled by continued strong revenue growth of 5%, an unmistakable sign of real demand.

The outcome of the mid-term elections does have some ability to be disruptive to investor sentiment. A Democratic sweep would raise the possibility of Presidential impeachment hearings, although realistically the earliest the White House could be out of Republican control is 2020. In any sort of divided government scenario, successful legislation would have to be sorted out by centrists in order to be palatable to all, which could be a positive. If Republicans maintain control of Congress, the President would likely feel emboldened on trade and further tax reform could be in the offing. This scenario is considered less likely at the moment, although we all learned from the 2016 Brexit vote and U.S. elections that polls and odds-making websites are not reliable indicators of actual voting outcomes.

Three months ago the US was engaged in trade skirmishes on seemingly all fronts. As of today, with the notable exception of China, they have all deescalated to some degree and in some cases new agreements have already been reached. The Chinese economy appears to be suffering far more from the sanctions imposed to-date, which will hopefully result in an agreement being reached sooner rather than later. However, it is important that we work to level the playing field by altering their most egregious trade practices, even if doing so involves more near-term discomfort.

2008-2018

2008 produced most of the memorable headlines about the unraveling of the US financial system including the failure or takeovers of Bear Stearns, Lehman Brothers, and Merrill Lynch amongst others. The latter two occurred in September, so recently article after article in the press has reflected back on what happened ten years ago and in the time since. The 50%-plus drop in the stock market and interrelated drop in housing prices nationwide damaged the psyche of an entire generation. Those investors who had just experienced another 50% drop in the stock market only as recently as 2000-'01 were no more prepared for the trauma.

Even if the next recession and material pullback in the stock market are several years off, we are still likely closer to the end of the current expansion than the beginning. Since the stock market bottomed in 2009, there has been a palpable sense that any 5-10% drop in stock prices would inevitably lead to much worse, almost as if the only two options are prices going up, or crashing. Of late we are starting to hear more rational discussions about the inevitability of a garden variety bear market because no economic expansion can really go on forever. This perspective has helped keep valuations in check as mentioned above, and could help avoid a final euphoric run-up that exacerbates whatever pullback finally occurs.

The information contained in this investment update has been taken from sources which we deem reliable. We do not represent that it is accurate or complete, and it should not be relied upon as such. Any opinions expressed herein reflect our judgment at this date and are subject to change.

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