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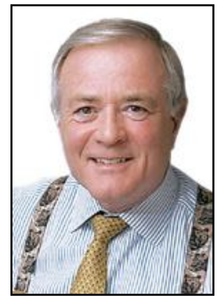

William Rutherford

# Market trudges on in spite of headwinds

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This column is being written on an unusual day: the same day that the month and quarter end. So it is an opportunity to reflect on the year to date and the previous quarter.

In spite of persistent worries among investors, the third quarter turned out to be quite good. The Dow Jones was up 9.0 percent, the S&P was up 7.2 percent and the NASDAQ was up 7.1 percent.

So far for the year, the Dow is up 7 percent, the S&P is up 9 percent and the NASDAQ is up 16.6 percent.

The market was spurred on by strong earnings and the effects of the tax bill. Earnings last quarter were up 17.9 percent, which is not likely to be repeated. The tax bill led to increases in earnings because of lower taxes and spurred stock buybacks and mergers – all shareholder-friendly activity.

At the same time, the market braved substantial headwinds: interest rate increases, election uncertainty and tariff threats.

Annualized GDP growth was 4.2 percent for the second quarter, with most segments of the U.S. economy posting solid gains. The economy will likely cool going forward, but that may be positive for the long-term outlook. Consumer spending contributed an exceptionally strong 2.6 percent to GDP growth in the second quarter, up from the comparatively weak first. Consumer confidence remains strong, suggesting that the consumer will be a strong contributor to GDP going forward.

Inflation remains tame. Still, the Federal Reserve increased interest rates by 25 basis points just as the quarter ended and signaled another rate rise is due in December. The yield curve remained under pressure, perhaps indicating a slowdown in the economy … or worse.

Rising interest rates contributed to a continued strong dollar, which suggests that U.S. exports will slow in coming months and also contribute to a slowing economy. Exports were particularly strong in the recent quarter, adding 1.2 percent to GDP growth. The export growth may have been because foreign buyers were trying to get ahead of tariff threats.

U.S. growth, annualized, for the current year should end up at about 2.7 percent. Longer term, that level of growth may be unsustainable. Higher inflation seems likely, if long-term growth exceeds 2.0 percent.

European economic growth has slowed to 2.2 percent, although few signs point to a coming recession. Because the dollar remains strong, Europeans have a trading advantage, unless of course tariffs disrupt. A strong European Purchasing Managers Index (PMI) of 55.1 suggests a strong outlook for the European economy. Interestingly, the European PMI is about the same as the U.S. PMI, but U.S. growth has been stronger.

In Asia, the Nikkei is at a 27-year high, but still below its all-time high reached 42 years ago. The lesson: beware of bubbles.

Core inflation index readings are at 2.0 percent, exactly where the Fed would like it to be, so the inflation rate should not pose a problem for the Fed.

Looking forward, earnings do not look as strong as in the past few quarters. The last two quarters have seen overall growth at its highest level in eight years. Zacks forecasts earnings growth of about 20 percent for the current quarter and for the first quarter of 2019, but slowing thereafter. Analysts' earnings estimates for the current quarter have been softening too.

The new cycle will start next week. Total earnings expectations for the third quarter of 2018 are up 17.9 percent on 7.3 percent higher revenue. This follows earnings growth of 25.5 percent for the second quarter – the highest growth rate since 2010. Already 16 companies of the S&P 500 have reported. Although it is too soon to draw conclusions from those 16 companies, their total earnings are up 26.8 percent over the same period last year. This is similar to the results from the same group of companies in the preceding quarter.

The admonition to remain fully invested in a well-diversified portfolio has worked so far. However, it is clear that the economy will be slowing in the not-too-distant future. So, while remaining invested, do so in a well-diversified portfolio with emphasis on the economy's best sectors.

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