Financial Advisory Service, Inc.

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FAS Monthly Economic and Market Update

November 2018

As of October 31, 2018

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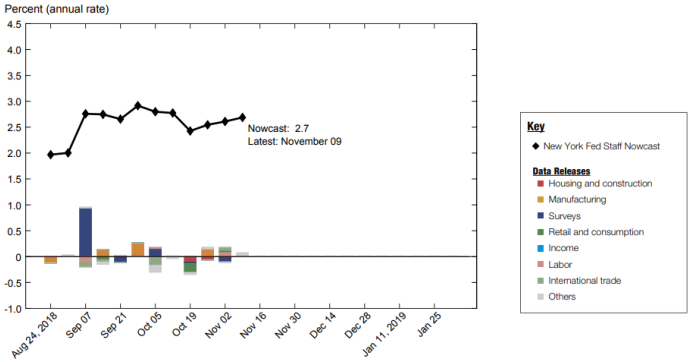
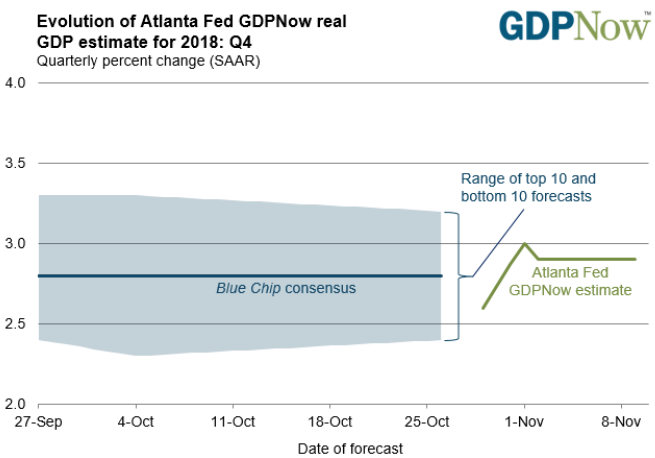
Economic Conditions

Gross domestic product grew at an annual rate of 3.5% in the third quarter of 2018 according to the advance estimate released by the US Department of Commerce marking the first time the US economy has grown above a 3% annual rate for consecutive quarters since early 2015 in what has been one of the longest economic expansions in post-WWII history. Growth was driven mainly by consumption and government spending in the third quarter as Congress reached an agreement on a two-year budget deal that increases government spending by nearly $300B despite limits imposed by a 2011 budget law. Growth in business investments slowed last quarter which has led economists to question whether or not the current growth rate is sustainable. The Federal Reserve projects 2.5% growth in 2019 and slower growth in the following two years. Despite expectations of slower growth in the near-term as well as criticisms from the President, the Fed still anticipates another interest rate increase in December and several more throughout 2019 as they attempt to prevent the economy from overheating. The Fed's inflation indicator showed a 1.6% annualized increase in Q3, still below their 2% target.

New York Fed Nowcast Report, Q4 GDP: 2.7% (est.)



Atlanta Fed GDPNow, Q4 GDP: 2.9% (est.)



Market Conditions

Index Returns	Oct '18	YTD
S&P 500	(6.94%)	1.43%
DJIA	(5.07%)	1.60%
NASDAQ	(9.20%)	5.83%
MSCI EAFE	(8.03%)	(11.49%)
Barclays Aggregate	(0.79%)	(2.38%)

October was a rough month for stocks as the markets began feeling early pressure leading into earnings season. We saw several pre-announcements of negative earnings guidance from multiple companies which ultimately led investors to question 2019 earnings estimates for 2019. Future earnings expectations are important because they effect how the market is priced since the stock market is a leading indicator. If earnings expectations begin to fall, valuations in the market will tend to follow suit. For example, if the S&P 500 is trading at 2925, which is where the index was at the beginning of October, and expected future earnings of the S&P 500 were $179, that means the S&P is trading at 16.3 times earnings (16.3 price to earnings ratio, or P/E), which is around the 25-year average of the index. But if expected earnings get cut to, say $170, then all of a sudden the S&P 500 is trading at a 17.2 P/E which is a little on the expensive side. Again, because the stock market is a leading indicator, as earnings expectations fall, the prices of stocks will tend to fall as well. Uncertainty in Europe, trade talks with China, and the fear of rising rates all come into play when estimating future earnings and these macro factors have been a headwind faced by the markets and the current economic cycle. The Dow and S&P were down 5.07% and 6.94%, respectively, while technology led the decline causing the NASDAQ to fall 9.2% in October. The 10-year treasury rate rose by 0.10% last month at about the same pace the 2-year treasury rate rose (0.08%). The flattening yield curve (short rates increasing at a faster pace than long rates) is something to continue to monitor as it is typically an early indicator of a recession.

Markets and Midterms

The political landscape over the last several years has been anything but boring. Regardless of which side of the aisle you stand on, one thing we can all agree on is the fact that our country is at odds with itself. It came as no surprise the Democrats managed to reclaim a majority in the House while the Republicans will maintain their control in the Senate leaving the country again with a divided government. While we cannot say for certain what actions the Democrat-controlled House will take and whether or not they are serious about bringing forward impeachment resolutions, a two-thirds majority vote would be needed in the Senate to remove the President from office.

So what does all of this mean for the markets? As always it helps to analyze historical data to get an idea of what the next two years may look like. The weeks leading up to the recent midterm elections have been painful to say the least. A 7% drop in October was the worst month for the S&P 500 since the Great Recession and the index is now up a paltry 1.4% for 2018. This is not surprising considering dating all the way back to 1928 the second year of a presidential term has yielded the lowest annual return compared to the other three years. The third year of a presidential term has yielded the highest. In fact, since 1946 stocks have increased in the 12 months following midterm elections *every single time* – 18 out of 18 midterm election cycles, regardless of the political combination. The average

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Markets and Midterms

12-month return in stocks following midterm elections dating back to 1946 is 17%. Furthermore, the average 12-month return measured from the low point in a midterm year is 32%. It should not come as a surprise the markets pulled back leading up to midterm elections since over that same time frame stocks fell an average of 1% from January through October in each midterm election year compared to an average increase of 7% over the same months during non-election years.

We are by no means claiming we anticipate the S&P 500 to rally 17% over the next 12 months from here because, as we say time and time again, past performance is no indication of future returns. We are simply stating despite recent pain in the markets, the fundamentals are still strong, the economy is still growing, and we should not allow political noise to interfere with our long-term expectations. Just as the President cannot take all the credit for the 27% gain since the 2016 elections, the political landscape more than likely will not be the catalyst that ends the current business cycle. That being said, we feel confident in saying the volatility we have experienced thus far in 2018 will not be fading any time soon. The historical lows in volatility throughout 2017 were an anomaly which means diversification is important now more than ever despite what this third year after an election cycle, and the many years to follow, might have in store for the markets.

Disclosures & Index Definitions

Under style performance boxes, indexes referenced in the equities section for large, mid and small reference the Russell 1000, Russell MidCap and Russell 2000 stock indices, respectively. The Barclays US Government, Barclays Credit and Barclays High Yield fixed income indices refer to Gov't, Corp, and HY, respectively. Short, Intermediate and Long refer to the time frame of the investments and their positions on the yield curve.

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All dates are as of October 31, 2018 unless stated otherwise.

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Index Definitions

The **S&P 500 Index** is based on the market capitalizations of 500 large companies whose stocks are listed on the NYSE and NASDAQ. This is widely regarded as the single best gauge of large cap US Equities.

The **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials. It is used as a barometer of how shares if the largest US companies are performing.

The **NASDAQ** is a market capitalization weighted index of the more than 3000 common equities listed on the NASDAQ Stock Exchange. These securities include American Depository Receipts, common stocks, real estate investment trusts, and tracking stocks.

The **MSCI EAFE (Europe, Australasia, Far East) Net Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America, Europe, Australia, and the Far East.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 countries, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Barclays US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

All index information has been gathered from public sources who are assumed to be reliable, although we cannot guarantee the accuracy or completeness of those public sources.