

# Investment Outlook

Fall 2018

## Third Quarter 2018 Review; Fourth Quarter 2018 Outlook

# The Great American Profit Machine

This past quarter, U.S. equity markets surged as profit growth surpassed even the most optimistic expectations. Persistent worries of trade wars, mid-term elections and rising interest rates seemed immaterial by comparison. However, many non-U.S. markets lagged badly. Emerging markets, for example, entered full-blown correction territory, resulting in an unusually wide dispersion of returns.

A critical aspect of the “Great American Profit Machine” has been profit margins sustained at record levels (see chart). Many less ebullient forecasters have expected profit margins to “regress to the mean,” as has happened during many past economic cycles. Further, corporate tax cuts have not always passed through directly to the profit line. Corporations have a choice when given a tax cut: Reduce prices in a highly competitive world, increase wages or purchase more capital equipment.

**S&P 500 Profit Margins**



The exceptional profit growth and record margins raise the question of whether something is structurally different from past cycles. Wages normally rise robustly with an unemployment rate below 4%, yet increases have been restrained so far. Newly appointed Fed Chairman Powell contributed

**Global Equity Performance Year-to-Date**



to this debate with a recent speech referencing detailed research from the Fed about whether the so-called Phillips Curve (a theory that states inflation and unemployment have a stable and inverse relationship) is dead, partially dead or just delayed. The answer to that question will have great consequences for inflation, interest rates, profit margins and market returns.

Our take is that it is hard to get too bearish on U.S. equity markets with profit growth so robust and margins sustaining at record levels. While we fully expect rate or growth in profits to decelerate from the torrid (and tax cut-induced) 20%-plus growth rates, growth in the range of 8 to 10% would still be realistic. U.S. equity markets could easily experience a correction of 5 to 10% if profits were to decelerate sharply. If it were to occur, we would likely view such a short-term correction as a buying opportunity.

A more challenging question is whether the huge lag of non-U.S. equity markets represents an opportunity to add to those markets. Our current stance is, not yet. Yes, many of these markets are cheaper on a variety of metrics that we measure. Emerging markets are the cheapest by a significant margin. However, these markets also have less robust rates of growth and meaningful risks. We continue to hold appropriate allocations to properly diversify our

portfolios but will not be tempted to add unless differentials become more extreme.

Within U.S. equity markets, we have greater conviction as to market leadership and are making meaningful adjustments. Specifically, a subset of the U.S. growth market, most commonly identified as the FANGs (Facebook, Amazon, Netflix, Google), has led steadier sectors by a staggering margin. That has resulted in a number of excellent companies being left behind, in relative terms. The group of companies we favor most can be identified as “dividend growth.” We are increasing weights here in a disciplined manner.

By comparison, fixed-income markets were boring. U.S. interest rates continued to drift higher, but there was not a breakout to a higher rate structure. The yield curve continued to flatten, meaning shorter-term interest rates were rising faster than longer-term interest rates. That suggests the bond market has confidence that inflation will not surge anytime soon.

Credit markets, such as high yield, remained remarkably firm and stable. Default rates are at very low levels and showing no signs of deteriorating in a robust economy. Firmness of energy prices was an additional positive, as that sector is a significant percentage of issuance.

### Fixed Income Performance Year to Date



## The Fed Approaches “Neutrality”; What Next?

The Fed increased the federal funds rate to two and, more importantly, removed the long-held “accommodative” description of its monetary policy. In simpler terms, the Fed is no longer seeking to stimulate the growth of the economy for the first time since the Great Recession of 2008 ended.

The critical questions for interest-rate markets now becomes: what’s the path and what’s the terminal (ending) fed funds rate? Here, too, we believe there are important structural differences from past cycles. We believe the fed funds cycle will be more contained than many in the past. After almost 10 full years of zero short-term interest rates, it is quite difficult to contemplate interest rates moving up too much too quickly. To do so would risk tipping the economy back into a deflationary condition at a time of high debt burdens.

A more likely scenario is the Fed stops raising short-term interest rates in the range of 2.5% to about 3%. Just as we expect profit growth to recede from the current torrid pace, economic growth will likely follow the same general trajectory. The turbocharging from tax cuts and regulatory relief will begin to fade. Unless inflationary expectations were to surge, the Fed would have little motivation to raise rates in a slowing economy with the inflation rate still low.

We believe any kind of substantive geopolitical event, such as a major trade war or considerable market correction, would end the Fed’s tightening cycle.

This has important implications for our positioning within fixed income. We have been correctly positioned all year, with underweight duration and allocations to sectors such as floating-rate bonds that benefit from rising interest rates. That is now changing.

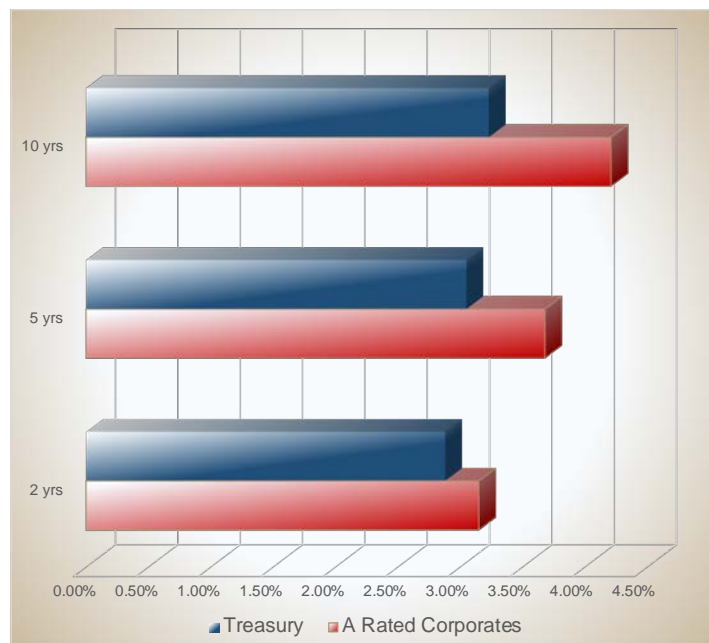
With the yield curve quite flat, we find little motivation to buy long maturity debt. The only rationale to buy long maturities would be if we anticipated falling inflation or a recession. Low-probability scenarios, in our view.

Credit spreads in areas such as high yield are exceptionally low. While we do not anticipate default rates rising much in a robust economy, there is just not much compensation to take on credit risk. Further, high-yield bonds tend to correlate with other risk assets such as equities. That is a major problem, as it undermines the kind of diversification we seek to create in our portfolios.

### Difference Between 10-Year and 2-Year U.S. Government Yield



## A-Rated Corporates vs. Treasuries



As such, we find the investment-grade corporate bond market compelling in the short-intermediate maturities. Generally, a “laddered” portfolio of two-year to five-year maturities is most attractive. There is a meaningful pickup in yield versus owning pure Treasury bonds, but an immaterial risk of actual default of any bond. Investment-grade corporate bonds add quite a bit of yield, diversification and stability within the context of a total portfolio. That makes riding through the inevitable market fluctuations a whole lot less stressful.

If interest rates were to rise more, as we very much hope happens, we would look to extend maturities of our investment-grade bond ladder.

### Keep it Simple

Within equities, we favor the rock-solid, dividend-growth sectors of U.S. markets the most. We find both international markets and particularly aggressive growth areas of the U.S. equity market to be less rewarding. At a minimum, aggressive growth, from the current starting point, will be more volatile in any kind of market correction.

As discussed earlier in this report, fixed-income markets offer limited reward for extending maturities or taking on credit risk in areas such as high yield. Again, it is the rock-solid investment-grade corporate bond market in shorter and intermediate maturities that offers the best relative value.

Making things more complicated or stretching for extra returns by taking on additional risk would be unwise at this time. Of course, the time will come again whereby outsized returns are available in those areas. For example, we have very successfully exploited the high-yield market when spreads are generous and default rates are peaking or falling. Market dislocations create opportunity to add returns for investors who are disciplined and patient.



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