

October 2018

## Quarterly Update – 2018 Q3

The year 2018 continues to reward, and sometimes confound, investors with diversified, balanced portfolios. In contrast to the “Goldilocks” year of 2017, when investment returns were high and inflation was low, few financial markets have delivered positive results, after inflation, this year. US stock markets have produced double-digit gains, with the S&P 500 index up **+10.6** and the Russell 2000 index of small companies up **+11.5%**. However, virtually every other stock market and most of the bond markets have offered no reward for investors this year. International and emerging markets stocks are down, **-1.4%** and **-7.7%** in dollar terms, respectively.

Investment grade bonds have declined by **-1.6%**, including coupon interest (as measured by the Barclays Aggregate bond index). Returns on high yield corporate bonds are modestly positive, up **+2.6%**, aided entirely by the average **6.35%** coupon interest in that market (Barclays Corporate High Yield index). While cash returns have improved this year due to the Federal Reserve raising the overnight Fed Funds rate to **2.25%**, cash still yields significantly less than inflation. According to Morgan Stanley, if these trends continue in the fourth quarter, 2018 will end up delivering the lowest returns across most major asset classes since 2008.

Asset Class	Investment Category	Year To Date Return Through 9/30
Equity	US Large Companies S&P 500 Index	10.6%
	US Small Companies Russell 2000 Index	11.5%
	International Developed MSCI World Index	-1.4%
	Emerging Markets MSCI EM Index	-7.7%
Fixed Income	Investment Grade Bonds Barclays Aggregate Bond Index	-1.6%
	Municipal Barclays US Municipal Index	-0.4%
	US High Yield Bonds Barclays US Corporate High Yield	2.6%
Cash	Cash 90-Day T-Bill	1.2%

Source: Morningstar database. Monthly total returns, in US dollars, as of September 30, 2018.

## Update – Current Investment Themes

As we do each quarter, let's review the progress of the major investment themes that have guided our clients' portfolios for the year.

### **THEME: 1** Hand off from monetary to fiscal policy, increasing interest rates.

#### **Assessment: Accurate**

This theme has the greatest potential to determine overall portfolio returns for 2018 and, thus far, has worked mostly as anticipated. Interest rates have risen with faster nominal economic growth and Federal Reserve policy this year. The yield on the benchmark Treasury ten-year note hit **3.09%** on October 1st, and has climbed even higher this week, hitting **3.23%** on Oct 5th. We began 2018 with the ten-year Treasury yielding **2.41%**. We approached this theme by reducing fixed income allocations to long-term bonds and prioritizing floating-rate bank loans and inflation-indexed bonds in order to avoid the worst of the bond market sell-off. We anticipate maintaining this positioning for the rest of the year. While the current down cycle for bonds is over two years old, we don't believe that fixed income investors are out of the woods yet. We would further reduce any remaining long-term bond exposure, pending any acceleration in inflation, wages or manufacturing activity.

### **THEME: 2** Maintain equity risk levels, but hand off to greater diversification.

#### **Assessment: Mixed results, mostly accurate**

This theme dovetails with Theme 1 above. The fiscal stimulus of tax reform and deregulation has led to faster earnings for US companies (at least this year). With the current bull market in US stocks closing in on its tenth year, we have kept the overall equity allocation near the long-term target for each client's portfolio. The decision to maintain the overall equity level of holdings has contributed meaningfully to client results this year.

At the beginning of the year we wrote about diversifying into US small cap, international and emerging markets. Small company stocks have outpaced large caps this year, so increasing this allocation has added value. Thankfully we delayed the implementation of increased allocations to foreign markets, as international and emerging markets have declined **-1.4%** and **-7.7%** respectively. Foreign market declines have been largely influenced by the temporary US dollar rally that began in May 2018. With US economic growth accelerating quickly on the back of the 2018 tax cuts, dollar-denominated assets have drawn capital away from foreign markets. This could provide an opportunity in the future to sell higher-priced US large companies and reinvest in non-US stocks at lower valuations (assuming global growth trends remain positive).

### **THEME: 3** Expect lower returns ahead in 2018.

#### **Assessment: Accurate**

Theme 3 continues to evolve as expected this year. The stock market has delivered greater price volatility compared to 2017: the S&P 500 sank by **-10.2%** for two weeks in late January and early February, yet has returned **+10.6%** (including dividends) for the year through Sep 30th. Meanwhile, the bond market has continued the grind downward that began two years ago, with the benchmark Barclays US Aggregate bond index down **-1.6%** for the first nine months of the year. For an investor with a typical 60/40 stock-bond allocation, the returns above translate to **+5.7%** before transaction costs and fees. We expect returns will continue to be meager for fixed income investments and are positioned for this environment by keeping bond maturities short. Given the outperformance of US large-cap stocks over foreign markets, we anticipate diversifying equity allocations further away from US large companies, however, such actions will be tactical and based on evidence of improving growth in foreign markets.

## Midterm Showdown

Next month's midterm Congressional elections are in the spotlight, with some pundits proclaiming a potential "blue wave" election that would have major consequences for financial markets. However, based on the history of midterm elections and subsequent stock market returns, the upcoming elections are not as dramatic as the current news cycle makes them seem.

There have been 22 midterm election years since the Great Depression. Across those 22 elections, the average number of Congressional seats lost by the President's party was 32. The worst outcome (for the sitting President) was in 1938, when Democrats lost 79 seats. The best outcome was in the previous midterm election of 1934, when FDR's Democrats picked up 18 seats. Currently, polls forecast that Republicans will lose an average of 34 seats in the House and none in the Senate next month, which is close to the historical average (poll forecast from FiveThirtyEight.com, Oct 2).

What do the midterm elections mean for investors? Likely, not much. The stock market has returned **+3.77%** on average during the November-December period in midterm election years. Returns were negative following only five midterm years (1930, 1974, 1994, 1986 and 2002), three of which were already in the throes of a sustained bear market (1930, 1974 and 2002). The November-December period is seasonally a strong one for the stock market, and well-functioning markets discount any known or potentially important information in the pricing of securities. If anything, the resolution afforded by the democratic process of Congressional elections removes uncertainty. After the peaceful transition of power occurs, market participants focus on fundamental economic and company information that drives the valuations of investments.

Source: Morningstar database, monthly price returns for S&P 500 index. Election results from "Election Statistics, 1920 to Present," US House of Representatives ([http://history.house.gov/Institution/Election-Statistics/Election-Statistics/and "The American Presidency Project," Univ. Of California, Santa Barbara \(www.presidency.ucsb.edu/data/mid-term\\_elections.php\)](http://history.house.gov/Institution/Election-Statistics/Election-Statistics/and%20The%20American%20Presidency%20Project)).

## Stock Market Returns Following Midterm Elections (Nov-Dec)

Year	S&P 500 Change (Price)	President's Party	Seat Change In Congress	House	Senate
1930	-9.45%	Republican	-60	-52	-8
1934	7.83%	Democrat	+18	+9	+9
1938	0.30%	Democrat	-79	-72	-7
1942	4.38%	Democrat	-53	-45	-8
1946	3.10%	Democrat	-65	-54	-11
1950	4.51%	Democrat	-33	-28	-5
1954	13.57%	Republican	-20	-18	-2
1958	7.56%	Republican	-61	-48	-13
1962	11.64%	Democrat	-2	-4	+2
1966	0.16%	Democrat	-50	-47	-3
1970	10.69%	Republican	-11	-12	+1
1974	-7.23%	Republican	-49	-45	-4
1978	3.18%	Democrat	-18	-15	-3
1982	5.18%	Republican	-26	-26	0
1986	-0.74%	Republican	-13	-5	-8
1990	8.63%	Republican	-9	-8	-1
1994	-2.77%	Democrat	-62	-54	-8
1998	11.88%	Democrat	+5	+5	0
2002	-0.67%	Republican	+10	+8	+2
2006	2.93%	Republican	-36	-30	-6
2010	6.29%	Democrat	-69	-63	-6
2014	2.02%	Democrat	-22	-13	-9
<b>Averages</b>	<b>3.77%</b>		-32	-28	-4
When Positive	<b>6.11%</b>	17 elections	-31	-28	-4
When Negative	<b>-4.17%</b>	5 elections	-35	-30	-5
<b>When President Is...</b>					
Democrat	<b>4.38%</b>	12 elections	-36	-32	-4
Republican	<b>3.05%</b>	10 elections	-28	-24	-4

## Conclusion – Where Do We Go From Here?

Our positioning for the first three quarters of the year has resulted in most client portfolios exceeding their relevant market benchmarks. Our investment themes for 2018 have evolved as expected, and the tactical decisions we made in light of the themes have, for the most part, added value.

“ **For those with short time horizons, increased cash allocations make sense as volatility may increase going into year end.** ”

The fourth quarter is likely to remain “interesting,” and 2019 gets harder to predict. Global growth has slowed, US companies are lowering forward guidance and the Federal Reserve is on track to increase interest rates at least two more times over the next year. Emerging markets are challenged by a strong US dollar and slowing growth in China. Italy and the

United Kingdom present challenges to the European Union. While valuations in foreign markets look appealing, we await a catalyst for growth that would make these investments attractive.

As a result of the growing list of worrisome variables, we have raised our cash and liquid alternative allocations modestly, and remain confident that any near-term volatility will provide good entry points to markets. For those with short time horizons, increased cash allocations make sense as volatility may increase going into year end. For longer-term clients, we do not see recessionary signals and anticipate redeploying cash balances through the coming months.

As always, we welcome your insights, concerns and questions. Please contact your Webster Private Bank Portfolio Manager at any time for a discussion about your personal investment portfolio.

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