After starting the year a bit sluggishly, the US economy is currently displaying signs of accelerating growth, both relative to its recent trend and also against its international peers. Consequently, US stocks are outperforming international issues, but stocks as a whole continued to outperform bonds in 2018 through the third quarter.

In our mid-year update and outlook publication, we stated: “As we look ahead to the balance of the year and beyond, our view might best be summarized as more cautious than optimistic. To be clear, full-blown pessimists we are not, but risks are rising in our view, and as such, investors should be preparing for lower returns, higher volatility, and continued uncertainty relative to the recent past.”

With the benefit of hindsight, we can say that our cautiousness was not rewarded, as stocks gained 7.71% in the third quarter. Nonetheless, we continue to believe that prudence is warranted, and we encourage investors to expand their definition of diversification and explore uncorrelated return streams to the extent they are able to do so.

And above all else, we believe in remaining disciplined and focusing on one’s long-term objectives. These are things we can and should control, and these are the determinants of long-term investment success.

3rd quarter review – US Equities

Despite the headlines focused on rising trade tensions, the Federal Reserve (Fed) hiking interest rates, and tumultuous Senate hearings, the S&P 500 index climbed the proverbial “wall of worry” and gained more than 7% in the third quarter. That was its best quarterly performance since the fourth quarter of 2013. With the S&P 500 ending the quarter near its all-time high, it would only be natural to assume that investor giddiness has bid up stocks to expensive valuations. But that’s simply not the case. As Figure 2 shows, the trailing price-to-earnings ratio (P/E) on the S&P 500 is 19.5x, which is well below its average P/E of 20.5x from 2015 through 2017.

The primary driver of the S&P 500’s year-to-date return of 10.6% is strong earnings growth. According to Bloomberg, the S&P 500’s earnings per share grew 19.7% in the first quarter and 24% in the second quarter. The consensus estimates for the third and fourth quarters are +25.6% and +27.1%, respectively. If those earnings per share (EPS) estimates are met, the S&P 500 will deliver earnings growth of 23.5% in full-year 2018.

That impressive earnings growth is a step-function higher than the S&P 500’s EPS growth in 2017, which was 10%. While the solid economic backdrop and the Fed’s interest rate policy play an important role, it is the corporate tax cut that was passed at the end of 2017 that is having the biggest impact on earnings growth in 2018.
**Looking ahead to Q4 – US Equities**

While we expect the economy to remain on solid footing, the Fed to maintain its measured pace of rate hikes, and further benefits from lower corporate tax rates – we also expect the upside for equities to be limited during the upcoming third-quarter earnings season.

In the first half of 2018, S&P 500 companies topped quarterly estimates at an above average rate. In the first quarter, 79% of companies surpassed EPS estimates, and 81% beat EPS expectations in the second quarter. For the third quarter, we believe EPS reports will be more subdued relative to current expectations. We base this view on company guidance given during second quarter conference calls.

Specifically, the percentage of companies issuing positive EPS guidance (EPS guidance above consensus estimates) fell dramatically for the third quarter. Only 20% of S&P 500 companies issued positive EPS guidance for the third quarter. While that is in-line with the average of 27% in the 10 quarters prior to 2018, it is down from 48% in the first quarter and 39% in the second quarter.

The optimistic corporate guidance in the first two quarters of this year reflected the positive impact from federal tax reform, but it took a few quarters for analyst estimates to finally incorporate the benefits of tax reform. S&P 500 earnings should grow around 25% in the third quarter, but fewer companies will beat expectations. As a result, we expect US equities to continue to march higher through year-end, but caution that upside from third-quarter earnings reports is likely to be subdued.

**Fixed income overview**

The Federal Open Market Committee (FOMC) continued to normalize interest rates during the third quarter by raising short-term rates by 25 basis points at its September meeting to the range of 2.00% – 2.25%. Meanwhile, investors have been focusing on the path of rate hikes and the trade war.

Trade war rhetoric continues to intensify and uncertainty as to the resolution of discussions remains, increasing volatility across the US Treasury market. While the US, Canada, and Mexico appear to have negotiated a deal, the US and China remain far apart.

As China and the US continue to add tariffs to each other’s goods, the impact is being felt in China. China’s official manufacturing purchasing managers’ index (PMI) fell a half point during the month of September to a reading of 50.8 – weaker than the consensus estimate of 51.2. Tensions between the US and China are likely to rise in the coming months, which could lead to added uncertainty over interest rates.

Treasury yields were higher across the board during the third quarter, with the 2-year note yield rising 29 basis points to 2.82% and the 10-year note yield rising 20 basis points to 3.06%. The yield curve continued to flatten (2-year note yield rising faster than 10-year note yield) as the rate normalization process by the FOMC continued.
While China has yet to do so, as one of the largest holders of US Treasuries at just under $1.2 trillion, should they begin selling its holdings, rates in the US could rise faster than expected as added supply hits the market.

Returns across the fixed income asset class were muted during the quarter as the Bloomberg Barclays Aggregate Index, a broad measure of the US bond market, returned just 0.02% during the quarter bringing, the year-to-date return to -1.60%. Long-dated US Treasuries were the worst performing fixed income asset class in the US, falling 2.88% during the quarter (-5.79% year-to-date), while high yield was the best performing fixed income asset class during the quarter, returning 2.40% (2.57% year-to-date).

2018 and beyond

As the FOMC continues to normalize rates, one additional rate hike for 2018 and three rate hikes for 2019 are expected. The FOMC will keep a close eye on inflation, which has remained in check so far. While wage inflation has remained subdued, with the unemployment rate at 3.9% we believe the risk of higher wage inflation is elevated.

We believe volatility is likely to rise across the Treasury market as trade war tensions with China increase. We estimate Treasury yields will continue to gradually rise in the next 12–18 months, with the 10-year note yield ending 2018 around 3.00% and rising to 3.50% by year-end 2019. With the increased trade tensions, corporate bonds will likely see increased volatility as well. While we remain overweight corporate credit, we prefer the front end of the credit curve (maturities of three years and less) versus longer maturities, as the flatness of the yield curve makes it attractive on a duration adjusted basis. We expect the fixed income markets to remain challenging for the remainder of 2018, as well as 2019.
Investment Grade Credit

US Investment Grade Credit outperformed the broader market in the third quarter, returning 0.97% versus a return of 0.02% for the Bloomberg Barclays Aggregate Index. Year-to-date, US Investment Grade Credit has underperformed the broader market, returning -2.33% versus -1.60%.

US Investment Grade Credit spreads ended the quarter at 105 basis points, 18 basis points tighter. Spread tightening was led by lower rated ‘Baa’ rated credits, which tightened during the quarter. Single ‘A’ rated credit spreads tightened to 85 basis points, while ‘Aa’ rated credit spreads tightened 15 basis points to 56 basis points.

Higher Treasury yields should help drive demand for Investment Grade as investors begin to find potential returns attractive again. We believe that solid corporate balance sheets and a benign economic environment will continue to be supportive for US Investment Grade credit. We remain overweight US Investment Grade credit and believe the front-end of the credit curve (3 years and less) provides attractive returns versus money market alternatives. A risk to our overweight in corporate credit is a “rush for the exit scenario” caused by increased tension over the trade war.

To learn more about how this quarter’s outlook impacts your portfolio, consult with your Key Private Bank Advisor.

Contributors

Bruce McCain, CFA®, PhD
Chief Investment Strategist

Paul Toft, CFA®, PhD
Director of Municipal Investments

Kevin Gale
Head of Taxable Fixed-Income

Stephen Hoedt
Head of Equity Research

Key Private Bank

Any opinions, projections, or recommendations contained herein are subject to change without notice and are not intended as individual investment advice. Investment products are:

- NOT FDIC INSURED
- NOT BANK GUARANTEED
- MAY LOSE VALUE
- NOT A DEPOSIT
- NOT INSURED BY ANY FEDERAL OR STATE GOVERNMENT AGENCY

©2018 KeyCorp. KeyBank is Member FDIC. 181015-481392