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A Tale of Two Regions:
The United States vs. The World

As we start the fourth quarter of 2018, the U.S. economy continues to show the same strength that it has for most of the year, while international economies face several threats that have led to diverging performance between the two sets of markets. In this quarter's investment outlook, we look at what is driving the divide.

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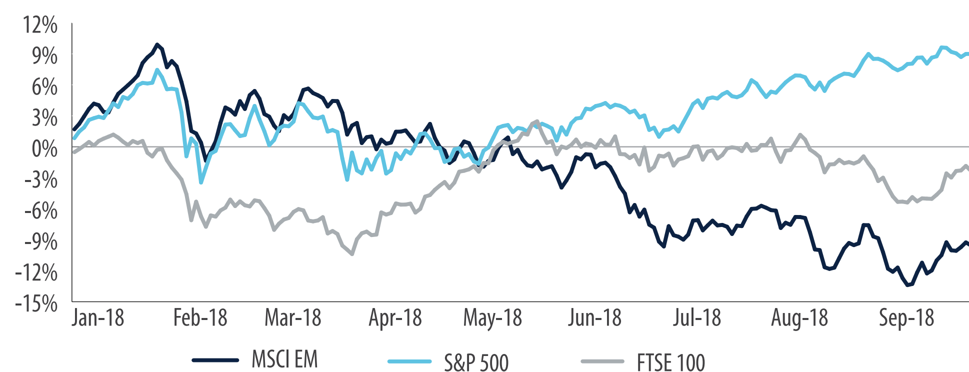
The U.S. Economy Looks Solid

The U.S. continues to be our preferred market in which to invest for several reasons. Consumer confidence remains high, the tax regime is now more favorable for U.S. based companies, and, most importantly, corporate earnings continue to meet or exceed expectations. The labor market has been exceptionally strong with the unemployment rate sitting at a nearly 50 year low of 3.7%[1], although wage growth remains fairly muted at 2.8%[2]. The last quarterly GDP print, which was for the 2nd quarter, showed robust 4.2% growth[3]. The divergence in market performance among different global regions reflects the relative strength of the U.S. economy.

YTD Performance through Q3 2018



Trade Policy Effects TBD

Despite recent economic strength, much has been made of the Trump administration's trade policy and the possibility of derailing the economy via trade wars. While there is no doubt, all else being equal, that the implementation of tariffs is a negative for the economy, we think it is most likely that any new tariffs will be a temporary, rather than permanent, part of trade policy. The new NAFTA agreement with Mexico and Canada (the United States-Mexico-Canada Agreement or USMCA) is a heartening sign that the administration can reach a compromise under tense circumstances. The deal also puts pressure on China to make some concessions or risk having corporations move production out of the country to avoid U.S. tariffs. When it comes to dealing with China, tariffs may hurt in the short term, but would possibly be worth the near-term pain if it helps to reduce the flow of intellectual property pilfered from the United States. Fortunately, there are signs that the U.S. economy may be able to remain resilient in the face of heightened trade fears. The Institute for Supply Management reported in early September that its manufacturing index rose to the highest level since 2004[4].

Emerging Markets Cracking Under Pressure

After an extremely strong 2017, the MSCI Emerging Markets Index is down nearly 10% through the first three quarters of 2018. While the trade issues described earlier are putting some downside pressure on these markets, a more immediate concern pertains to the ability of EM countries with large dollar-denominated debt loads, such as Turkey and Argentina, to repay these loans. As these countries have binged on cheap debt to grow their economies, the economies

1. https://data.bls.gov/timeseries/LNS14000000
2. https://www.epi.org/nominal-wage-tracker/
3. https://www.bea.gov/
4. https://www.wsj.com/articles/u-s-factory-sector-growth-picked-up-in-august-1536070478

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U.S. Performing Significantly Better Than International Markets
Through first three quarters, S&P 500 beating FTSE 100 by 11.3% and MSCI EM by 18.5%

are now struggling at a time when the U.S. Federal Reserve is raising rates, therefore shifting investment flows away from the riskiest economies and into safer assets. This has led to weakness in EM currencies, which exacerbates the difficulty of paying off debt denominated in U.S. dollars or euros. Rarely are issues of this magnitude resolved swiftly and so we are not adding EM exposure aggressively on this weakness. However, during periods of broad-based selling, we would expect some good opportunities to arise on a selective basis, and our tactical approach to the emerging markets asset class allows us to take advantage.

Are Rising Bond Yields a Problem?

Recently, rising bond yields have spooked the markets mildly, but we do not see the need to panic. Indeed, the benchmark 10-year treasury note yield rose to levels above 3.2% last week[5], putting it at the highest level since 2011. This is what should happen, given that the U.S. economy is strong enough to absorb the slow and steady rate increases that have been implemented by the Federal Reserve since 2015. During this time, the pace of inflation has been moderately positive, and the inflation rate stands at 2.7% year-over-year[6], which is far from concerning. The continuation of normalizing interest rates after almost a decade of 0% rates is a good thing. The key here is to understand at what point rates would be elevated enough to impact corporate earnings, due to a slowdown in credit growth and problematic debt loads facing higher interest expense. As investors grapple with this issue, expect more market volatility as rates increase.

Positioning Through the End of 2018

We expected 2018 to be a moderately positive year for the S&P 500 and so far that has played out. Not wanting to fight record growing corporate earnings in the United States, we have focused our exposure selectively on domestic assets and less on the international markets where negative headlines and signs of weakening fundamentals have taken hold. Much of the performance in the equity markets over the past few years has come from growth-oriented stocks. Therefore, we are acutely focused on maintaining a reasonable balance between growth and value exposure in client portfolios, as we are likely in the late innings of the business cycle.

Despite market-moving global headlines, mid-term election rhetoric, and expectations for increasing volatility over the next few months, we maintain our view that the U.S. economy and markets are where we would expect them to be at this late stage of the market cycle. Normalizing interest rates, credit conditions, and strong company fundamentals continue to create a healthy backdrop for investors to prudently maintain a diversified portfolio and selectively identify opportunities which will undoubtedly be present over the coming period.

5. https://www.wsj.com/articles/u-s-government-bonds-fall-after-employment-report-shows-continued-gains-1538748372
6. https://inflationdata.com/Inflation/Inflation_Rate/HistoricalInflation.aspx

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The S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity, and industry. The MSCI Emerging Markets Index is designed to represent the performance of large- and mid-cap securities in 24 Emerging Markets, including Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates. The FTSE 100 Index is a market-capitalization weighted index of UK-listed blue chip companies. The index is part of the FTSE UK Series and is designed to measure the performance of the 100 largest companies traded on the London Stock Exchange that pass screening for size and liquidity.

This letter contains certain forward-looking statements, opinions and projections that are based on the assumptions and judgments of Matrix Private Capital Group with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of Matrix Private Capital Group. Other events which were not considered in formulating such projections, targets or estimates may occur and may significantly affect the returns or performance of any client portfolio managed by Matrix Private Capital Group. Because of the significant uncertainties inherent in these assumptions and judgments, you should not place undue reliance on these forward-looking statements, nor should you regard the inclusion of these statements as a representation by Matrix Private Capital Group that any client portfolio will achieve any certain strategy, objectives or other plans. For the avoidance of doubt, any such forward-looking statements, opinions, assumptions and/or judgments made by Matrix Private Capital Group may not prove to be accurate or correct.

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