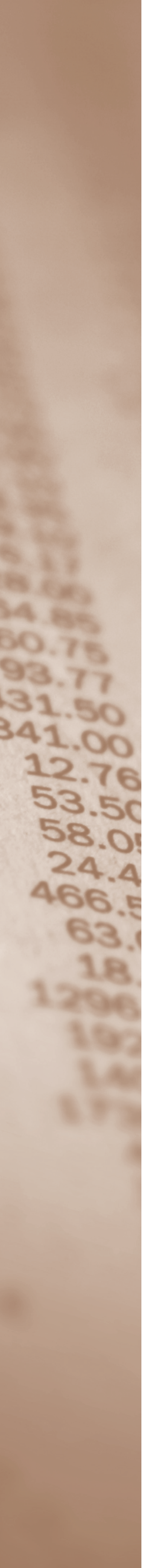


# The Advisor

A quarterly publication from Ables, Iannone, Moore & Associates, Inc.

## Market Update – *Fourth Quarter, 2018*

**A STRONG US ECONOMY** took center stage in the third quarter of 2018, propelling markets to all-time highs. All sectors in the S&P 500 were positive with healthcare and industrials leading the way while basic materials and energy lagged. It's easy to see why the bulls won in Q3. Corporate profits continued to rise, fueling GDP growth. The unemployment rate fell to its lowest level in nearly 50 years while consumer confidence rose to an 18-year high. The Non-manufaturing Purchasing Manager Index (PMI), an indication of the economic condition of the services industry, hit 61.6, a cycle high. Readings over 50 indicate expansion. Furthermore, small business surveys showed strength in hiring, increasing wages and capital investment. We have highlighted this expansionary environment and its support of higher market prices for quite some time now.

We have also pointed out in recent newsletters some of the headwinds this bull market faces as it continues to grind higher. As the calendar rolled over to October, even the most casual of market follower saw the swift decline that roiled both equity and bond markets. The bears have taken control as Q4 gets underway. So what is behind the sudden change of sentiment and market decline? In our opinion, a convergence of several factors vs one single catalyst.

### Inflation Concerns …

Despite core inflation remaining in check at 2.2%, reports of higher input costs for companies such as labor and materials stoked the inflationary fire. Higher input costs directly affect profit margins. To neutralize this, companies will traditionally look to increase pricing especially if they have the power to do so without sacrificing market share to their competitors. Bottom line, price increases are passed along to the consumer. Rising cost of goods and services is the definition of inflation.

### … In Addition To The Fed

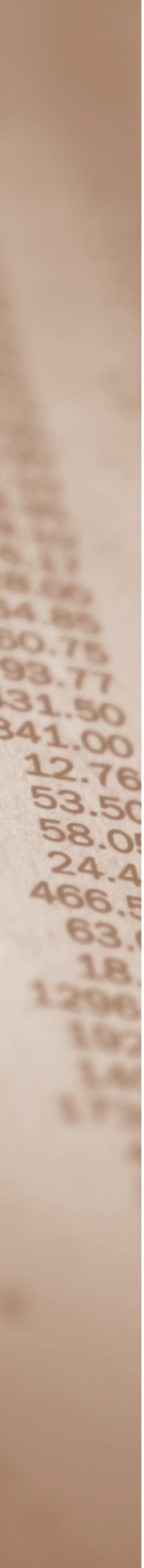
The Fed raised the federal funds target rate in September to a range of 2.00 – 2.25% and is expected to raise rates once again in December. Forecasts currently estimate an additional three more rate hikes in 2019.

### … Leads Us To Rising Yields

Longer dated bond yields are a proxy for where investors believe growth and inflation are headed. This is due to supply and demand forces in the market. If inflationary pressures are building on the horizon, investors will sell bonds because inflation erodes the future earning power of the coupon payment. Selling pressure also stems from not wanting to hold a lower coupon bond if prevailing rates are higher. Additionally, if investors believe growth prospects are rising and the economy is strong they will sell bonds and look for assets that participate in that growth.

Rising yields also impact the stock market in several ways. For example, investors can become attracted to the higher US treasury yields, which are still considered the world's risk-free asset, therefore selling equities and rotating into bonds.

An even greater impact of rising yields on equity markets is in valuation. Many investors overlook the basic premise that a stock is worth the present value of the future cash flows the company is able to produce. Intuitively, it makes



sense, one has to determine what the future cash flows or earnings of the company are worth today. This can be calculated by what is known as a discounted cash flow analysis. A deep discussion of this concept is beyond the scope of this newsletter but a primary factor influencing the present value outcome is called the discount rate. It is helpful to think of the discount rate as the opportunity cost of investing in one place over another. Since rising yields produce more options for an investor to put their money to work in the marketplace, discount rates used in stock valuation must rise as well to reflect these other opportunities. This effect reduces the present value of any future cash flows and now requires even greater cash flow in the future to justify today's stock price.

Another practical illustration of how higher yields impact stock market valuation is seen in higher borrowing costs and debt service that cuts into future profitability, lowering earnings-per-share, thereby lowering what price investors are willing to pay today for the future earnings of the company.

### ... On Top Of Trade Tensions

China continued to dominate the trade conversation despite the United States coming to terms with both Mexico and Canada in a revised North American Free Trade Agreement, or NAFTA. In addition to the $50 billion worth of tariffs on Chinese goods that went into effect over the summer, $200 billion more was added at a levy of 10%. At year end, the levy will increase to 25%.

### ... Exacerbated By Systematic Trading Strategies

With the advance of technology it is now commonplace for computers and algorithms to conduct the majority of buy and sell orders in the market each day. Trading strategies developed by firms, banks and hedge funds based on these algorithms are able to execute orders in astonishing, almost incomprehensible speed. We are talking fractions of seconds. Moreover, many of these strategies are driven by technical levels of various market prices and not the underlying fundamentals of individual companies. It is easy to see how quickly matters might escalate as the buying or selling momentum reinforces what essentially becomes a feedback loop among the systematic trading strategies.

### ... Which Brings Us Back Around

To our belief that maintaining the long-term view is critically important. In our opinion we are still in an expansionary climate. Corrections and pullbacks are a healthy function of markets as short-term views and speculation adjust to the evolving long-term thesis prevelant in the global environment. Despite inflation worries, the current data says it is under control. Rising rates cause a repricing of equity and bond markets but are still historically low. Consumer and business confidence remains strong. Jobs are being created and companies are making money. To be clear, we are not blindly euphoric and recognize a moderation of favorable conditions will mostly likely unfold into 2019 and furthermore in 2020 but as we stand today the momentum remains positive.

As always, thank you to our clients for allowing us to continue working to meet your individualized needs and we appreciate your countless referrals. Please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, we are a firm built on integrity and trust. If you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. We take our role as fiduciary very seriously and will happily provide you with an unbiased opinion based on your specific situation.

Lastly, be sure to check us out on the web at www.aimainc.com and follow our blog for our latest views and insights on investing and the marketplace.

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