MALVERN CAPITAL MANAGEMENT

MCM

Third Quarter 2018
Market Review and Outlook

October 2018

Quarter Highlights

The third quarter 2018 was amazing for U.S. equities. The Dow Jones Industrial Average returned 9.63% for the quarter while the S&P 500 Index returned 7.71%. U.S. mid cap stocks did not do as well returning a mere 5% for the quarter. U.S. small cap stocks advanced 3.58% during the third quarter and developed international stocks were up a modest 1.35%. Not all stocks were positive during the quarter. Tariff talk contributed to sharp declines in emerging market stocks for the quarter.

Bonds were flat for the quarter as measured by the Bloomberg Barclays U.S. Aggregate Bond Index. Strong economic growth and Federal Reserve tightening lead to rising interest rates which acted as a headwind for bond prices. Savers saw a boost in money market and CD rates.

It would be unreasonable to expect a fourth quarter to rival the returns of the third quarter but as we move into the last quarter of the year, there is a lot of room for continued optimism.

Index Performance

Category	Representative index	3M	Y-T-D	1 Yr	3 yr*	5 Yr*	10 Yr*
Mature US Large Company	Dow Jones Industrial Average	9.63	8.83	20.76	20.49	14.57	12.22
Broad US Large Companies	S&P 500 Index	7.71	10.56	17.91	17.31	13.95	11.97
US Mid size Companies	Russell Mid Cap Index	5.00	7.46	13.98	14.52	11.65	12.31
US Small Companies	Russell 2000 Index	3.58	11.51	15.24	17.12	11.07	11.11
Largest 100 NASDAQ Companies	NASDAQ 100 Index	8.61	20.18	28.91	23.63	20.28	18.23
Developed International	MSCI EAFE Index	1.35	-1.43	2.74	9.23	4.42	5.38
Emerging Markets	Credit Suisse Emerging Markets	-4.34	-3.19	5.69	4.69	4.77	3.43
Broad US Bonds	Bloomberg Barclays US Agg Bond Index	0.02	-1.60	-1.22	1.31	2.16	3.77
High Yield Bonds	Bloomberg Bar. US Corp. High Yield Index	2.40	2.57	3.05	8.15	5.54	9.46
Commodities	Bloomberg Commodity Index	-2.02	-2.03	2.59	-0.11	-7.18	-6.24
Total US Market (all cap stocks)	Russell 3000 Index	7.12	10.57	17.58	17.07	13.46	12.01
Real Estate Investment Trusts	Wilshire US REIT Index	0.72	2.25	3.99	7.08	9.25	7.38
Oil	West Texas Crude Int Oil	14.27	22.61	61.08	7.62	-5.11	-6.16
Cash	US T-Bill 90 Day	0.46	0.85	1.41	0.71	0.44	0.31

** 3 year, 5 year and 10 year returns are annualized*

Tightening at the Federal Reserve

The Federal Reserve (Fed) has raised the Fed Funds rate eight times since 2015 after nearly seven years of accommodative and zero interest rate policies. Prior to its beginning to raise interest rates, the Fed had also implemented four rounds of quantitative easing and had increased its balance sheet to $4.5 trillion at one

point. Globally, central banks poured in over $12 trillion of liquidity through various quantitative easing programs. But that has all started to unwind.

We expect the Federal Reserve will continue to raise interest rates likely through 2020 with one more rate increase this year. Although the President has been quite critical of the Fed's tightening recently, the Fed maintains independence and historically has not given into political pressure. The Fed has a dual mandate of maximum sustainable employment and price stability. Nothing more, nothing less. It cannot risk letting inflation get out of control in order to appease a President who nominated its chairman. Even though higher interest rates could or will slow the economy, if the Fed is careful with its interest rate increases, it will avoid causing a recession and accomplish its dual objectives of low unemployment and price stability.

Interest Rates

Since the Fed began raising short-term interest rates in 2015, longer-term interest rates have been slow to increase. The Federal Reserve only directly has impact over short-term interest rates and little impact over longer-term rates. As of the end of the third quarter, the spread between the 10-year U.S. Treasury Note yield and the 2-year U.S. Treasury Note yield is very narrow. The 10-year minus the 2-year is just .24%. Historically when that spread turns negative (for example, the 2-year yield becomes higher than the 10-year yield or any longer dated maturity bond) it generally signals a recession is on the horizon. This is referred to as an inverted yield curve.

Because of the still large balance sheet at the Fed, longer-term interest rates are artificially low. The Fed is letting longer-term bonds mature or roll off its balance sheet but it is doing so at a measured pace so that longer-term rates only gradually increase. However, strong economic growth should ultimately lead to higher longer-term interest rates. Although the 10-year/2-year spread is very narrow, we should be able to avoid an inverted yield curve and the almost certain recession which would follow the yield curve's inverting.

Although the 10-year U.S. Treasury Note yield has hovered below 3% most of this year, in recent weeks it has begun to rise to 3% and beyond. We believe that we will continue to see the 10-year U.S. Treasury Note yield increase this year. Stronger economic growth in the U.S. and the gradual roll off of longer-term bonds from the Fed's balance sheet will put pressure on the 10-year yield. We expect that the 10-year yield should continue to rise toward 3.5% by the end of 2018. At 3.5%, the 10-year U.S. Treasury Note yield will still be historically very low. In the 20 years prior to the 2008 financial crisis (1988 through 2007), the average 10-year U.S. Treasury Note yield is 5.83%. The gradual rise in yields should not disrupt the economic growth we are experiencing.

Inflation

The Federal Reserve targets a 2% annual rate of inflation in the United States. If inflation is tracking below 2% the Fed can be more accommodative. If it tracks higher than 2% the Fed will likely raise interest rates to combat inflation. As of August, 2018, the Consumer Price Index (CPI) – ex food and energy was 2.7%. For comparison purposes, the average CPI – ex food and energy for the last 10 years was 1.6% and the last five years it was 1.4%. The average since 1948 was 3.5%.

It is our view that inflation will continue to trend upwards over the upcoming 12 to 18 months due to expected strong growth in the economy and excess aggregate demand. We also expect to see continued wage growth as the unemployment rate falls, demand for employees increases and shortages of qualified workers in many fields occurs.

Economic Growth and the Economy

The United States' $19.4 trillion economy is firing on all cylinders right now. Gross Domestic Product (GDP) growth for the second quarter of 2018 stands at 4.2% the highest rate of growth in nearly four years. The unemployment rate for September, 2018 was recorded at 3.7% which is the lowest unemployment rate since the 1960s. Average Hourly Earnings have been increasing steadily for months. Wage stagnation has been a problem in this country for years and may actually be improving.

Most other economic data are being reported very positively right now. The Institute for Supply Management (ISM) surveys show that manufacturing is running near full capacity right now. Durable goods orders increased 4.5% in August where analysts only expected an increase of 2.2%. Consumer confidence surged to an 18 year high in September.

Although there is a lot of tariff talk out there right now, we do not believe that we will experience any lasting trade wars with our trading partners. We view the tariff talk by the President as part of a negotiating ploy with the intent of bringing all sides to the table to craft trade deals that are fair to all parties, including the United States. Nobody will win from a trade war.

Stocks should respond positively to strong economic data and the data's presumed positive impact on corporate earnings. However, ironically, a really strong economy can be a headwind for stock prices. If the Fed raises interest rates too quickly in the eyes of investors in response to an economy that is heating up, stocks can sell off and correct for the higher interest rates. We do expect bonds, especially longer-term bonds, to be adversely affected by a strong economy because the strong economy will result in higher interest rates. It will be prudent to avoid longer-term maturity bonds in favor of short duration bonds.

Mid-term Elections

Investors are well aware that we are fast approaching the mid-term elections this November. There are vast implications to which way the results turn out that can foster either continued market advances or possible declines. Historically the party in power in the White House loses seats in both the House and Senate at the mid-term elections. This would mean that depending on the magnitude of the losses, the Republicans could lose enough seats to lose their majority in the House or current slim majority in the Senate.

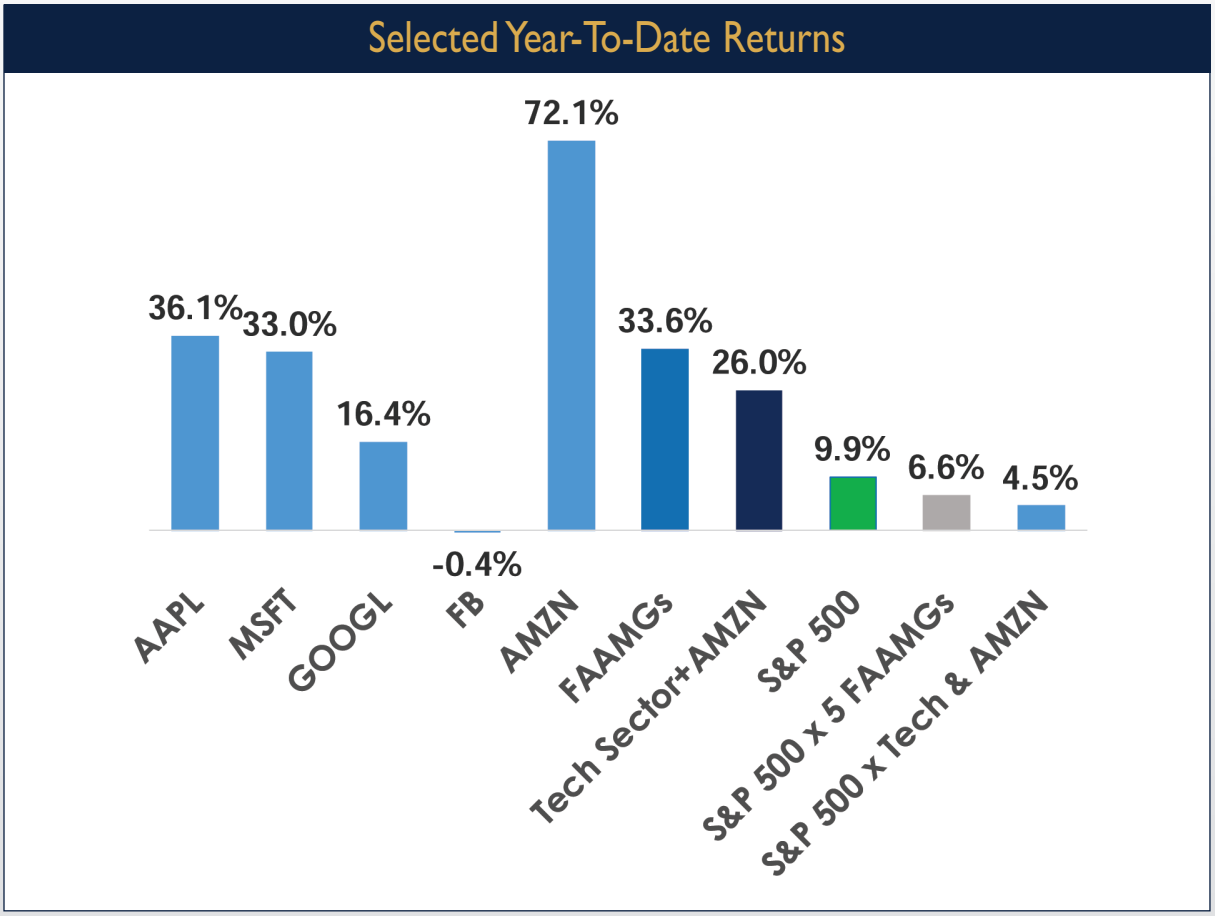
It is possible that if the Democrats win control of the House, the House will be mired in investigations and impeachment proceedings which will allow little time to work on the people's business. Many Democrats have said that if they gain control of the House, they will try to impeach the President. Although they could possibly impeach the President with control of the House, it would take a two-thirds vote in the Senate to remove the President from office. That is highly unlikely to occur. What is also highly unlikely to occur with

Democrat control of Congress is a repeal of the tax cuts, despite the assertion by some Democrats that they would try to repeal the tax cuts. The President would veto such a bill and there will not likely be enough votes to override a veto. It is our view that the current tax cuts are safe while Trump is President and we view the tax cuts as a net positive for the markets. However, impeachment proceedings will be a net negative for the markets.

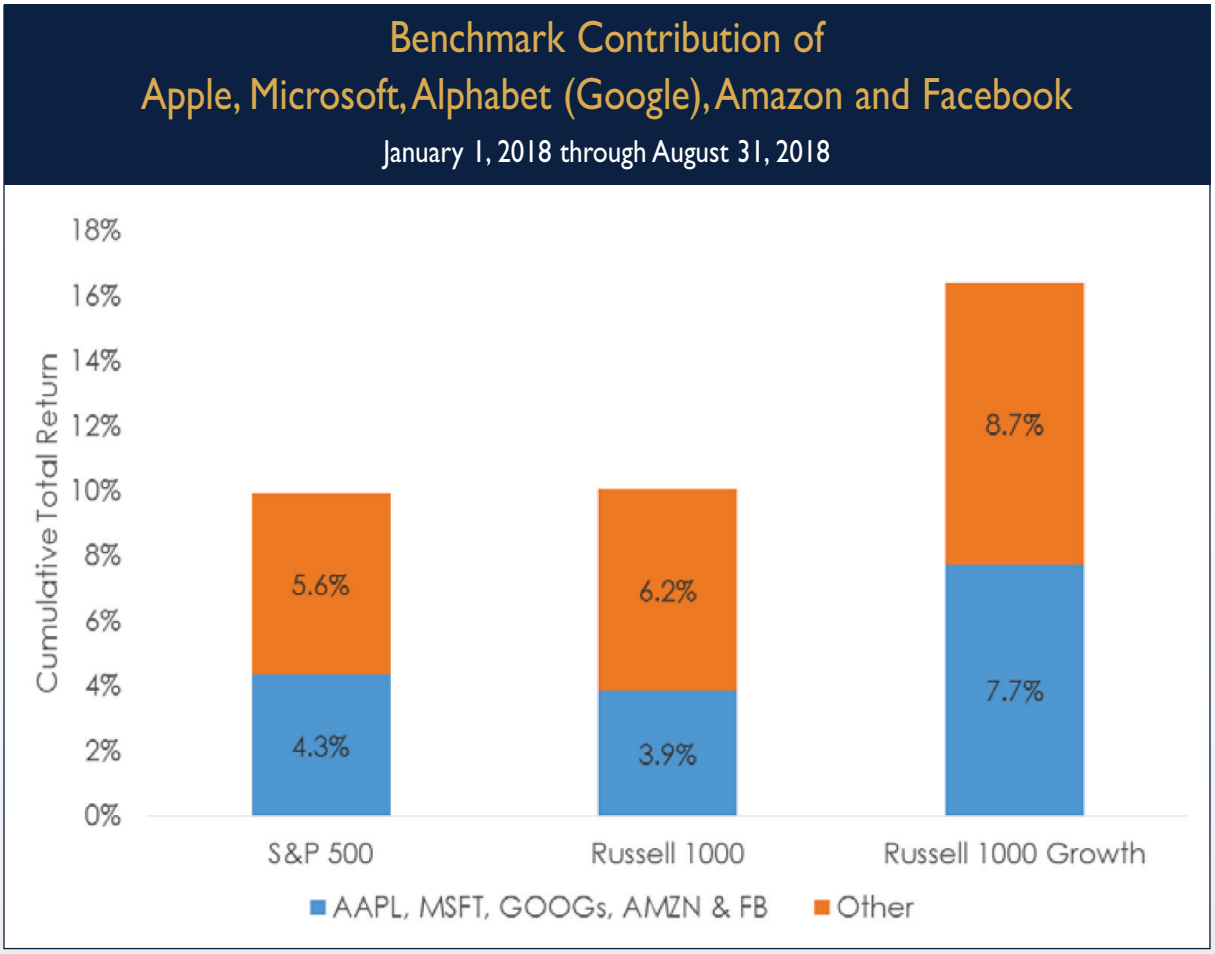
If the Democrats gain control of Congress, forego investigations and impeachment proceedings and focus on meaningful legislation to improve healthcare and infrastructure (among other things), the markets would probably respond positively. If the Republicans maintain control of Congress, we will probably see little change from where we are now. Healthcare does not seem to be a priority of the Republicans but an infrastructure bill is very possible. An infrastructure bill would again, be a positive for the markets.

Highly Concentrated Returns from Five Stocks

So far in 2018 (through August 31, 2018) the average return of Apple, Microsoft, Alphabet (Google), Facebook and Amazon has been 33.6%. Amazon has been up 72.1% this year. Likewise, the S&P 500 Index, excluding the technology sector and Amazon, has returned 4.5%.



These same five stocks have had a total return year-to-date (through August 31, 2018) of 30% and have contributed to about 44% of the S&P 500 Index's return. They have also contributed to 47% of the Russell 1000 Growth Index's return this year.



If you go back to the beginning of 2015, these five stocks have had an average return of over 100% and have contributed to about 28% of the S&P 500 Index's return. They have also contributed about 38% of the Russell 1000 Growth Index's return over this time period. *(Source Factset).*

These data suggest that our stellar market performance has not been very broad and has been dominated by just a sliver of the outstanding stock universe. It is also amazing how five stocks can have so much impact within the market cap weighted indices such as the S&P 500 Index and the Russell 1000 Growth Index.

Earnings and Market Outlook

The corporate tax cuts that went into effect earlier this year have been very positive for corporate earnings. Operating margins are at a record high of 11.55% versus the 20-year average of 8.08%. The improved margins have come from higher earnings per share growth and not from higher sales growth. The Standard & Poor's Corporation analysts currently estimate a trailing 12 month earnings per share on the S&P 500 Index

at $149.09. At the current price for the S&P 500 Index at 2919.38 (9/28/18), the price to earnings (P/E) ratio of the index is 19.55. Based on historical averages, the market is a little expensive at present but not overvalued. In fact, the 20-year average quarter-end trailing P/E ratio is 19.49.

The Standard & Poor's analysts estimate earnings for the next 12 months at $171.68 per share giving the market a forward P/E ratio of 16.97. A reasonable forward P/E ratio would be 16.50, according to many market analysts, so we are not out of line at the present time.

It is our view that stocks have room to continue to move higher. If the 12 month estimate for earnings on the S&P 500 Index do in fact materialize at $171.68 per share (or higher), interest rates stay reasonably low (realizing they are moving gradually higher from here) and the economy continues to grow steadily, we can expect the S&P 500 Index to advance another 15% in the next 12 months.

Conclusion

Returns on U.S. equities for the 3rd quarter 2018 were fantastic. Bonds did not fare as well. The economy is strong and getting stronger but as a result of its strength, interest rates are moving higher. The Fed has to keep inflation in check and maintain price stability. Mid-term elections are upon us and we are in a very highly polarized environment right now. The last thing the economy needs is impeachment proceedings and the distractions that would cause. Nobody will win.

Corporate earnings have been very good and are expected to continue growing. Part of that growth is due to tax cuts leading to improving profit margins but also part of it is due to revenue growth. We expect that domestic equities will continue to do very well and bonds will provide modest returns. It is certainly no time to abandon bonds but rather seek alternative fixed income sources of return through floating rate notes and unconstrained bond funds but also invest in short duration bonds.

We are committed to helping our clients navigate through the seemingly complicated financial markets and seek returns consistent with their risk tolerance and financial goals.

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