American Heritage Financial

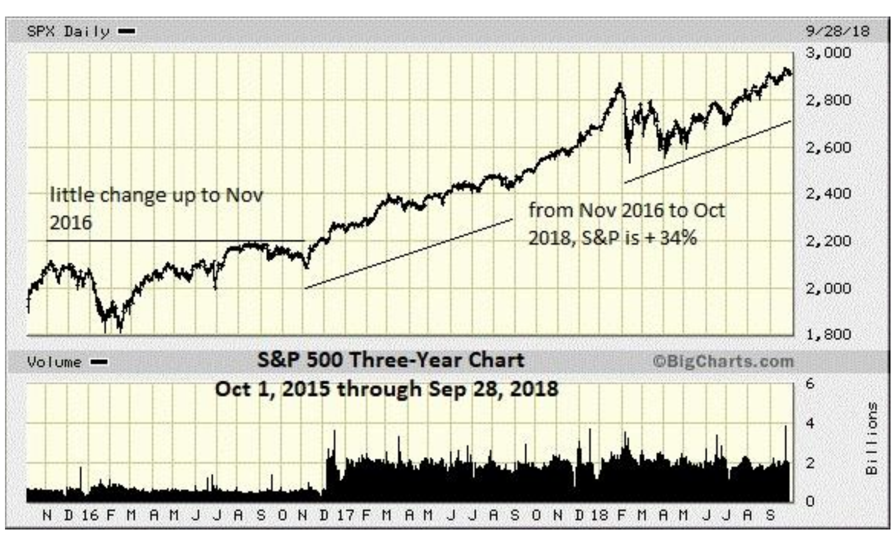
October Update **October 2, 2018**

Keep Calm and Carry On

Conditions in our country definitely don't resemble the dire outlook in Great Britain in 1939 when it urged its citizens to *"Keep Calm and Carry On"* in the face of WWII. But the thought does have merit in our current conflicted environment. Turmoil surrounding political and global concerns escalated into the end of September as the U.S. government moved ever closer to total chaos and the fragile global economy teetered on disturbing news.

On the U.S. political front, the painful spectacle of the Kavanaugh confirmation is just the latest (and possibly most extreme) example of the way our politicians and media (and all who encourage them) are tearing our country apart. Supreme Court justices are supposed to be impartial and above the political fray but, since much of our government is dysfunctional, more and more of our laws are defined by the Supreme Court. As a result, the process of appointing judges has become desperate as political sides attempt to control those decisions. The current battle will leave us with either a tainted Supreme Court judge or with increased rancor among the alienated right-leaning populous. Either way, neither side will see a shred of justification or understanding for those of the opposite opinion. There will be no "winners" in this battle but it will leave the country even more polarized and divided.

Globally, September offered the same long list of issues that have been concerns for months. The U.S. driven trade war continued to add to global tensions. While the first day of October brought a big positive surprise with a reworked NAFTA, additional tariffs between the U.S. and China were levied in late September and the fallout from the trade war is damaging fragile emerging economies as well as adding to inflationary pressures at home. China is struggling with its own soft economy, excessive leverage and plunging stock market (the Shanghai Composite Index is down 15% YTD). China's most effective weapon to fight these problems is devaluation of its currency. Unfortunately, that has a negative impact on the rest of the world's struggling economies.



Trade wars, global economic weakness or our political and social issues all have the potential, if taken to extreme, to have a devastating impact on our economy and markets. So far, however, the most amazing thing about the markets and economy—for two years running—is how they have managed to plow ever forward (and upward) despite constant dire news. (See the attached chart showing market strength over the last two years versus the prior twelve months.)

The third quarter was a great one for U.S. markets. The S&P 500 and Dow Jones Industrial Average surpassed record highs previously hit in January. The Dow is now up 7.0% for the year while the S&P 500 has increased by 9.0% year-to-date. Since both indices were near zero at the end of the second quarter, most of the year's gains have come in the last three months. Global stock markets did not follow the U.S. lead; emerging markets declined (some significantly) and developed markets were generally flat.

The story of what is driving the markets isn't new. Our strong economy, strong dollar, lower taxes, reduced regulation and continued reasonable interest rates (although the Fed bumped rates higher in September) are making U.S. stocks the obvious choice for investors throughout the world. Many of the issues and concerns mentioned above existed at the beginning of this quarter but strong earnings, better than expected economic growth and a continued favorable outlook drove U.S. stock prices higher.

Will the market nirvana continue into the fourth quarter? Risks certainly have not gone away and might be getting worse. Still, just as with last quarter, the effect these risks have on the economy and markets should not be as dire as people fear. Policies that actually drive the economy (such as tax and spending) remain stimulative. We are in a rising interest rate environment—a possible headwind for stocks—but that is due to solid economic growth. Historically, according to ***S&P Global Research***, rate increases at this level have been good for the market. Finally, the midterm elections may be a near-term cloud of uncertainty but should not have an economic consequence for the fourth quarter.

The economy seems to be in a sweet spot with more growth ahead. Hiring remains strong, and wage growth is finally accelerating. Consumer confidence has responded by increasing to its highest reading since 2000. Business confidence and investment also continue to be strong. Although soft housing numbers are a perplexing concern, the major sectors of the economy should continue to expand. Continued growth will boost earnings—which should ultimately continue to support stock prices.

Bullish investors can not only point to earnings increases but the ***valuation*** of the market is "reasonable" or better. Normally, long bull markets move to extreme over-valued levels. With the S&P 500 at just 16.8 times the next four quarter's earnings, according to JP Morgan Chase, the market is far from extremely overvalued. In fact, the S&P valuation is currently at the lower end of its range over the last five years, according to Brad McMillan of ***The Independent Market Observer***.

Of course, markets could be negatively impacted by a sudden turn to the worse from any of the many risks we discussed. More likely, markets could turn on an ***unexpected surprise*** such as a jolt to inflation, a surge in interest rates or a sudden slide in economic conditions. But, taking all into consideration, it appears the last quarter of 2018 might be one where the advice to "**Keep Calm and Carry On"** might be easy to follow.

Best regards,

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Questions or comments?
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