J.W. Burns & Company

Investment Counsel

Quarterly Update - October 2018

Stocks Climb the Stairs But Go Down the Elevator

"The key to making money in stocks is not to get scared out of them." - Peter Lynch

Dear Clients and Friends,

We are now well out of the summer lull, and the final quarter of 2018 is in full swing. Meanwhile, we leave behind an exceptionally strong third quarter, with the S&P 500 Index now up 10.56% as of 09/30/18, the Dow Jones Industrial Average Index up 8.83%, and the Lipper Balanced Index positive by 3.35%. International stocks continue to lag, with the MSCI all World ex USA Index down -2.67% as of 09/30/2018, but fortunately, unlike most investors and investment firms, we have limited exposure here. More on this later.

"With a robust U.S. economy humming along, the Federal Reserve has made it clear its intention to achieve 'normalization' with continued, gradual rate hikes."

For domestic equity markets, the bull market went full steam ahead in Q3. In fact, the S&P 500 posted its best quarter since 2013, soaring more than 7%! Market volatility evaporated in the third quarter with the CBOE Volatility Index, a popular measure of market turbulence, experiencing its biggest drop since the beginning of 2016. In fact, throughout the entire third quarter of 2018, the S&P never closed a single session up – or down – 1%!

However, as I write this here in early October, the tune of the market has changed dramatically, with the Dow Jones Industrial Average down almost 6% in less than ten trading days. The reasons are many – markets always have a wall of worry – but the primary cause of this current decline is the sudden rise in interest rates.

Following September's strong employment report, the rate on a 10 year Treasury bond jumped from 3% to 3.2% almost overnight. This led to a sharp sell-off in stocks that has continued at the time of this writing.

With a robust U.S. economy humming along, including record low unemployment, rising consumer confidence, and strong GDP results, the Federal Reserve has made clear its intention to achieve "normalization" with continued, gradual rate hikes.

In our view, rising interest rates are not unexpected, especially in an economy as strong as this one. To quote John Lynch from LPL Financial, "When interest rates are rising because of better economic growth, stocks historically do well over time[1]."

J.W. Burns & Company
5789 Widewaters Parkway
Dewitt, NY 13214
(315) 449-1341
Fax (315) 449-1349
jburns@jwburns.com
www.jwburns.com

Additionally, interest rates are right where Janet Yellen, the previous Fed Chair, predicted they would be back in March 2016!

The market has known that interest rates are heading higher, so the real question is will rates spike dramatically like recently, or gradually? Our view is that a Fed overshoot is unlikely because the current chairman, Jerome Powell, has repeatedly stated that the Fed remains data dependent and "accommodative."

Indeed, as the stock market has declined sharply over the last few days, the yield has gone back down somewhat. So I don't think rates and/or the stock market will spin out of control.

As such, we believe this current market correction is episodic, healthy, and should be expected. Volatility, as I have stated previously, must be part of the investment process.

At the end of the day, earnings drive stock prices. We are in the midst of third quarter earnings season, and we are expecting continued strong results from your superb, durable companies. Results reported last quarter were outstanding, coming in at 25%, and estimates for this quarter's reports point to 20%-plus earnings growth[1].

"While some of this earnings power may have been 'pulled forward' in the third quarter's strong stock market, we are cautiously optimistic there is still room to run."

While some of this earnings power may have been "pulled forward" in the third quarter's strong stock market performance, we are cautiously optimistic there is still room to run in stocks here in 2018.

So, now is a good time to get to your questions:

Q: What major concerns are there for the market, the economy, and my portfolio? What is your team watching out for?

Beyond a spike in interest rates, the first issue of concern I would mention is the recurring trade war theme. While markets largely ignored trade developments in the third quarter, the issue of trade was mixed. On the one hand, President Trump was able to gain concessions from both Mexico and Canada, likely leading to the revision of NAFTA into the United States–Mexico–Canada Agreement (USMCA). These were no doubt victories for the President, whose unconventional and aggressive tactics were able to bring both Canada and Mexico to the negotiating table to work out a deal.

But on the other hand, trade tensions with China continue to intensify with the United States placing upwards of $200 billion in additional tariffs on Chinese goods. China also retaliated with more tariffs of its own, likely indicating that any further trade negotiations will not take place until at least after the midterm elections and possibly not until next year. Or even later.

As such, I believe trade tensions will continue to be a recurring issue of concern. As exemplified in Q3, the market has disregarded much of the trade drama between the United States and China, but a full trade war would be clearly negative for stocks.

Additionally, we will be carefully monitoring wage inflation, which can put pressure on margins and depress profits.

And – not our least concern – is the United States national debt.

"The future is now"
- From the movie "Time Machine," by H.G. Wells

As of July 31, the U.S. national debt is $21.4 trillion and the fiscal year 2018 deficit sits at $830 million, with a projected $150 million added on for fiscal year 2019.

Eventually, the burgeoning U.S. federal deficit and debt will become a serious issue (record corporate and student debt is also right behind in major concerns). Assuming interest rates continue to rise, our increasing debts service costs will come front and center for investors.

As far as I am concerned, both political parties have been complicit in this abdication of fiscal responsibility. This is a major concern, and I am not real optimistic that any compromise, which includes spending cuts and tax increases, will be reached – before a crisis, anyways.

Hopefully the future is not now!

Finally, we are also concerned about the large performance divergence between U.S. and international stocks. This fits in with our next question.

Q: What about international stocks? I hear that I should be putting more money there as domestic stocks hover around all-time highs.

For the last several years, the conventional wisdom has been to be in international stocks, largely due to their supposedly low valuations and upside potential. On average, U.S. investors have roughly 15% of their holdings in international equities and many model portfolios recommend allocating 20% even 30%.

"While many investor dread market pullbacks and heightened volatility, they provide a favorable environment for stock picking."

At J.W. Burns we have looked past the Wall Street noise and instead been significantly underweight in international relative to our peers, holding roughly 5%–7% in most portfolios.

Thus far, this strategy has paid off as international stocks have significantly underperformed U.S. equities for multiple years. In the international space, we have positioned your portfolio in one of the best performing international index funds: Ishares MSCI EAFE Small-Cap ETF (Symbol: SCZ). We also have a relatively small position in an emerging markets index fund (Symbol: EEM).

We believe their performance should improve, assuming the global economy remains healthy. But for now, we will stick with our relatively modest position in international equities.

Q: I see that many of my bond holdings are losing money. Why is this taking place?

For those clients in a balanced portfolio of stocks, bonds, and some cash, you will have some bond funds. As interest rates have gone up over the last two and a half years, the bonds have depreciated a bit.

However, when you receive your statement from us, it does not show the interest payments you have received. So, in almost all cases (except in the newest of clients) at this point, ***you have actually made money on these bond funds, in fact, probably a nice return.***

As always, please contact us if you have any questions on this.

To sum up, we had a very strong third quarter, but many of those gains have been given back in just the first ten days of October. As our title says: "stocks go up the stairs but down the elevator" meaning stocks go down a lot faster than they go up.

This frequently scares investors out of great companies with rising earnings and dividends, the ultimate key to making money in stocks. Remember, the overall economy is strong, earnings are robust, and valuations – while not cheap – are reasonable. We acknowledge many concerns, and you will likely see some adjustments in your portfolio as we transition to higher yields. But, overall, your portfolio is well-positioned, and we remain cautiously optimistic.

While many investors dread market pullbacks and heightened volatility, they provide a favorable environment for good old-fashioned active stock picking, the bread and butter of J.W. Burns & Company. We are on it, and we already see some interesting values in this most recent market correction.

Thank you for your continued confidence, and please call us with any questions or concerns.

Best wishes,

Jim

James C. Burns, CFA
President

J.W. BURNS & COMPANY, INC.

INVESTMENT COUNSEL

Important Disclosure Information

1 John Lynch, LPL Financial, October 2018