



PRIVATE CAPITAL MANAGEMENT  
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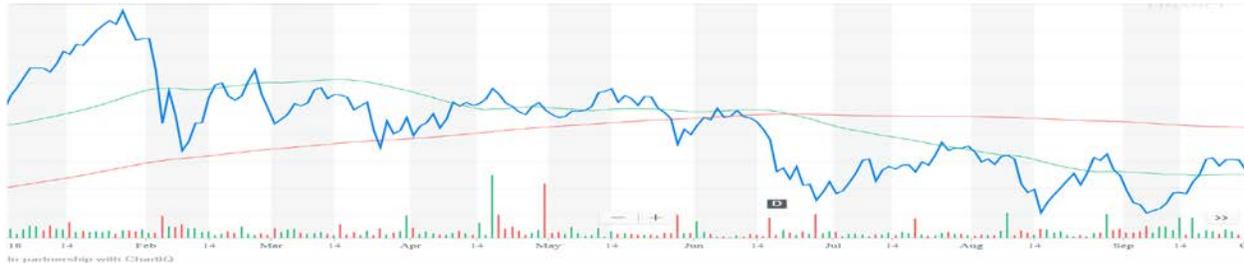
Third Quarter 2018

*"It all comes down to interest rates. As an investor, all you're doing is putting up a lump sum payment for a future cash flow."*

- Ray Dalio

In the third quarter, U.S. broad equity markets posted solid gains and surpassed their January levels to reach new highs. These gains occurred despite escalating tariff threats with China, rising interest rates, and a flatter yield curve. Foreign and emerging market stocks, in contrast, have had a much tougher year. The same trade and interest rate issues that U.S. markets have managed to shrug off have weighed on foreign markets. Non-U.S. stocks have declined just over 10% since the January peak and lost 2.7% YTD.

**Global ex-US Stock Index: YTD 2018**



Source: Yahoo Finance; blue line shows iShares MSCI ACWI ex-US ETF (ACWX) YTD through 9/30/18

Bonds have also experienced negative returns so far this year. Bond prices, which move opposite to interest rates, have declined due to rising rates across the yield curve. Given these mixed returns for stock and bond markets, investors have generally experienced positive but very modest returns this year. A simple 60/40 combination of global stocks and U.S. bonds, for example, would have returned 1.8% YTD.

Key drivers of U.S. stock returns have been solid economic data, trade progress ex-China, and higher than expected corporate earnings growth. Notably, corporate revenue growth has been quite strong as well, reflecting solid underlying demand and adding credibility to the earnings story. Valuations for most broad-based indices remain above-average but reasonable compared to longer term averages.

Among the recent headlines moving markets has been an upside acceleration for the benchmark 10-year U.S. treasury yield. The 10-year yield has more than doubled since its mid-2016 Brexit lows, and has increased 83 basis points so far this year, a 35% move. Rising 10-year rates reflect the bond market's higher confidence in growth and inflation going forward. While rising rates are negative for bond prices in the short term, higher rates are good news for bond investors over the medium term, as they should

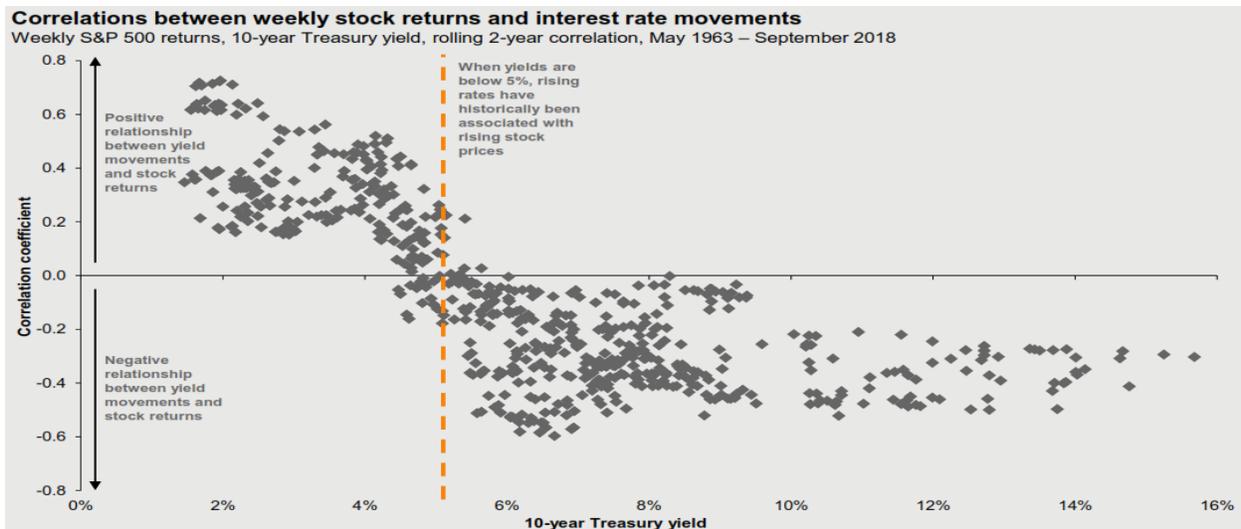
provide both greater returns and lower risk. Higher yielding bonds will also allow investors to reallocate more dollars to safe assets over time.

## 10 Year Treasury Rate: 3.23%



Source: Federal Reserve Economic Data. Chart shows the 10-year constant maturity treasury over the trailing 5 years.

Stocks often perform well in a rising interest rate environment. Increasing interest rates, especially from very low levels, are a positive economic signal and tend to be associated with rising stock prices. However, higher rates do pose a threat to stocks at some point. Historically, stocks begin to struggle when the yield on the 10-Year treasury reaches approximately 4%-5%. The higher cost of capital at these levels limits investment spending and hurts margins. Higher rates also reduce the price investors are willing to pay for stocks, weighing on valuations. Most strategists currently expect the 10-Year treasury to level off somewhere between 3.25% and 3.50%.



Source: JP Morgan Guide to the Markets

Closely tied to interest rates is inflation. Just as interest rates are not currently expected to reach extreme levels, neither is inflation. Moderation in the pace of economic growth going forward should limit significant inflation increases. In addition, the secular trends of aging consumers, globalization of supply chains, broad-based technology improvements, and more competitive labor markets all help to limit inflation upside. It is notable that even headline inflation remains moderate at a time when the unemployment rate is at record lows and oil prices have increased significantly. U.S. inflation forecasts for the next 10 years hover just above 2%.

## 10 Year Breakeven Inflation Rate: 2.16



Source: Federal Reserve Economic Data. Breakeven inflation is a market-based measure of inflation. It is the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity.

Ten years after the Lehman Brothers bankruptcy and nine years and counting for this bull market, we are cognizant of the passage of time and the greater risks that may be present for investors. We continue to expect higher volatility going forward as markets adjust to rising rates and generally tighter financial conditions. Recession risk remains low for now. This fact, along with current economic momentum and corporate earnings strength, keep us generally constructive towards risk-based assets within the context of a diversified portfolio.

As is always the case, there are no shortage of threats to this outlook. Trade tensions with China, rising oil prices, global politics, U.S. mid-term elections, and monetary policy mistakes all pose near term risks and add to short term noise. Somewhat longer term, we view rising corporate and government debt levels as credible risks to the current bull market. These are all factors we will be watching closely.

## By the numbers...

Index	Close	3 <sup>rd</sup> Quarter	Year-to-Date
S&P 500	2914	+7.7%	+10.6%
Dow Jones Industrial Average	26,458	+9.6%	+8.8%
Russell 2000	1697	+3.6%	+11.5%
MSCI EAFE	1974	+1.4%	-1.4%
MSCI Emerging Markets	1048	-1.1%	-7.7%
Barclay's US Aggregate Bond	2014	+0.02%	-1.6%
Bloomberg Commodity	176	-2.0%	-2.0%

Domestic total return and international net return data provided by Morningstar as of 9/30/2018

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# C O M M E N T A R Y

capitalization index that is designed to measure equity market performance of emerging markets consisting of 21 emerging market country indices. The Barclay's U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The Bloomberg Commodity Index is an index composed of the futures contracts on 19 physical commodities. Additional information is available upon request.