TW Advisors

Newsletter 3rd Quarter 2018

Fourth Quarter Commentary on Market Volatility

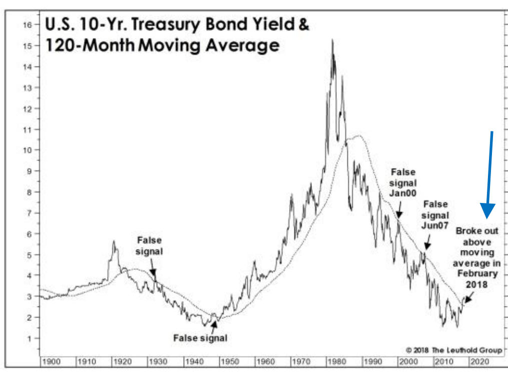
We believe that in order for this pullback to turn into a bear market, we would need to see signs of a profits recession, significant tightening of liquidity and/or unrealistically bullish investor expectations. None of these conditions exist today. While fundamentals overseas have slowed, the domestic economy and corporate earnings remain robust. Meanwhile, liquidity remains ample, and investors fear a repeat of 2008 more than they fear missing out on gains.

Trade Issue: Not that Bad??

While the themes that have endured for quite some time in the stock market continued in the third quarter, that is, growth stocks outpacing value stocks and domestic outpacing international, several bubble stocks popped. This is best seen by the FANG+ index which was down -3.2% in the quarter. It is very encouraging that some of the frothiest parts of the market could correct meaningfully without causing any broad-based damage. We would not be surprised to see further rotation in the fourth quarter and into 2019. A change in market leadership to value and international stocks would allow the equity market to continue to post positive, but most likely, more moderate returns.

Stocks powered ahead in the third quarter as investors seem to have determined that lower taxes and less regulation is overwhelming any potential negative effects of the trade wars. This assessment could change in the future, so we will be looking for signs that global growth is turning down. The immediate impact of lower taxes and less regulation has been an improving economy and very strong corporate earnings. As a result, stock valuations are less imposing than they were a year ago which is encouraging.

The other big story in the investment world is the bond market. As we've stated in the past it appears the 30+ year bond bull market is over (see chart). **Many investors don't realize that as rates rise the value of bonds, especially long bonds, can decline. The aggregate bond market is down about -1.5% on the year with interest rates creeping higher as the Federal Reverse has steadily increased short-term interest rates.** Our strategy has been to emphasize ownership of short-term bond (ETFs) to reduce or eliminate the negative effects during periods of rising rates. The silver lining to higher rates is that we're moving to a place where initial yields are starting to look attractive. The longest bond ETF on our buy list is the iShares iBonds (ETF) Dec 2022 Corporate (ticker IBDN) with a yield of 3.6% and a modest duration (measure of maturity and volatility) of only 3.4 years. **Bonds will continue to be a buffer to any stock market correction and they are now finally able to provide some income to investors.**



Overall our outlook has improved since the sharp, quick downdraft early in the year. **The stock market can be vulnerable when growth rates slow, as is expected in the future, so more volatility would not surprise us.** However, we are not expecting major, permanent declines as there are no obvious excesses in the economy or stock market.

James Tillar, CFA and Steve Wenstrup

OUTSIDE COMMENTARY

Howard Marks: Excerpt 10-1-2018

The Seven Worst Words in the World

Before closing, I want to share my view that equities are priced high but (other than a few specific groups, such as technology and social media) not extremely high – especially relative to other asset classes – and are unlikely to be the principal source of trouble for the financial markets. I find the position of equities today similar to that in 2005-06, from which they played little or no role in precipitating the Crisis. (Of course, that didn't exempt equity investors from pain; they were hit nevertheless with declines of more than 50%.)

Instead of equities, the main building blocks for the Crisis of 2007-08 were sub-prime mortgage backed securities, other structured and levered investment products fashioned from debt, and derivatives, all examples of financial engineering. In other words, not securities and debt instruments themselves, but the uses to which they were put.

This time around, it's mainly public and private debt that's the subject of highly increased popularity, the hunt by investors for return without commensurate risk, and the aggressive behavior described above. Thus it appears to be debt instruments that will be found at ground zero when things next go wrong. As often, *Grant's Interest Rate Observer* puts it well:

> Naturally, the lowest interest rates in 3,000 years have made their mark on the way people lend and borrow. Corporate credit, as [Wells Fargo Securities analyst David] Preston observes, is "lower-rated and higher-levered. This is true of investment-grade corporate debt. This is true in the loan market. This is true in private credit."

> So corporate debt is a soft spot, perhaps *the* soft spot of the cycle. It is vulnerable not in spite of, but because of, resurgent prosperity. The greater the prosperity (and the lower the interest rates), the weaker the vigilance. It's the vigilance deficit that crystalizes the errors that lead to a crisis of confidence.