Review & Outlook

Third Quarter 2018

October 15, 2018

Executive Summary

John Augustine, CFA, Chief Investment Officer

Strong Economy, Mixed Markets

Year-to-Date market returns:

S&P 500	10.56%
S&P 400	7.48%
S&P 600	14.52%
MSCI EAFE	-0.99%
MSCI EM	-7.49%

Barclays Intermediate Bond Index	-0.76%
Barclays High Yield Bond Index	2.57%
Barclays TIPS Bond Index	-0.84%
Barclays Municipal Bond Index	-0.40%
Gold	-9.00%

In this piece a quarter ago, we noted that we were experiencing a "strong economy, flat markets." As you can note from above, we slightly changed that title for the third quarter.

Stocks, particularly domestic stocks, showed some signs of life in the third quarter, led by U.S. large cap stocks. The S&P 500 saw a total return of 7.7% in the third quarter, which was its best quarterly performance since Q4-2013. Even larger companies, as measured by the S&P 100, returned nearly 9%.

Going into the third quarter, it was small and mid-cap stocks that were leading to the upside. That changed in September, as the U.S. Dollar rolled over in value and corporate profit growth continued to surpass estimates for the S&P 500. However, they still had respective 3% and 4% returns in the quarter, while overseas stock indexes continued to lag.

What did not change in the third quarter was the drift higher in interest rates. The yield on the U.S. 2- and 10-year treasury notes are now both higher than the year-over-year rate of consumer inflation for the first time since 2015. In addition, the Fed lifted its Fed Funds rate for the 8th time in the past three years, and is expected to do so several more times through 2019.

With yields drifting higher, we do note for bond and bond fund investors that it is causing negative total returns this year for most of the bond indexes listed above. Investors should be aware of this for their portfolios. This is a large reason the average balanced mutual fund is only 3% higher year-to-date.

The U.S. economy continued humming in the third quarter, as George Mokrzan notes in his following economic piece.

Our outlook for the fourth quarter is predicated on many variables, such as the Fed, inflation, trade, the mid-term elections, and Italy's finances. However, we believe we will continue to be impressed by the overall performance of the U.S. economy with the unemployment rate near a 40-year low and business optimism at an all-time high.

Perhaps, this year, investment returns stay below their long-term average of 6-8% for the average balanced mutual fund (…primarily due to negative bond total returns). However, strong economic and profit activity this year should put businesses and investors on solid footing moving into 2019.

The Economic Forecast

George Mokrzan, Ph.D., Senior Vice President, Director of Economics

Real GDP growth will likely edge lower in the second half of 2018 from the vigorous 4.2% growth in the second quarter, yet still grow a solid 2.9% overall in 2018. Momentum in the economy is forecasted to continue into 2019 with 2.6% forecasted real GDP growth. Buoyed by historic business tax reforms, solid balance sheets, and an expanding overall economy, business spending on capital expenditures is expected to remain strong throughout the forecast, with small business performing especially well. Benefitting from rising disposable personal incomes, strengthening labor markets and healthy finances, consumer spending growth is forecasted to remain strong in 2018, but slow somewhat in 2019 as interest rates rise. The international economy is expected to continue moderate growth overall. Risks in some emerging market economies with weak underlying fundamentals and repercussions from trade disputes represent risks to the forecast, but have not had significant impacts on the macro-economy to date. Inflation is expected to remain moderate at 2.3%, right in line with long-term trends. This should enable the Federal Reserve to maintain a slower pace of Fed Funds rate target increases in 2019 than the regular 25 basis point hikes in each of the last 4 quarters. An expected moderation in consumer spending growth and inflation next year should also allow long-term interest rates to rise at a slower pace, with the 10-year Treasury yield initially forecasted at 3.25% at year-end 2019. However, recent guidance from monetary policy makers has been hawkish, especially if inflation surprises to the upside. Therefore, risks in interest rates are to the upside.

[Please see The *Economy in Focus* report for the third quarter of 2018 for a detailed discussion of key developments in the economy.]

Fixed Income Markets

Kirk Mentzer, Senior Vice President, Director of Fixed Income

Global markets had plenty to worry about during the summer months, including geopolitics, Italy's deficit defiance, trade negotiations, central bank tightening of monetary conditions, and emerging market volatility. However, by September, the gloom started to lift and markets responded accordingly.

Benchmark 10-year Treasury yields remained within a well-defined range of 2.8% to 3.00% for much of the second quarter before breaking higher in late September to 3.06%.

Yield curves continued to flatten during the period as the gap between 2- and 10-year Treasury notes fell to 0.24%. In our last publication, we observed that corporate bond value had been restored at mid-year. Strong earnings growth, low default rates, and relatively high yields reinforced our conviction to overweight this segment of the fixed income markets. Results were better than we expected due to manageable new supply and fading macro concerns enumerated above. Credit spreads narrowed significantly, giving the corporate bond segment a gain of 1.74% greater than similar maturity Treasury securities. Taken together, the Bloomberg Barclay's Intermediate index produced a positive total return of +0.21% for the quarter.

Looking ahead, we anticipate yields will rise modestly for the balance of 2018 and into 2019. The combination of Federal Reserve tightening, strong economic growth, increased government bond issuance, and rising inflation pressures will keep the path of least resistance higher for bond yields. Special comment on the yield curve: in terms of strategy, we focus on 2- to 10-year yield relationships for market direction because this measure is less directly influenced by Fed policy and better reflects what market participants expect in the future. Maximum steepness of the yield curve this cycle was achieved in February 2010 at 2.87%. At quarter-end, the measure stood at 0.24% and momentum towards a flatter curve was diminishing. Our expectation of a slowing Federal Reserve tightening phase means markets will be wary of inflation risks in the future. This in turn places upward pressure on longer-term yields while lessening the upward trajectory of 2-year note yields. Thus, a more balanced view is now warranted, which calls for more evenly applied maturity allocations.

In terms of investor positioning, we offer these suggestions to best navigate the current macro environment:

• Expect the yield curve to stabilize around current levels. Moving maturity allocations towards the middle ranges (5- to 7-years) takes advantage of a stable or even steeper yield curve movements. As an added bonus, removing the "barbell" portfolio structure adds to the overall portfolio income.

• Seek additional ways to improve portfolio income streams with minimal risk. Callable agency notes offer higher yields in exchange for potentially early redemption. In a rising rate environment, this risk is low, and as a result, callable notes have beat non-callable issues by 0.28% over the past year. Adding to quality corporate bonds is another way to enhance returns with incremental yield. We find the best risk-reward in large banks, REITs, utilities, and financial technology issuers.

Equity Markets

Randall Hare, Senior Vice President, Director of Equity Research

The third quarter was a positive environment for U.S. stocks. Stocks, as measured by the S&P 500, had their strongest quarterly performance since 2013. Investors seemed to get more confident that the trade concerns were adequately priced in to the market. By the end of the quarter, the market began to receive positive movement in North America trade. Within equities, U.S. large capitalization stocks outperformed small capitalization stocks, reflecting investors' confidence that trade concerns were adequately priced in to stocks. Developed International stocks outperformed Emerging Market stocks.

- The biggest story of Q1 & Q2 earnings (reported in Q3) was the concern that this will represent the peak growth rate for U.S. earnings per share. Earnings per share for the S&P 500 grew 24.5% year-over-year in the first quarter and 24.2% in the second quarter. Estimates are for 19% earnings per share growth in the third quarter.

Looking ahead to the fourth quarter of 2018 and 2019, some of the factors that we are keeping our focus on at Huntington include:

- U.S. economic growth, as noted above, is forecast to show strong growth for 2018. We forecast an acceleration in inflation, with a continual rise in the Fed Funds rate.

- With a boost from pharmaceutical stocks, Healthcare was the best performing sector (+14%) in the S&P 500, and the only sector with double-digit returns in the third quarter. Industrials also had strong performance on reduced trade fears. Materials, Staples and REITs were the only sectors with negative returns in the third quarter.
- Despite the peak in S&P 500 EPS growth, the earnings outlook has and should continue to provide a favorable environment for stock investors.
- Headline risks to domestic equity markets have waned, providing a lift to stock valuations. We could see volatility in International markets as trade and growth uncertainty create a less favorable global investment. We continue to favor Domestic stocks over International stocks.
- Given the uncertainty around the timing of higher rates and faster growth, we believe this is not the time to be aggressively buying or selling portfolio holdings, only trimming or adding where portfolio excesses or deficits exist. We continue to focus on strong earnings growth where valuation presents attractive opportunities. Staying invested is likely to provide investors with the best opportunity to achieve their portfolio objectives.

Weighing the headwinds and tailwinds, we see a continuation of double-digit earnings growth, which should be beneficial for stocks. This will allow for U.S. investors to be patient, yet maintain a positive environment for U.S. equity investors.

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