Hughes Investment Advisory Service LLC

October 1, 2018

Dear Clients and Investors,

The third quarter surprised me with a S&P 500 + 7.2% return, its best quarterly performance since the 3rd quarter of 2013 and the S&P 500 is now up 9% YTD. With the trade dispute and tariffs being levied during the 3rd quarter I was really not expecting such a positive showing from equity markets during the summer but we will take gains wherever and whenever the market decides to give them! On a positive note, value stocks are starting to outperform growth stocks which suits our portfolios and shows a healthy rotation from one market sector to another – in this case from what I believe is an overvalued sector to an undervalued sector. I have been expecting this rotation and we should hope that it continues in the 4th quarter and into 2019.

The stock market hit an all-time high 2 weeks ago. It was surprising how little attention this event attracted in the news media… I believe that is a good thing. We all remember the media hype and exuberance witnessed during past market peaks in 2000 and 2008. Remember this past February when markets corrected rapidly on fears of higher interest rates and inflation? Since then the Fed has raised rates twice and inflation continues to rise but the markets are back to all time highs. The good news is that rates have been climbing on the back of healthier economic data. We now have, above trend growth, record corporate earnings, buoyant financial conditions, an unemployment rate at its lowest in two decades, high business and consumer confidence, continued relatively easy monetary policy from the Fed and all this taking place with a large tax cut that will continue to provide additional economic stimulus. 2nd quarter GDP growth came in at +4.2% and 3rd quarter GDP growth estimates are currently at + 3.6%

So what could go wrong? One of the prime reasons that some investors are cautious is simply the longevity of the current bull market, which by some measures in August became the longest in history. I just read a WSJ Opinion piece by noted economist Martin Feldstein who makes the case that a recession is looming. He makes some strong points and compares today to past recessions. There are however some stark differences between 2000, 2009 and today. I do not see the excesses today that we had before the last recessions in 2000 – (Dot-Com and Telecom spending boom and inflated stock prices), and 2009 – (inflated housing prices). He and others make the case that todays bubble exists in the corporate bond market and high stock prices. There is a case to be made for both of these concerns and others but there is also a strong case to be made that the positives will continue to outweigh them and the Bull market can continue.

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The Bull case would have the Federal Reserve bringing the US economy in for a soft landing all while corporate profits continue to climb. Every recession is preceded by a Federal Reserve that raises rates too fast and too much. Will the Powell Fed be able to pull off an unprecedented soft landing – that is, slow the economy to a sustainable growth rate without tipping it into recession? This Fed could very well pull off this historic feat, because of the lack of excesses that preceded the last two recessions as I mentioned above.

Regarding the remaining trade disputes and tariffs being levied – there is progress in some areas and stalled negotiations in others. On the plus side, Mexico and the US have come to terms for NAFTA 2.0 The US has signed a new trade agreement with South Korea in the last week. In the negative column we have not come to terms with Canada or China and tariffs are in place and planned. I am confident that agreements will come to fruition out of necessity by all parties. There are reports that an agreement with Canada could come in the next 24 hours. The key is for this to happen in the near-term so that we don't drag this on to the point where either our economy and/or our trading partners slip into a deep slowdown or recession before these disputes are resolved.

Corporate earnings while still strong will slow in the third quarter. S&P 500 companies are expected to report a 20% jump in profits when earnings season kick off in mid-October. That is down from the 25% increase they posted in the first and second quarters but still very strong. The streak of strong profit growth has made valuations much more attractive than they were in January at the markets previous peak. Markets are at records, but valuations are reasonable because earnings have been incredibly strong.

At this time I continue to favor large-cap, industry dominant, dividend paying, international corporations with strong balance sheets and special situation growth orientated equities. Risk/reward continues to favor equities over fixed income. For the first time in many years I like short term Government bills and notes with the 2-year yielding 2.80% Select MLP's, REIT's and specialized bond funds continue to look good as income producers.

Sincerely,

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