Fourth Quarter 2018 Outlook October 17, 2018 www.bairdfamilywealthgroup.com

Summary: The domestic and developed international equity markets were positive in the third quarter, while most other asset classes were either flat or down. The Federal Reserve moved the target for short rates to 2%, the highest level since early 2008. The target rate has now been raised 7 times since Donald Trump was elected President, which he has recently taken issue with. Ironically, it was the fiscal stimulus provided by the tax cuts that has allowed the Federal Reserve to continue its push to "normalize" monetary policy. "Normal" means short rates of 3% by the end of 2019 based on the statement released after their most recent meeting. As short rates have moved up, longer rates have also risen, but at a much slower pace causing the yield curve to remain extremely flat. A flat yield curve is generally associated with slower future economic growth. Given the high levels of debt across the globe, we are expecting the rise in interest rates to negatively impact the global economy. Corporate debt as a percent of GDP is now higher than it was before the credit crisis. Driven by demand for higher yielding investments, the quality of corporate debt today is also significantly lower in credit quality than it was before the credit crisis. Similarly, emerging market debt levels have soared. Rising U.S. Government debt makes further fiscal stimulus unlikely. The tax cuts have lifted stock market optimism and helped keep corporate earnings strong. But, with stock market valuations already at high levels, much of the good news is likely priced in. Because stock market valuations are high, debt levels are high and interest rates have risen, we suggest clients remain cautious and rebalance to 5% to 10% below their normal risky asset allocations.

- The domestic and developed international equity markets were positive in the third quarter while most other asset classes were flat or down. Domestic large cap stocks led the way up 7.7%, while emerging markets were down 1.1% in the quarter. The S&P 500 is now up 10.6% and the Russell 2000 small-cap index is up 11.5% year-to date. Most other broad asset class indices are still down for the year. The equity market continued to be biased toward growth stocks over value. Interestingly, utilities are positive year-to-date in spite of higher interest rates. Less risky taxable bonds ended the quarter almost unchanged while municipal bonds were off just under a quarter percent.

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- Corporate debt as a percent of GDP is now higher than it was before the credit crisis. Driven by demand for higher yielding investments, the quality of corporate debt today is also significantly lower in credit quality than it was before the credit crisis. Similarly, emerging market debt levels have soared. The Moody's loan covenant quality index has been hovering near record lows while Standard & Poor's reports that covenant-lite loans now represent almost 80% of the higher risk leveraged loan market. Leveraged loans have been primarily used to finance private equity transactions.

- Similarly, emerging market debt levels have soared. Across all emerging nations, nonfinancial corporate debt represents almost 100 percent of their GDP. According to the Institute of International Finance emerging market debt in total has ballooned from $23 trillion in 2008 to $70 trillion today.

- Rising U.S. Government debt makes further fiscal stimulus unlikely. Just recently, the Congressional Budget Office reported that it expects the Federal budget deficit to hit $1 trillion in the next year or two. The CBO reported that from 2021 to 2028, deficits will average 4.9 percent of the total American economy — higher than at any point since World War II other than during the recession in 2008 and 2009.

- The tax cuts have lifted stock market optimism and helped keep corporate earnings strong. But, with stock market valuations already at high levels, much of the good news is likely priced in. One measure of stock market valuation is the CAPE ratio. Our analysis of the CAPE ratio indicates that the 5-year forward return of the S&P 500 from current levels averages just over 2%.

- Because stock market valuations are high, debt levels are high and interest rates have risen, we suggest clients remain cautious and rebalance to 5% to 10% below their normal risky asset allocations.

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