First Commonwealth Advisors

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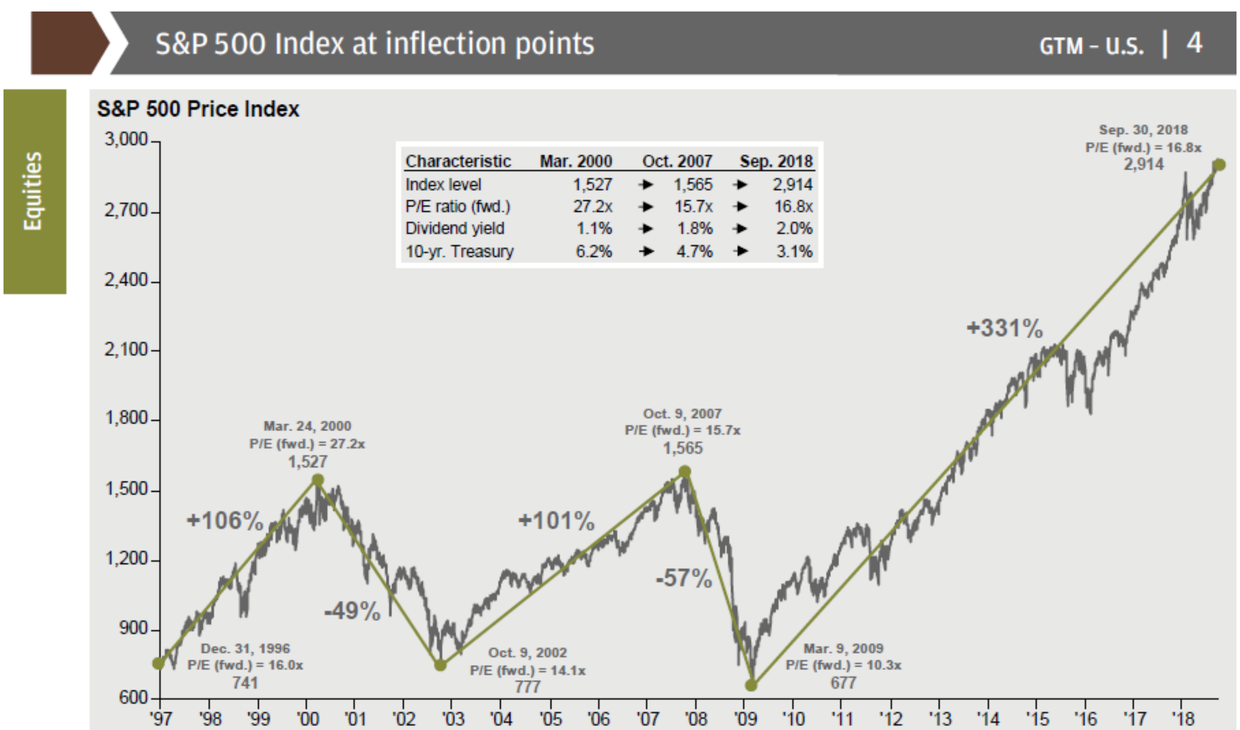
Quarterly Review & Outlook

September 2018: "Just Keep Swimming"

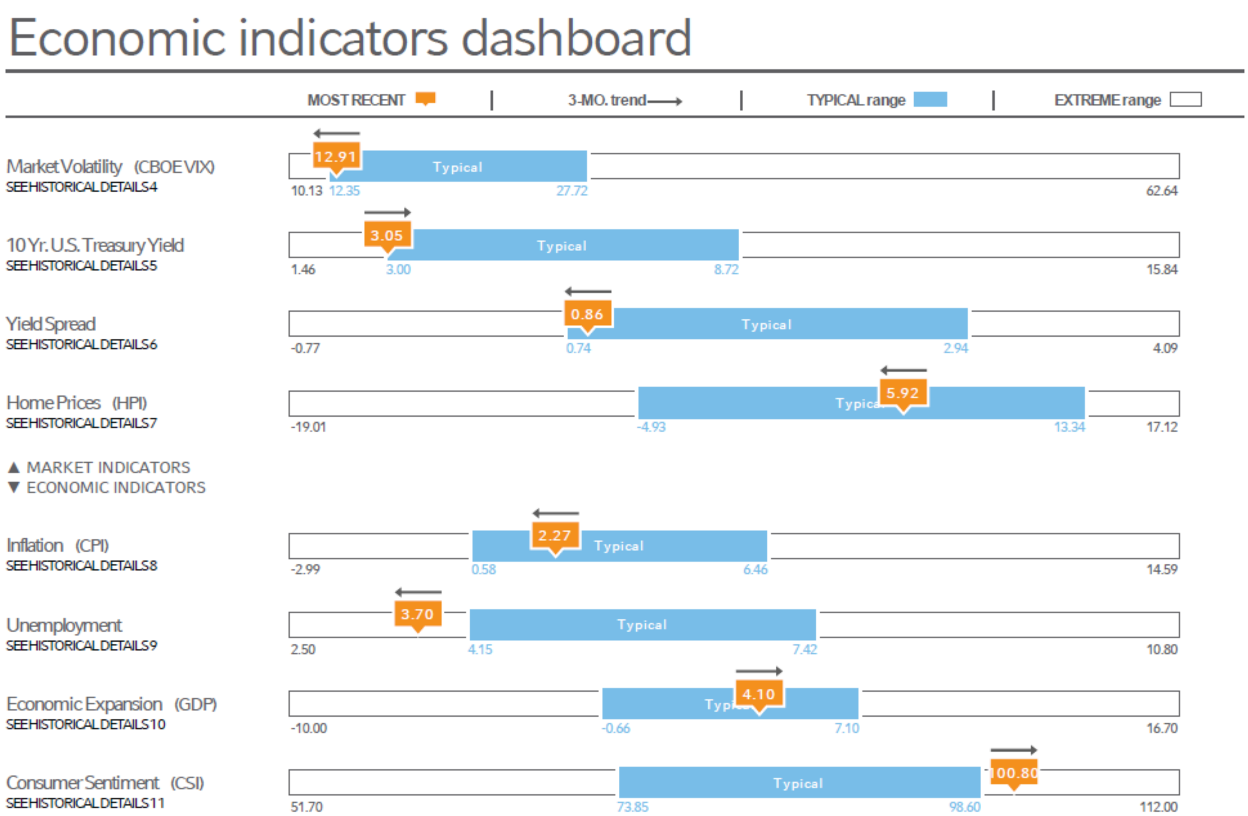
A Look Back – 3rd Quarter 2018

The full quote from the kid's classic, *Finding Nemo,* is "When life gets you down, you know whatcha gotta do? Just keep swimming, just keep swimming, swimming, swimming." The popular inspirational line came from Dory as she spoke to Marlin, Nemo's father, as she tried to encourage him to not give up in his search for Nemo. It has become a theme used by many motivational speakers and keynote graduation speeches as a reminder of what we should all do when we find ourselves in unknown territory or facing an uncomfortable situation. The chart below shows the S&P 500 price return over the last 20 years, and specifically, the sustained bull rally over the 9 ½ years. What a difference a few weeks can make…The first three weeks of October have served up a heaping helping of discomfort.



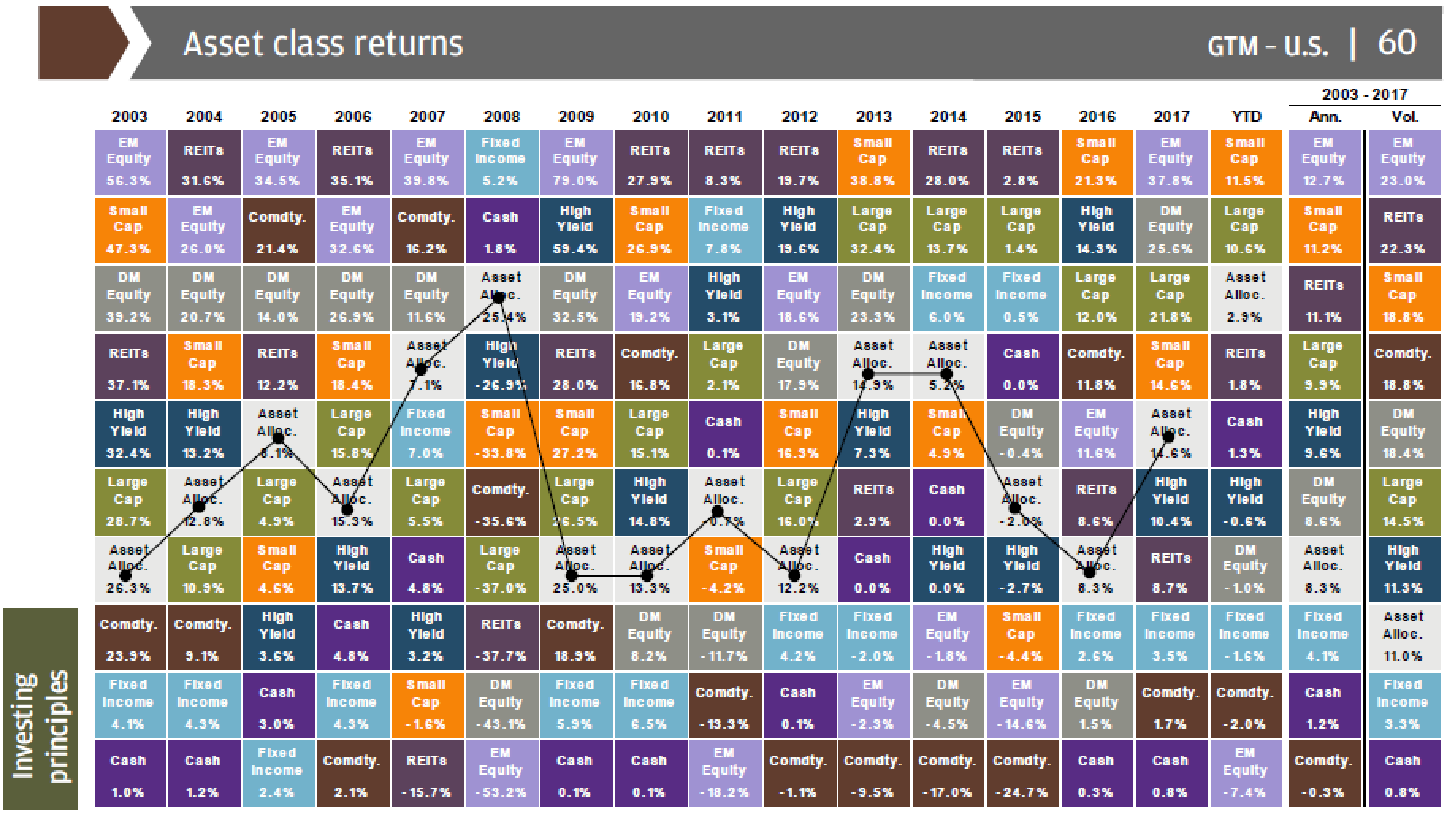
We continue to show this chart of over 20 years of performance because it is particularly useful in times of stress. There have been two time periods in this chart, the dot.com bust of the early 2000's and the Great Recession in the 2007-2009 band where it would have been extremely difficult to keep a steady hand and stay true to your investment allocation. However, if you had kept swimming as Dory instructed Marlin, you would have been just as happy.

At the end of the third quarter, we did see some changes in the economic indicators as shown in the dashboard below. Most notably, the 10 year treasury yield jumped above the 3% level, and after moving to 3.3% in early October, now stands at 3.11%. Rising interest rates in general have been one of the main bugaboos mentioned by many as a catalyst for the recent swoon in equity markets. We believe that the rate hikes already realized have been well telegraphed, and that Fed intimation of three additional increases in 2019 has been more of a concern recently for market participants. Cited by many as a contributing factor to the recent uptick in market volatility, Fed Chairman Powell said earlier this month that rates are a long way from so-called neutral, a level neither accommodative nor restrictive for the economy. Two additional Fed members said recently that they didn't believe that the current market activity should alter their rate-hiking path. Although the rate increases are welcome for some, including banks and those investors relying on short-term cash yields and CD's, others looking to borrow money to purchase homes and automobiles have found the sledding much tougher of late. A friend in the car business told me recently of the difficulty of clients coming off two and three year leases, and finding that they can't afford the new lease on the same car as a result of rates moving over two percent in the same timeframe. In some cases, the lease amounts have nearly doubled and they are forced to spend less and look for cheaper alternatives.



Inflation concerns, one of the main factors of interest for the Fed remained under control at 2.27%. Additionally, the PCE price index, a key measure of inflation, increased by 1.6% in recently released numbers, far lower than the 2.2% expected by economists. Historically low unemployment levels continued to be a positive driver for the overall economy, but even that has come under scrutiny lately as doubters suggest that level has nowhere to go but up. From a longer-term perspective, we tend to agree. We have suggested here many times that, although the exact timing is never known, we see time and time again throughout history how outperformance leads to underperformance and vice versa in categories like growth/value or large cap/small cap. We see similar relationships when individual indicators move out of their typical range and approach historical extremes like current unemployment levels. After a strong second quarter reading of 4.1%, GDP levels for the third quarter came in at a strong 3.5% level in recently released numbers, besting estimates of 3.4%. Consumer spending, which accounts for more than two thirds of U.S. economic activity, grew by 4% in the quarter, the strongest level since the fourth quarter of 2014. The fear is that this level of growth may be derailed by factors such as the trade war currently playing out with China. Both countries have already slapped billions of dollars of tariffs on goods this year, increasing concerns that tighter trading conditions will slow down the global economy.

At the end of the third quarter, our asset class return table told many stories. Small and Large Cap domestic equities led the way YTD with solid double digit returns. Interestingly, although a long way away, the asset allocation strategy was the third best performer at 2.9%. One of the main reasons for the sizeable gap is that fixed income as an asset class has been a serious negative contributor so far this year. As measured by the Bloomberg Barclays Aggregate, core fixed income has returned -1.6% in 2018. Indeed, diversity in general has not yielded the results we expect to see, and what we have come to know over longer time periods. In the most recent down turn in equities in the first few weeks of October, fixed income provided little buffer as prices continued to fall as rates increased. International equities continued to underperform in the quarter. There is generally a fairly strong correlation between international and domestic equities over longer periods, but so far that gap has only widened. Through the first nine months of 2018, Large Cap domestic stocks have beaten Emerging Market stocks by 18%!



2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	2003 - 2017 Ann.	2003 - 2017 Vol.
EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Small Cap 11.5%	EM Equity 12.7%	EM Equity 23.0%
Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Large Cap 10.6%	Small Cap 11.2%	REITs 22.3%
DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. 25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	Asset Alloc. 2.9%	REITs 11.1%	Small Cap 18.8%
REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	REITs 1.8%	Large Cap 9.9%	Comdty. 18.8%
High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Cash 1.3%	High Yield 9.6%	DM Equity 18.4%
Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	High Yield -0.6%	DM Equity 8.6%	Large Cap 14.5%
Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	DM Equity -1.0%	Asset Alloc. 8.3%	High Yield 11.3%
Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Fixed Income -1.6%	Fixed Income 4.1%	Asset Alloc. 11.0%
Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	Comdty. -2.0%	Cash 1.2%	Fixed Income 3.3%
Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -7.4%	Comdty. -0.3%	Cash 0.8%

A Look Ahead

The million dollar question…where do we go from here? The S&P 500 is down over 10% from its September 20th high, and officially in correction territory. We had a similar correction in February earlier this year and rallied back to be up 10.5% by September month-end. Is this just another pause in the bull market run? Our belief is this could be the start of something a little bit different from what we have seen lately. We have already seen some rotation in leadership, where the high-flying FAANG stocks (Facebook, Apple, Amazon, Netflix, Google) have relinquished their front-running role. They are now among the 10 most shorted U.S. stocks as investors are betting on additional downside pressure. As mentioned earlier, there are still a variety of economic indicators that remain positive. Unemployment, consumer spending, and corporate earnings remain potential tailwinds to further market advances. Others, such as the mid-term elections seem more of a true unknown. An old Chicago floor trader used to tell me of certain news events, that he wouldn't know how to trade the market if he knew the news ahead of time, as we waited for whatever news release that was important at that time. I believe the mid-term elections may fall into that category. I have heard plausible arguments from both sides on why a Democratic or Republican victory might be good/bad for the markets. The tariff situation with China is a real thing, but it is certainly not impossible to imagine how a surprise agreement or understanding between the two countries could lead to another upside push. The top chart on the following page shows the number of times we have had at least 5% pullbacks in the S&P 500 since the low we made in March of 2009. In all, it has happened 21 times, with some well over the 10% correction territory that we are currently in. Historically, markets experience a 10% correction from peak to trough around one and a quarter times a year. In 2016, we were down 12% in the first couple of months of the year, only to finish with a 24% rise, and a positive 12% calendar year. The point is, from a long-term, historical perspective, it is not unusual to experience significant down moves and increased volatility, even in bull markets.

FIGURE 3. PULLBACKS ARE A NORMAL PART OF BULL MARKETS

We have purposefully not used the "R" word of recession. Trying to accurately predict one is more folly than finance. It is technically described as two consecutive quarters of negative GDP growth. That doesn't look to be in the immediate future, but we have also seen in the past where current economic numbers look just fine, and the path to not-so-fine is fairly quick and volatile. With all of technology available to quickly disseminate and understand information that might affect a stock's price, it is not surprising that equity markets tend to be a leading indicator of recessions, not the other way around. The chart below shows various recession periods over the last 60 plus years. Again, recessions are part of the full cycle. However, like the equity markets, they are near impossible to call, and difficult to know how long they are going to last. So many factors contribute to the severity as we saw most recently in 2008-09, when the Federal Government stepped in and took unprecedented measures to ensure economic stability. Finally, it is why it is so important to just keep swimming…swim, swim, swim.

Date Of Market Peak	Market Peak Price	Recession Start	Market @ Recession Start	Market @ Recession Lows	Peak To Trough Decline	Market Lead Of Recession Recognition	NBER Recession Recognition	Recognition Lag
7/1/1956	48.78	9/1/1957	43.98	40.30	-17.38%	14		
7/1/1959	59.74	5/1/1960	55.22	53.73	-10.06%	10		
12/1/1968	106.48	1/1/1970	90.31	75.58	-29.02%	13		
1/1/1973	118.42	12/1/1973	94.78	67.07	-43.36%	11	NBER Dates Recessions	
1/1/1980	110.87	1/1/1980	110.87	102.97	-7.13%	0	6/3/1980	6
11/1/1980	135.65	7/1/1981	129.13	109.38	-19.37%	8	1/6/1982	5
6/1/1990	360.39	7/1/1990	360.03	307.12	-14.78%	1	4/25/1991	10
8/1/2000	1,485.46	3/1/2001	1185.85	1,044.64	-29.68%	7	11/26/2001	9
10/1/2007	1,539.66	12/1/2007	1479.23	757.13	-50.82%	2	12/1/2008	12
9/1/2018	2,901.50	???	???	???	???	???	???	???