

**Investment Review and Outlook**

**September 30, 2018**

***“In every contradiction there is truth. The search for that truth is what makes human behavior so maddening, and yet so fascinating.”*** **Robert Ludlum, American Author (1927 – 2001)**

Financial markets are in a perpetual state of contradiction. The search for new opportunities is in constant battle with the fear of what lies ahead. Financial markets rise and fall, or just bounce sideways, as they try to strike a balance between optimism and pessimism. Although frustrating, this conflict among investors is necessary for markets to function.

Contradictions in the financial markets were evident in the third quarter as equity markets rallied in the face of troubling geopolitical news that could easily have triggered a selloff. Escalating trade tensions, rising interest rates, economic instability in Italy and Turkey, and the widening divide among policymakers in Washington offered enough fuel to ignite a market retrenchment. Despite these headwinds investors enjoyed a rally in stock prices. In fact, the S&P 500 rose by 7.71% and the Russell 3000 jumped 7.12%, marking their best quarterly gains in over five years.

Despite record gains in many indices, there was wide return dispersion among market segments. For instance, small caps significantly trailed large caps as the Russell 2000 index rose 3.58%, less than half the gains of the S&P 500. Mid-Caps delivered similar results as the Russell Mid Cap Index increased 3.30%. Through the fog of geopolitics and Washington drama investors remained focused on market fundamentals. Stocks were pushed higher by strong economic data, earnings momentum, and rising confidence in the Fed’s steady policy.

The good fortunes of U.S. stocks were not shared by international markets. For the fourth consecutive quarter international stocks trailed the U.S. Rising trade tensions, slowing economic growth in Asia, the U.K.’s protracted “Brexit” process, and Turkey’s currency crisis weighed heavily on international markets. Developed markets as measured by the EAFE Index including Japan, Australia, and the Eurozone posted an anemic 1.35% gain. Emerging markets fared worse as the MSCI Emerging Markets Index led by China, Brazil, and India dropped 1.10%.

Bond markets delivered mixed results. The Bloomberg-Barclays Global (BBG) Intermediate Credit Index rose 0.73%, and the 1-3 year Treasury Index increased 0.22%. However, the BBG 1-10 year Municipal Index declined modestly by 0.07%. Although bond returns were relatively tranquil, interest rates experienced a meaningful move higher. The Federal Reserve orchestrated its third rate hike of the year in late September, raising the fed funds rate 25 basis points to a range of 2.00-2.25%. Strong economic data throughout the quarter pushed long term rates higher, allowing the slope of the yield curve to remain modestly positive. The 10-year Treasury yield approached five year highs as it pushed through the 3.00% mark to close the quarter 3.06%.

The fourth quarter is expected to bring more contradictions as opposing economic and political views collide.

**The Economy: *Time for a standing ovation, or are there more acts to follow?***

***“Keep it simple, when you get too complex you miss the obvious”* Al McGuire, Legendary College Basketball Coach and Sports Commentator (1928 – 2001).**

Although not intended for the financial markets, Coach McGuire’s words offer us good advice in understanding today’s economic debate. In these times of around the clock market news, and the parade of economists that appear daily in the media, it is refreshing to have someone cut through the economic noise with a message that is direct and easy to understand. It is even more impactful if the economic messenger is the Chairman of the Federal Reserve. Chairman Jerome Powell held a news conference in late September following the Fed’s quarterly Open Market Committee meeting. His opening statement read as follows:

*“Good afternoon. Our economy is strong. Growth is running at a healthy clip. Unemployment is low, the number of people working is rising steadily, and wages are up. Inflation is low and stable. All of these are very good signs. Of course, that’s not to say that everything is perfect. The benefits of this strong economy have not reached all Americans. Many of our country’s economic challenges are beyond the scope of the Fed, but my colleagues and I are doing all we can to keep the economy strong, healthy, and moving forward. That is the best way we can promote an environment in which every American has the opportunity to succeed.”*

Concise, simple, and accurate! It is refreshing to hear such a clear description of the obvious, especially from someone who understands the complexity of today’s economy. When we strip away all of our personal motivations and biases and tune out the media hype we are left with a simple conclusion. The U.S. economy is experiencing a period of strength that is creating employment opportunities and wage growth without the detrimental effects of inflation. After a brief pause to marvel at our current economic accomplishments it is important that we turn our focus on where we go from this lofty economic perch.

Our view is the current economic trajectory will continue for the balance of the year, and well into 2019. Real gross domestic product (GDP) increased in the second quarter by 4.2%, following a 2.6% jump in the first quarter. Although the second half of the year is expected to cool a bit, we anticipate full year growth will approach 3.5%, marking the strongest calendar year expansion since before the financial crisis. However, there are three market hurdles that await investors in the fourth quarter. Global trade resolution, the U.S. mid-term elections, and the Fed all loom large on the horizon.

Global Trade Resolution:

In the first half of 2018 the U.S. imported $1.69 trillion in goods and services versus total exports of $1.41 trillion, creating a $280 billion trade deficit. This net outflow of capital is on track to meet last year’s $566 billion deficit. This trade deficit represents 2.5% of GDP, and is consistent with levels experienced by the U.S. for the past forty years. The current administration has made this component of GDP a priority. Tariff implementation and threats by policymakers to initiate additional trade restrictions with key trading partners have been met with threats of retaliation.

After drawn-out negotiations Canada joined the U.S. and Mexico in what is being referred to as the U.S. Mexico Canada Agreement (USMCA). The agreement was signed on the first day of the new quarter and serves as a replacement for the 1994 NAFTA agreement. The new trade pact is not radically different from its predecessor, but it does serve to address supply-chain inequities in the automotive industry as well as even the scales on key commodities such as dairy products, lumber, and metals. Although the new agreement is not considered revolutionary in its impact, the removal of uncertainty in our trading relationship with our geographic neighbors was a welcome relief for investors.

Although the new trade pact with Canada and Mexico is meaningful, the most significant “prize” remaining is striking a trade deal with China, the world’s second largest economy. A trade agreement with the Chinese is complicated by concerns over intellectual property theft and differences in trade philosophy. Since trade negotiations with China began in late 2017 the U.S. has continued to flourish. However, Chinese markets have lost significant value, with the Shanghai Index dropping over 15% this year. This economic divergence should strengthen the U.S.’s ability to negotiate. Our view is that progress will be made, and the smallest amount of concessions by the Chinese will allow the administration to declare victory. Until that occurs we anticipate continued anxiety and increased volatility.

U.S. Mid-Term Elections:

This fall the U.S. electorate will be thrust into one of the most heated midterm elections in modern history. Although markets generally look past the drama and rhetoric associated with elections, this November’s outcome is expected to add additional stress and volatility to the financial markets. The new congress will take up debate and will likely vote on trade agreements with China. In addition, they will be voting on Tax Reform 2.0, a bill to make permanent specific aspects of the recently passed tax bill that lowered individual and corporate tax rates. We do not anticipate any meaningful rollback of policy that will threaten the current direction of economic growth. However, a shift in control of both the House of Representatives and the Senate, if it occurs, will certainly be interpreted as a threat to the pro-business agenda of the administration. We cannot predict the outcome of an extremely divided electorate; however, we know that uncertainty is always a market disruptor. In the end, we are counting on continued gridlock in Washington, which most often proves beneficial over the long term.

Fed Policy:

History tells us that the greatest threat to economic expansion is a monetary event that “chokes” the economy. In December 2015 the Federal Reserve initiated its first hike in short term interest rates since before the financial crisis. Since then, the Fed has responded to U.S. economic strength with a steady program of six increases in the fed funds rate. Rate adjustments to this point have been slow and steady, keeping pace with underlying economic growth. Our view is that the easy work of the Fed is coming to an end, and more difficult rate adjustments lie ahead.

The Fed has not yet “taken away the punch bowl”, as monetary policy has tracked along in sequence with the strengthening economy. However, with U.S. labor markets pushing full employment and core inflation breaking through 2.0%, there is strong impetus for the Fed to gradually move monetary policy into restrictive territory. With every quarterly rate hike the Fed is moving closer to the “tipping point” where policy becomes a means to slow the economy rather than allowing it to continue to heat up. We expect the Fed to be mindful of what is occurring in other global economies before tapping on the brakes. Stress in many significant emerging markets exaggerated by the rising value of the U.S. dollar could influence their decisions. We have confidence in the current Fed and Chairman Powell to make sound monetary decisions.

Investors will have a lot to navigate in the final quarter of 2018. Trade, mid-term elections, and monetary policy are the three we know will be waiting to challenge market participants. We’re sure there will be more that have yet to surface. However, our continued focus on the market’s underlying fundamentals and managing portfolio risk through diversification will offer us the best opportunity to achieve our objectives during what is expected to be a very turbulent finish to the year.

**Equity Markets: *The Market Follows a Narrow Path***

**“The burden of many is too often carried by only a few.” Winston Churchill, Prime Minister of Great Britain, (1874 – 1965)**

With just three months remaining in 2018 U.S. stocks are cruising towards another strong year. After posting gains of nearly 13% in 2016, and over 20% in 2017, the S&P 500 is up 10.6% through September. The economic expansion is being enjoyed by most segments of the economy, including manufacturing, consumer services, technology, and health care. However, these broad economic gains are not being shared with the equity market. In fact, as many indices continue to set record highs market leadership is becoming narrower. As fewer individual stocks contribute to index gains it becomes more difficult for diversified portfolios to deliver results that are consistent with what is hyped by the popular financial media. Over the past three years headline market results have not translated into investors’ return experience. The reason for this is that major segments of the market have been left behind as a limited subset of stocks has pushed market indices higher.

Value-oriented stocks found in the financial, industrial, and energy sectors that trade at low P/E’s and traditionally pay higher dividends have been left behind. In contrast, growth-oriented stocks typically concentrated in the technology and health care sectors have delivered strong relative performance. In fact, year-to-date the Russell 1000 Value Index is up 3.9% versus a 17.1% surge in the Russell 1000 Growth Index. Over the trailing twelve months the spread between growth and value returns has widened to 16.9%, the largest year-over-year dispersion in nearly 20 years. The portfolio implication of this market anomaly is that well-diversified portfolios that include exposure to value-oriented strategies such as high-dividend payers have faced difficulty in keeping pace with underlying benchmarks.

The dispersion of individual stock returns within major indices has also reached extreme levels. For instance, through the third quarter over 70% of the individual stocks in the S&P 500 have *underperformed* the index, with 182 stocks (36%) actually declining in value. The year-to-date median return of stocks in the S&P 500 is 5.11% versus 10.71% for the index. With the ‘average’ stock trailing the underlying index by such a wide margin, keeping pace with the index has been extremely difficult.

Performance of the S&P has gotten so “top heavy” that the returns of a handful of stocks has accounted for a disproportionate amount of the index return. The chart below shows the extreme narrowness of the market. By excluding only five mega-cap performers from the index (Amazon, Apple, Microsoft, Netflix, and Alphabet) the year-to-date return on the remaining 495 individual drops significantly from 10.71% to 6.96%, indicating that over 35% of the S&P 500 return is attributable to only five stocks.

It is not unusual for the market to discriminate among companies and sectors by rewarding (or punishing) their underlying equity. In fact, we find several of these stocks fundamentally attractive, and own them in appropriate portfolios. However, it is important that investors not lose sight of the benefits of focusing on the long term and maintaining diversification even during periods when the market gets micro-focused on a select group of individual stocks. Our view is that the market goes through phases that at times reward a focused approach to investing. However, these periods are subsequently followed by a broadening out into a wider universe of stocks.

It is frustrating to compare a portfolio’s return to an index when it is skewed by a narrow group of “winners”. However, we are confident that maintaining our focus on underlying market fundamentals will allow us to withstand these market anomalies, and allow portfolios to participate more fully when the return “burden” is more evenly shared within the index.

**Investment Strategy: *Don’t get distracted by the unimportant!***

***“When you are hunting elephants, don’t get distracted chasing rabbits”* T. Boone Pickens, Legendary Investor and Philanthropist (1928 – Present).**

There are many significant events that await investors as we finish out the year, and we’re confident some meaningful unknowns will pop up along the way. However, we believe it is best to stay focused on what really matters to the markets, and do our best to ignore distractions that are driven by the most recent headline. It is for these reasons that our investment outlook remains focused on the long term, and controlling risk through diversification.

U.S. Equity Markets

Despite the market’s continued advance, and its ability to break through to record highs with ease, we remain positive on U.S. stocks. We have concerns over simmering trade uncertainty, a possible jolt from an anti-business surprise in the midterms, or an overly aggressive mis-step by the Fed. While we expect to safely clear each of these hurdles, we are not ignoring the possibility that a stumble could occur. Our belief is that these factors will add a heavy dose of volatility; but we do not see a protracted decline in U.S. equity markets in the foreseeable future.

Corporate earnings exceeded expectations in the first and second quarters of this year. Year-over-year profits have grown in excess of 20% in both quarters, and we believe earnings momentum continue for the third quarter. As comparisons get more challenging going into 2019 we expect profit growth to taper off to more normalized levels. The U.S. economy is expected to continue expanding, consumer confidence should remain high, valuations are reasonable and corporate actions including M&A, buybacks and dividend increases should continue.

Our biggest challenge over the next several quarters will be to brace for shifting market leadership. Timing changes in leadership is a futile exercise. Small caps have swung in and out of favor over the past two years, and mid-caps have trailed considerably. Our strategy continues to emphasize diversification across capitalization, investment style, and discipline – to include both active and passive approaches. This should allow us to capture shifts in market leadership, and mitigate volatility risk.

International Markets

U.S. equity markets have enjoyed the benefits of higher than expected growth while international markets have suffered from declining growth expectations and uncertainty over trade. After leading all global markets in 2017 with the MSCI Emerging market Index surging over 37%, markets such as China, Brazil, and India are all in negative territory in 2018. While the EM Index is down 7.71% so far this year, the developed markets in the Eurozone, Australia and Japan are also struggling with the EAFE Index down 1.43%.

Our position regarding international markets in the current environment calls for investors to maintain patience. Non-U.S. markets represent nearly 55% of global equity capitalization, and their share is rising. International markets are modernizing and demographic shifts are offering new market opportunities. In addition, recent underperformance has greatly improved fundamental valuations relative to the U.S.

Given this dynamic opportunities we are maintaining our exposure to international equities in both developed and emerging markets. We currently favor developed markets over export-oriented emerging markets due to a higher level of certainty regarding near-term growth prospects. Our exposure to developed markets includes small cap companies for many of the same reasons we favor this segment in the U.S. Small companies have less direct trade exposure, and are more consumer-oriented.

Fixed Income:

Interest rates rose across the maturity spectrum in the third quarter, continuing the trend that has persisted throughout the year. We believe upward pressure on rates will become the norm as economic growth, tightening labor markets, and inflationary pressures push rates higher on long-dated maturities.

Managing fixed income portfolios in an environment of rising rates presents unique challenges as the headwind of escalating rates negatively impacts underlying bond prices. This environment makes portfolio decisions regarding duration, credit selection, and yield curve positioning extremely important when considering the total return potential of bond portfolios. Our view is that the best approach is to emphasize corporate securities over Treasuries and agency bonds in taxable portfolios. In addition, we remain positive on high quality municipal bonds, and believe current yields relative to taxable bonds are attractive.

We are positioning portfolios short of their benchmark duration in order to reduce negative price pressure and allow for reinvestment as rates rise. On a more optimistic note, higher yields will result in increased income generation, something investors have not experienced in many years. We believe our current fixed income strategy is positioned well to effectively navigate through the current rising interest rate environment.

The balance of the year is bound to deliver plenty of new challenges for investors. Despite the political and economic obstacles that lie ahead, our view is that staying focused on the long term, while managing risk through asset class diversification, will allow investment objectives to be achieved.

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