MCGILL ADVISORS
A DIVISION OF BRIGHTWORTH

ROBERT V. SYTZ, JR., CPA, CFP®
JEFFREY A. HARRELL, CFA
BRETT S. MILLER, CPA, CFP®
K. WARREN POE, JR., CFP®
ERIC A. HARBERT, CPA, CFP®
THOMAS W. FARMER, CFP®
BRETT M. COVERT, JD, CFP®

Investment Commentary

3rd Quarter, 2018

Below you will find our investment commentary for the most recent quarter. We hope you find it informative and will consider our investment services in the future. If you have any questions or concerns about the market or your investment portfolio, please call our office to schedule a meeting or conference call.

Economic Review & Outlook

After a stunning 4.1% growth rate in the second quarter that exceeded nearly all economist expectations, output is expected to slow some in the third quarter. Current Wall Street Journal economic forecasts are for 3.2% real GDP growth. Before you react to the slower growth with concern, keep in mind this still represents the highest level of quarterly growth since the third quarter of 2016, not counting last quarter of course. The acceleration has been breathtaking to say the least and has resulted in a level of confidence we haven't seen in many years. One of the more interesting statistics we follow is the Job Openings and Labor Turnover Survey, sometimes referred to as the "quit rate". This tracks the number of workers leaving their jobs of their own free will. Earlier this year it increased to 3.3 million, representing 2.4% of the labor force. This is the highest rate since April 2001.

While an improving labor market is obviously good news for the economy, there are concerns it will eventually result in an elevated level of wage inflation. This could eventually hurt corporate America's bottom line and possibly cause what economists refer to as "stagflation" or above average inflation with little economic growth. Although the Federal Reserve has not suggested they are materially worried about this potential problem, they are addressing it by raising short term interest rates. The Fed has already raised rates eight times over the past couple of years, creating something we haven't seen in our savings accounts in years, interest!! Most economists expect the Fed to continue their rate hiking campaign for a little while longer, perhaps increasing rates by another 0.5% to 1.0% over the next couple of years. This has investors concerned that longer term interest rates will begin to rise, which could put a damper on the economy. In our view, these concerns are somewhat overblown for two reasons.

The first is a function of improving economic efficiency over the past couple of decades. Capacity utilization is a government statistic that tracks how efficient the economy is using its resources to produce economic output. This number currently stands at 78%, which is lower than the last couple of economic peaks in 2000 (82%) and 2007 (81%). This suggests more efficiencies can be squeezed out of corporate America before inflation becomes a problem.

Second, interest rates all over the world are substantially lower than in America. Europe is a prime example illustrated by the chart above. These three graphs represent the spread between 2 year, 5 year, and 10 year U.S. interest rates versus German interest rates. As you can see, the current spread is at its widest level in decades. This spread likely puts a ceiling on how high our interest rates can rise, which should support economic growth over the next couple of quarters.

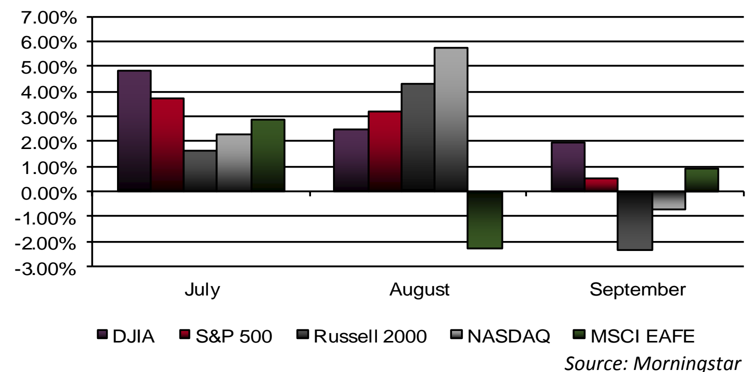
8816 RED OAK BOULEVARD SUITE 260 CHARLOTTE NORTH CAROLINA 28217
PHONE 704.426.6100 TOLL-FREE 866.727.6100 FAX 877.500.6798 WWW.MCGILLADVISORS.COM

Bond Market Review & Outlook

Bonds are definitely the unloved asset class at the moment, with most bond indexes still in the red this year. Last quarter saw bonds flatline with the Barclays Aggregate Index delivering a -0.1% return. High yield bonds continued to lead the pack returning 2.9%. This is one of the few segments of the bond market that is still in the black for the year, albeit by just over 2%. With the bond market delivering lackluster returns over the same time period that stocks march higher, some investors are once again questioning the validity of these securities in their portfolio. While the frustration of watching a security underperform versus other investments is understandable, it is exactly what one should expect from a well-diversified portfolio.

Why does an investor own bonds? Is it for the income? In most cases the answer is no. We do not invest our managed accounts in bonds for the income. Instead, the purpose of bonds in a portfolio is to balance out the risk of owning stocks. Although it may be a distant memory, there was a time when stocks were despised by investors. The devastating bear market in 2008 is the big one most remember, but since then there have been other periods, admittedly relatively short lived, where stocks performed poorly, and investors were convinced the next big drop was coming. These are mostly forgotten now. Although it hasn't happened in nearly a decade, rest assured another bear market is in our future. Over the past century, the Dow Jones Industrial Average has experienced a 20% or greater drop every 3.75 years on average. We are currently approaching 10 years without such an event. If you are an investor who can accept that this will eventually happen, and you are confident no matter how bad it gets, you won't react emotionally, you may not need a high allocation to bonds in your portfolio. However, our experience has been that as one sees the value of their portfolio rise, it becomes harder and harder to handle these large drops. Bonds have historically been one of the best assets to own during bear markets, thus finding an appropriate balance between stocks and bonds is the key to any long-term investment strategy.

Stock Market Review & Outlook

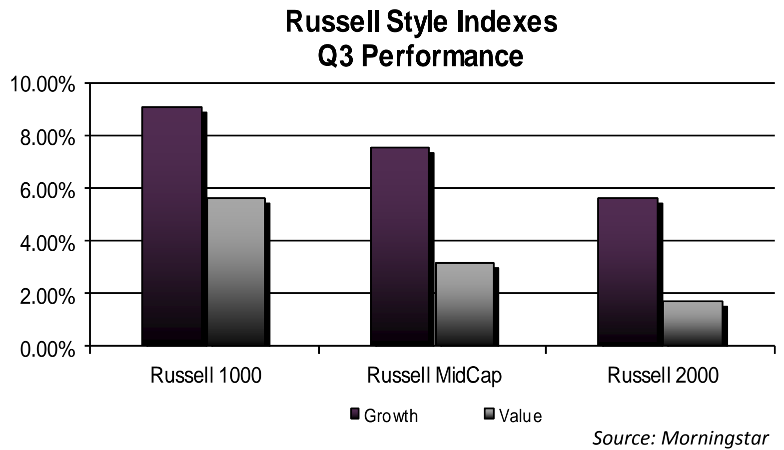


Source: Morningstar

After a pause in the first half of the year, the Dow Jones Industrial Average and S&P 500 registered new all-time highs in the third quarter. Both indexes delivered strong returns posting 9.5% and 7.7% gains, respectively. Small caps were left in the dust, delivering a mere 3.6% return. The NASDAQ paced the broader indexes, returning 7.4%. Unfortunately for international investors, returns outside of the U.S. remain lackluster as the MSCI EAFE returned 1.5%. The third quarter recovery has major U.S. indexes such as the S&P 500 and Russell 2000 up more than 10% for the year. A stark contrast from the international indexes where they are mostly in the red.

The underperformance by international stocks continues to drive investors crazy, causing many to question what purpose these investments serve. In the Q3 2018 Financial Market Highlights section on the next page, we have a chart illustrating the relative performance of U.S. stocks versus international stocks. What you will see is since around 2010, international markets have consistently lagged the U.S. markets. However, prior to this outperformance, international stocks outperformed U.S. stocks for roughly seven years. As you go further back through the chart you will notice these periods of outperformance tend to be clumped together, which is to say when a trend shifts, it typically will be measured in years. Thus, neglecting international investments is something we would advise against given the longevity of the outperformance by U.S. stocks over the past decade. With that said, we still have a significantly higher allocation of our managed accounts invested in U.S. stocks. The point we are trying to make is we simply want to remind our clients that international investments appear attractively positioned on a risk versus reward basis, even if in the short-term U.S. markets may continue to outperform.

The gap in performance between growth and value stocks continues to widen, with growth stocks easily outpacing last quarter. Over the past ten years growth indexes have outperformed value indexes by around 4% per year in both the large cap and small cap markets. This outperformance has created a relative valuation gap between the two styles that is reaching unprecedented levels. In a chart released by Woodford funds, their proprietary trend analysis suggests the gap between value and growth stocks has reached a level greater than any point in history. We highlight this chart in our quarterly webcast, so be sure to listen to the replay if you would like to hear more about this current phenomenon.



Stocks are outperforming bonds, the U.S. is outperforming international, and growth is outperforming value. These aforementioned themes are driving financial markets today. The trends are obvious and have been going on for some time. As a result, many investors have begun concentrating a disproportionate amount of their assets in these top performing areas of the market. For those who have done so, the results are difficult to argue with since you have likely performed much better than a well-diversified portfolio that includes all of these assets. How long this trend will continue is impossible to know. The last time the market experienced characteristics similar to today was in the late 1990s as technology and internet stocks became all the rage. It was so apparent at the time, then Federal Reserve Chairman Alan Greenspan, gave a speech in which he coined the phrase "irrational exuberance" when describing the performance of the stock market. This speech was delivered in December of 1996, yet the stock market didn't peak until March of 2000. Although in hindsight it was apparent stocks continued to perform irrationally for years after the speech, when you are in the middle of an irrational market it is very difficult to recognize it. We bring this up to simply remind our clients predicting the path of the stock market is a very difficult task in the short term. Nothing magical happened in March of 2000 that made it obvious the stock market would take seven years to reach new highs, nor will anything special happen when the current bull market eventually hits its peak. Instead, investors merely need to recognize that at some point stocks will go down, but certain areas of the market that have not done as well will likely become outperformers on the downside. This is exactly how diversification is supposed to work and why it is important to not lose sight of this in a market dominated by high flying U.S. growth stocks.

Sincerely yours,

Wealth Management Team
McGill Advisors

The statements and opinions expressed herein are subject to change without notice based on market and other conditions. The information provided is for informational purposes only and should not be construed as investment or legal opinion. Please consult a tax or financial advisor with questions about your specific situation.