First Trust

Quarterly Market Overview

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We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

Out with the old ("new normal") and in with the new ("normalize")

In 2009, Mohamed El-Erian and his colleagues at Pacific Investment Management Co. coined the term "new normal" to describe their forecast for slower economic growth and more regulation in the coming expansion, according to Bloomberg. Over the years, the term was embraced by the financial media, which is why we are revisiting it. U.S. real GDP growth has averaged a modest 2.3% in the current expansion (Q3'09-Q2'18), according to data from the Bureau of Economic Analysis. The outlook for growth, however, may be changing for the better. Today, El-Erian, now the chief economic adviser at Allianz SE, thinks that the U.S. is shedding its new normal constraints and believes the U.S. economy looks good for at least the next couple of years, with growth potentially hitting 3.0% in both years, according to CNBC. He sees labor force participation rising while the unemployment rate remains low, and believes that this backdrop is conducive for the Federal Reserve ("Fed") to raise interest rates without fearing it might choke off economic activity, according to Bloomberg. This is where the term "normalize" enters the discussion, as in it is time to normalize interest rates.

While we are not aware that anyone has been credited with coining this term in this context, we sure have been hearing it a lot lately. For the record, we have been unwavering in our belief that interest rates have been kept artificially low for way too long. We have held this view since before the Fed began its tightening phase. Interest rates have been slowly ascending since December 2015, when the Fed initiated its first rate hike since June 2006. The Fed has not been aggressive in its tightening of monetary policy to date, in our opinion. It has hiked the federal funds target rate a total of eight times since 12/16/15. That is a span of 33 months. The upper bound of its range has risen from 0.25% to 2.25%, or an increase of 200 basis points. For comparative purposes, the last time the Fed tightened, from 6/30/04 to 6/30/06, or a span of 24 months, it was far more aggressive. Over that period, the Fed raised the federal funds target rate 17 times from 1.00% to 5.25%, or an increase of 425 basis points. Some pundits believe that the Fed was too aggressive back then and that its actions helped push the U.S. economy into recession along with the subprime mortgage crisis. In keeping with the spirit of that argument, Chairman Jerome Powell has already gotten some blowback from some in the investment community and President Trump for the Fed's rate hikes to date and its guidance regarding future hikes. Brian Wesbury, Chief Economist at First Trust Advisors L.P., is forecasting one more increase in December 2018 and four more in 2019, though the Fed's guidance is projecting four more hikes through 2019, which would take the federal funds target rate (upper bound) from 2.25% to 3.25% at the current quarter-point per hike pace. For the 30-year period ended 9/28/18, the federal funds target rate (upper bound) averaged 3.23%, according to data from the Federal Reserve.

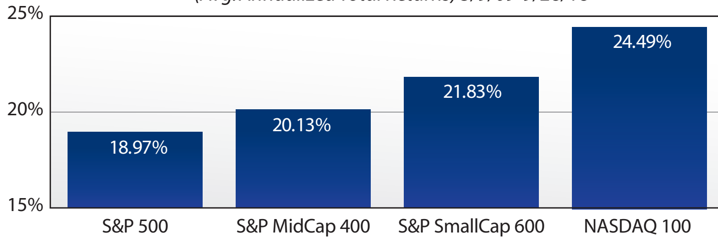
If expectations are for the direction of short-term interest rates to trend higher over the next 12-15 months due to the strengthening U.S. economy then it seems logical for bond yields to follow suit, in our opinion. While there has been plenty of discussion in recent months with respect to the flattening yield curve in Treasuries and the accompanying concerns that it could lead to an inverted yield curve and subsequent recession, we have not subscribed to that scenario. We believe that the yield on the benchmark 10-year Treasury note (T-note) is heading higher as well. Since the Fed began raising interest rates on 12/16/15, the yield on the 10-year T-note has risen 170 basis points from its all-time closing low of 1.36% on 7/8/16 to 3.06% on 9/28/18, according to data from Bloomberg. One of the more obvious reasons for why the yield on the 10-year T-note has been able to remain at such a low level for such a sustained period of time is because the yields on comparable foreign government bonds have been at even lower levels, thereby boosting demand for higher-yielding U.S. government bonds. Year-to-date, however, we have seen bond yields rise abroad as well. For the 30-year period ended 9/28/18, the yield on the 10-year T-note averaged 4.76%, according to data from Bloomberg. While we are not suggesting that bond yields are going to increase to that level anytime soon, investors may be interested to know that JPMorgan CEO Jamie Dimon commented in early August that investors should brace for a 4.00% yield on the 10-year T-note with the "distinct possibility" of it rising to 5.00% or higher, according to Bloomberg.

Now that we have some idea about what the normalization of interest rates and bond yields could look like moving forward, what does it mean for the markets? Providing that interest rates continue to trend higher as a result of a strengthening U.S. economy, we believe that the climate should be more favorable for investing in equities than for bonds. For those of you who have read our newsletters through the years, you already know that we have favored risk assets since even before the U.S. expansion began in the latter half of 2009. We expand on this a little further on the next page. One of the definitions of normalize is to make normal via a transformation of variables. Regardless of one's brand of politics, it is important to acknowledge that the Trump administration has changed some variables from the previous administration and these changes appear to be influencing U.S. economic activity and business sentiment for the better. We think it is because they are pro-business. The two that come to mind quickly are the passage of the Tax Cuts and Jobs Act last December and deregulation. We are still in the relative early stages of both, so we expect more good news to come. Should interest rates and bond yields trend higher, keep in mind that the levels they are projected to ascend to will not be high by historical standards, just normal.

Continued

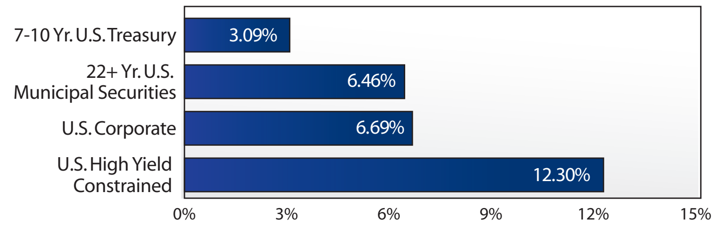
The more things change the more they stay the same (risk vs. return incentive has stood the test of time)

U.S. Equity Indices
(Avg. Annualized Total Returns) 3/9/09-9/28/18



Source: Bloomberg. Past performance is no guarantee of future results.

ICE BofAML Bond Indices
(Avg. Annualized Total Returns) 3/9/09-9/28/18



Source: Bloomberg. Past performance is no guarantee of future results.

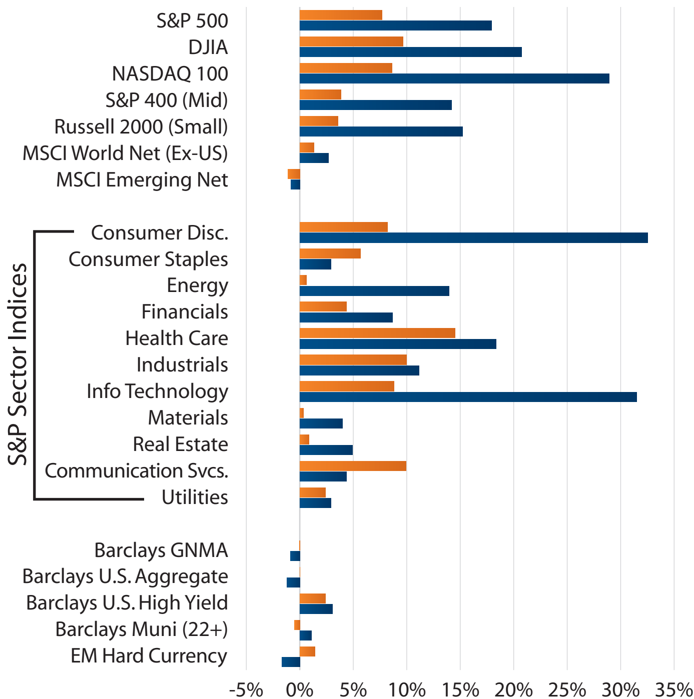
It has been said that this has been the "least-loved" bull market of all-time. Even at a glance, one would think that the sheer level of the returns posted by the U.S. benchmark stock indices in the chart above would be celebrated, not shunned. The disconnect may have to do with how some investors, particularly retail investors, reacted to the 2008-2009 financial crisis, in our opinion. Since the crisis was systemic in nature, involving banking and Wall Street institutions, it is possible that some investors may have lost trust in the system. To at least some degree, retail investors appear to have shied away from owning U.S. equities post-crisis. The financial media has touched on this issue through the years, but the evidence provided tends to be largely anecdotal in nature. Mutual fund flows, on the other hand, provide harder evidence. From 12/31/08-8/31/18, Domestic Equity mutual funds reported net outflows totaling $1.235 trillion, according to data from the Investment Company Institute.

The irony in this discussion is that the recovery in the U.S. stock market since 3/9/09 has played out just the way an investor should want it to, meaning the stocks with the highest level of risk should generate the highest returns. This is one of the cornerstones of investing and it is exactly what has transpired to date. We would hope that even the most skeptical of investors can take some solace from how stocks have performed.

While retail investors were liquidating huge sums of capital from equity mutual funds they were simultaneously funneling huge sums of money into bond mutual funds. From 12/31/08-8/31/18, Bond mutual funds reported net inflows totaling $1.445 trillion, according to data from the Investment Company Institute. Right or wrong, a lot of retail investors have favored current income over capital appreciation post-crisis. Thanks to the steady decline in interest rates throughout the bulk of the current recovery, bond returns have been fairly generous (see indices chart above). We would also like to point out that the riskier bond groups posted the best returns in the period.

As most investors are likely aware, interest rates and bond prices are inversely related, particularly with respect to higher-grade bonds. If interest rates and bond yields continue to rise, as previously discussed, investors should expect bond prices to decline moving forward. As we noted earlier, the yield on the 10-year T-note has already risen from its all-time closing low of 1.36% on 7/8/16 to 3.06% on 9/28/18. Over that period, the ICE BofAML 7-10 U.S. Treasury Index posted a price decline of 12.06%, according to Bloomberg. When you factor in the interest income, the index's total return was -7.15%. Interest rates and bond yields have been at very low levels since late 2008. It's time for rates to normalize.

Total returns for *Q3* and past 12 months (9/28/18)



Sources: Bloomberg and Barclays. Past performance is no guarantee of future results.

A Look Ahead:

A year-over-year earnings comparison in U.S. dollar terms. The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.

Index (Weighting In S&P 500)	Q4'18E	Q4'17A	Q1'19E	Q1'18A	2018E	2017A
Consumer Disc. (10.3%)	**10.30**	9.62	**9.15**	9.21	**39.66**	35.23
Consumer Staples (6.7%)	**7.72**	7.43	**7.11**	6.77	**29.67**	27.32
Energy (6.0%)	**7.94**	2.93	**8.17**	6.30	**28.71**	13.28
Financials (13.3%)	**8.95**	6.64	**9.40**	7.88	**34.59**	26.59
Health Care (15.0%)	**15.37**	11.42	**16.46**	12.15	**55.41**	45.08
Industrials (9.7%)	**9.60**	7.85	**8.82**	8.93	**37.63**	30.29
Information Tech. (21.0%)	**19.82**	17.28	**17.07**	15.30	**66.22**	50.59
Materials (2.4%)	**5.54**	3.57	**5.78**	5.49	**23.23**	17.18
Real Estate (2.7%)	**1.37**	1.38	**1.24**	1.49	**5.54**	5.60
Communication Svcs. (10.0%)	**2.26**	1.94	**2.13**	3.59	**11.75**	10.18
Utilities (2.8%)	**3.07**	3.06	**4.29**	4.45	**15.87**	14.53
S&P 500 Index	**42.14**	33.85	**40.99**	36.54	**157.38**	124.52
S&P 400 Index (Mid-Cap)	**29.00**	22.29	**27.30**	22.30	**103.72**	78.12
S&P 600 Index (Small-Cap)	**14.70**	8.45	**13.30**	9.14	**46.27**	31.19

Source: Standard & Poor's (9/27/18). Sector weightings as of 9/28/18.
There is no guarantee past trends will continue or projections will be realized.

All charts and tables herein are for illustrative purposes only. Indices do not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Indices are unmanaged and an investor cannot invest directly in an index.
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