Boston Trust Commentary

September 30, 2018

FINANCIAL MARKETS

All major domestic stock indices rose in the third quarter, with the S&P 500 posting its best quarterly return in almost five years. As has been the case in recent periods, the market was led by stocks of faster growing companies. In fact, close to forty percent of the S&P's 10.6% year-to-date return can be attributed to a handful of tech behemoths, the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google/Alphabet) along with Microsoft. Meanwhile, international markets lagged, registering meager gains in developed markets, while emerging markets fell.

Total Returns through September 30, 2018		
US Stocks	**3rd Qtr**	**YTD**
Standard & Poor's 500	7.7%	10.6%
Russell 2000®	3.6%	11.5%
International Stocks		
MSCI World Ex-USA	1.3%	-1.5%
MSCI Emerging Markets	-1.1%	-7.7%
US Fixed Income		
Bloomberg Barclays Gov't/Credit	0.1%	-1.8%
US Treasury Bill	0.5%	1.3%

Bond indices were effectively flat for the quarter. The yield on the 10-year Treasury inched back above three percent by the end of the quarter, pushing bond prices lower; the yield on the 2-year Treasury moved higher by a greater amount, further flattening the yield curve and reducing the yield advantage earned by owning longer bonds. The yield spread between the two bond maturities is its narrowest in over a decade. While a flat yield curve is often cited as a predictor of a recession, we do not believe such an economic downturn is imminent.

INVESTMENT PERSPECTIVES

Growth Continues

The bedrock of the ongoing stock rally has been the strong and persistent health of the economy. The labor market has continued to tighten with the unemployment rate holding below four percent and average hourly wages growing faster than a core inflation rate that has hovered around two percent. Accordingly, consumer spending has sustained a healthy pace, and consumer confidence is approaching the peak levels reached in the late 1990s/early 2000s.

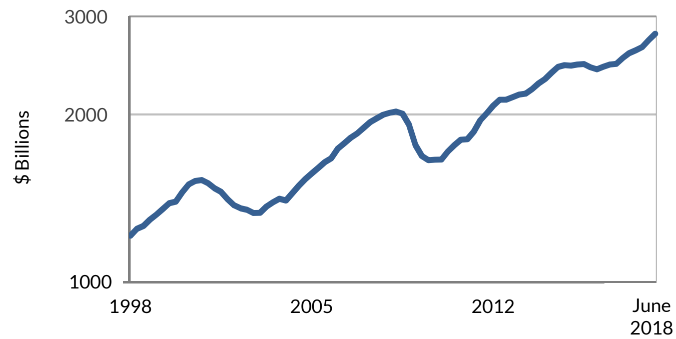
GDP growth is the fundamental metric of economic expansion, and indeed the domestic economy grew in the second quarter at an annualized rate of 4.2%. While that pace is not expected to continue through the end of the year, full-year 2018 GDP growth estimates remain north of three percent – a level that is consistent with multi-decade averages, but quite strong by recent standards. With robust evidence of economic strength, the Fed has continued its path of slow, but steady monetary tightening. After raising the Fed Funds rate to 2.25% in September, the third hike this year, the overnight lending rate now stands almost two percentage points higher than two years ago. Fed watchers expect another rate raise in December along with more next year, but interest rates remain at historically low levels that should support further economic growth. All things considered, we believe the economy remains on solid footing. Absent a deterioration in those conditions, we continue to favor stocks in mixed asset portfolios.

Consequences of the Tax Cut

It's been over nine months since the Tax Act was signed into law, and true to form, the fiscal stimulus has bestowed both individuals and corporations with more cash in their pockets. As noted above, US consumers, whose expenditures comprise over two-thirds of domestic economic demand, are feeling secure and continue to partake in the American pastime of spending. Corporations have also received a boost to their already robust profits and cash flows, and business confidence surveys reflect that. The OECD's US Business Confidence Index is at its highest point since 2004, while the NFIB Small Business Optimism Index is at an all-time high (albeit not far from its levels at year-end 2016).

With the wind at their back, corporate boards and executives have set about putting their capital to work – investing in growth, as well as their own shares. Non-residential private fixed investment, an important measure of capital spending, rose at an 8.7% annualized rate in the second quarter. This strong data point affirms underlying economic strength, but as shown in the chart, it is a continuation of the recent trend.

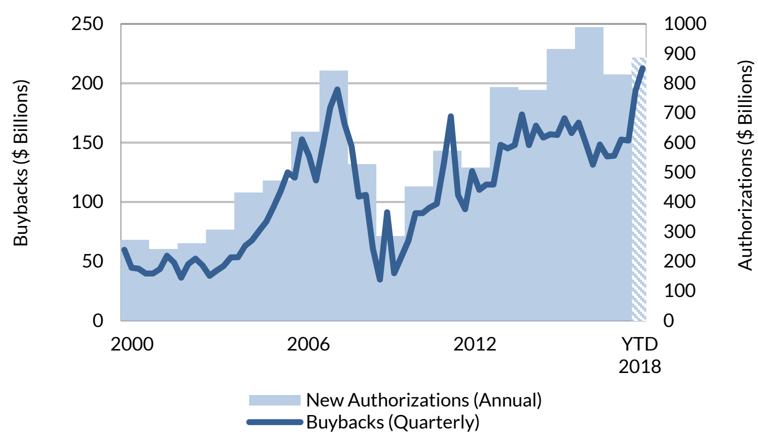
Non-Residential Private Fixed Investment



Data is seasonally adjusted and annualized. Log scale.
Source: US Bureau of Economic Analysis

More striking, however, is how much excess corporate cash is being allocated toward repurchasing shares. Record buyback activity can be attributed to the lower corporate tax rate, but perhaps more so, to a large but temporary repatriation tax break that incentivized corporations to bring home cash hoards previously held abroad. Total share buybacks for companies in the S&P 500 Index reached $384 billion in the first half of the year (full third quarter data is not yet available) – fifty percent higher than the same period last year, and outpacing buybacks in 2007, the previous high. And that is just what has been purchased. As noted in the chart, new buyback *authorizations* – the amount corporate boards have approved for purchase – are tracking far higher in 2018 than previous years and are expected to surpass one trillion dollars for the full year. Time will tell how much of this rising authorization is exercised.

Share Buybacks: Purchased and Authorized



It is possible that corporate insiders steadfastly believe their own stock presents an exceptional bargain, but judging their own corporate shares as underpriced is their natural tendency. More likely is that despite confidence in their own businesses and the economy at large, they may see a lack of attractive investment opportunities and don't want to get ahead of themselves in regard to expansion. Buying back shares is a more certain use of excess capital; the effort rewards investors by effectively manufacturing higher earnings per share, while also serving to boost the share price and/or reduce downside risk in the short term. To be sure, capital spending is robust and a positive indicator for the economy, but the sharp increase in buyback activity may reveal the limits of how much the recent corporate tax break will add to underlying economic growth.

Midterm Elections

We are finally entering the homestretch of a midterm election cycle that seems as though it has been in full swing since the 2016 election. Recent polling points to the Democrats gaining a majority in the House and the Republicans maintaining their narrow control of the Senate. We expect even the best political prognosticators to change their forecasts many times before election day, and suffice to say, we do not have an election prediction. Rather, our focus is on the potential impact of the election as it relates to the stock market and economy.

In the coming weeks, we are sure to be inundated with polls and punditry. Each data point or revelation has the potential to change investors' expectations of election results, sending the markets sharply up or down in the short term. Particularly susceptible may be those segments of the market that overlap with the hotbeds of political wrangling, including banking oversight, healthcare (e.g. insurance and drug pricing), and energy regulation.

Should we indeed end up with a divided Congress, the chances of major policy advancements regarding the above or other issues become more remote. Yet the Administration will still be able to impact/reduce regulatory regimes via Executive Order and government agency leadership. Importantly, while the Constitution's Commerce Clause gives Congress the power to regulate foreign trade, President Trump will retain the authority to levy tariffs and negotiate international trade agreements. This is notable given that we have previously commented that a disruption to global trade is a primary economic and market risk.

From a more political standpoint, President Trump has claimed that if the House is controlled by Democrats, impeachment proceedings will be sure to follow, and in turn, the stock market would crash. We have no comment on the likelihood of his potential impeachment and concede that the market could well suffer in the short term if the House pursues this path. But investors shouldn't assume that such an event would cause a long-lasting slide in stocks. As we have commented, over the long term, equity markets rise and fall on investors' assessment of the economy and prospects for corporate profits. In fact, in the two recent instances of initiated impeachment proceedings – President Nixon in February 1974 and President Clinton in December 1998 – stocks in the subsequent year followed decidedly different paths, falling 12% and rallying 22%, respectively. Those divergent returns reflect the respective economic backdrops of the time, specifically the oil embargo and technology-led economic expansion, rather than investors' feelings toward the sitting US President. We believe that will remain true regardless of the result of the upcoming midterms, too. Political machinations could certainly bring an influx of market volatility, but eventually stock returns will reflect economic expectations. As such, a change in economic fundamentals, not election results, will elicit a material shift in our portfolio positioning.

Data Sources: Bloomberg, FactSet.