W/C WILSON CAPITAL
INVESTMENT ADVISORY

We feel investors should have an information outlet for the financial markets that is thorough, but does not require a prerequisite degree in economics. We hope this makes our commentary informative and educational for all levels of investors. We have also included a glossary at the end of this commentary that defines terms marked with an asterisk (*).

Quarter in Review

Asset Class†	3rd Quarter 2018 Return	Past 12 Months
U.S. Large Cap Stocks	7.7%	17.9%
U.S. Small Cap Stocks	3.6%	15.2%
International Stocks	0.7%	1.8%
U.S. Bonds	0.0%	-1.2%
Commodities	-2.0%	2.6%

The returns for the stock market in the 3rd quarter hardly appear to be those from a bull market in its 10th year. The S&P 500 returned just shy of 8% for the quarter had the best quarterly showing from this index since the 4th quarter of 2013.

Unfortunately, those were the results from the 3rd quarter and the 4th quarter has blown in with an entirely new agenda. Much of the 3rd quarter's results can be explained by the continually strong corporate earnings and a robust job market. However, the considerable headwinds which include rising oil prices (highest prices since late 2014), a war on free trade, and the U.S. Federal Reserve* raising interest rates for a 3rd time this year have all started to spook investors at the start of the 4th quarter.

The market performance at the start of the 4th quarter has been noted by many news outlets as including "surging volatility" and "market plunges…sparking fears". While, not exactly "ho-hum" a two day decline of -5.3% isn't radically outside of the norm. In fact, since the bull market began in April 2008 there have been 6 occasions where the two-day return was worse than the -5.3% we saw on the second week of October, with the 4th quarter just getting underway. While we would always prefer the markets maintain a steady upward trajectory, it is important not to get wrapped up in journalistic hype when the tides are not in our favor.

In the Headlines: Rising Interest Rates

The fact that the Federal Reserve is raising interest rates is not a huge surprise to investors as this is the typically antidote to low unemployment and rising inflation, both of which are present in today's economy. However, due to the length and robustness of the

current bull market, the surprise may come in the outcome of what continually raising rates does to this current economic period where low interest rates have allowed nearly every aspect of the economy to prosper, from middle-income homeowners to our federal government. Will a reduction of easy money provide a soft landing that allows the economy to continue to grow albeit at a lower rate, or will it be a shock that marks the start of a recession? At this point there are arguments for both camps.

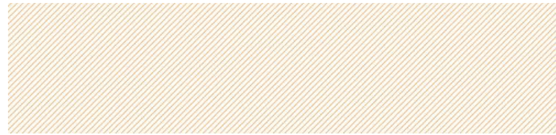
Positive effects of higher interest rates

Prevents runaway inflation. By raising interest rates, The Fed is aiming to keep inflation from increasing too much. While some inflation is part of a healthy economy (1%-3%), rapidly growing inflation can have disastrous effects. Rising inflation means that consumers and businesses have reduced purchasing power, meaning a dollar today is worth less than it will be tomorrow. When inflation starts rising rapidly the increased cost of goods may be quite noticeable, which can change buying habits and turn into a self-fulfilling prophecy leading to even more inflation. The past 30 years have been a period of extremely tame inflation in the U.S. when compared to the much longer history dating back to the early 20th century. Inflation above 10% was a normal occurrence for much of the 20th century, but was last seen in the early 1980's.

Best way to regulate a hot stock market. Related to the inflation argument, raising interest rates can act as a way of cooling down a hot stock market. As interest rates rise, investors are enticed by the increased yield on bonds thus reducing the amount of people buying stocks. It may seem counterproductive to try to reduce the growth in the stock market to strengthen the economy, but much like the inflation argument, an untethered market can lead to wild swings with of boom and bust, which can inflict significant pain in the long-term.

Negative effects of higher interest rates

Increasing the cost of debt hamstrings commerce from households to big governments. In all of the talk surrounding the Fed's raising or lowering of rates it is rarely pointed out how these actions can impact every aspect of the economy. Directly, higher interest rates can affect the number of cars sold and the prices of houses since both purchases are often made with debt and a higher interest rate will make those purchases more expensive. In the corporate world, nearly all companies are financed with debt and if that debt becomes more expensive, companies may feel the strain be less likely to expand operations. On top of the effects on the consumer, our entire government is run by debt financing…some $21 Trillion of it. Higher rates mean that each dollar borrowed by the U.S. treasury is more expensive. That expense needs to be paid either through higher taxes or reduced spending, two policy outcomes that neither political party has shown great strength in administering correctly.



Conclusions

While we can look at both the pros and cons to the results of raising interest rates, the crucial question is whether the timing of the current rate increases is appropriate. If the Fed is prescribing medication in the form of higher rates for what is only a perceived illness (overheating stock market and inflation) the result of this reaction could be more dire than no action at all. The key will be watching how nimbly the Fed reacts to market movement. The U.S. is at a time where careful consideration and possibly a reversal in policy may be what the economy really requires. The next 3-6 months should be an important period in watching their course of action.

Glossary and Article Links

Federal Reserve – The United States' central bank, which is responsible for regulating the banking industry and controlling the money supply through monetary policy.

October 11, 2018, Forbes.com: "Market Volatility is Surging" by Jesse Columbo

October 10, 2018, NBCNews.com: "Dow Jones plunges 800 points as higher rates spark fears" by Lucy Bayly

† Indices used to represent asset classes:
U.S. Large Cap Stocks – S&P 500
U.S. Small Cap Stocks – Russell 2000
International Stocks – MSCI ACWI ex-U.S.
U.S. Bonds – Barclays Aggregate
Commodities – Bloomberg Commodity

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