

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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Volume 77

October 2018

We liked the analysis we saw from one Wall Street commentator on the recent stock market surge. “This is not like the dreamy mood of the dot-com era. It was euphoria then. The sentiment today is more to the opposite. It is skeptical, cautious, and careful. People ask: how long can this go on? Recession is coming at some point.”

That sentiment is one we expressed in July. We agreed with a *Barron's* analysis that economic good times would last through 2019 and stock market gains – even if moderating – would remain healthy. We saw the change coming in 2020 when rising interest rates and the fading stimulus of the tax cut would finally put the brakes on the economy and the market.

We did not foresee the third quarter stock market surge which brought major indexes close to all-time high points. For the moment, even if skeptical, investors seem happy to ride the good news on economic and earnings growth. Concerns about a trade war have abated for the short-term. We too are happy to be part of this ride. However – let us stress a big caveat – our view expressed in July has not changed. The downturn is coming at some point. Perhaps it will be delayed until 2021 or 2022. The timing is hard to predict. But the event itself is inevitable.

Thus, despite the current happy times, our investment strategy is defensive. We are long-term investors of our client money. We are not buying the hot stock of the moment. We seek diversity, value, and staggered commitment. We want to prepare client portfolios for the tougher times whenever that period does arrive.

MARKET TRENDS

The accompanying chart summarizes stock and bond market prices for the third quarter and year-to-date of 2018. Stocks recovered the losses experienced in February and March – and reached near record levels. In contrast, bond prices suffered losses at the prospect of rising interest rates.

Equity Market: U.S. stock indexes in the third quarter moved steadily upward. Investors embraced the strong U.S. economy and the reports of impressive gains in corporate earnings. They shrugged off uncertainties about trade disputes

The Dow Jones Industrial Average reversed its losses earlier in the year. It was ahead 8.15% for the quarter and 6.02% for the year. The S&P 500 was ahead 7.2% for the quarter and 9.0% for the year. Consistent with the first half of the year, the strong performer was the Nasdaq Composite with a quarterly gain of 7.14% and a year-to-date gain of 16.6%. The Russell 2000 index lost some of its earlier momentum and was ahead 3.26% for the quarter and 10.5% for the year.

Fixed Income Market: The bond market had been relatively stable in the first half of the year, but bond prices took a strong hit as investors accepted the reality of rising interest rates and potentially steeper inflation. The yield on the 10-year Treasury was 3.05% at the end of September – versus 2.84% at the end of March. (Yields move inversely to prices.) It rose to 3.22% in the first week of October.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Industrials Composite PR	6.02
S&P 500 Index PR	8.99
Russell 2000 Index PR	10.49
NASDAQ Composite PR	16.56
EAFE Index NR	-1.43
Barclays Aggregate Bond Index TR	-1.67

source: Morningstar®

THE OUTLOOK

The Economy: The U.S. economy is hitting on all cylinders. GDP growth was 4.1% in the second quarter and is expected to be over 3% for the year – the highest in more than a decade. The unemployment rate is down to 3.7% and hourly wage gains have improved 2.8% in the last 12-month period. Consumers are confident and spending.

The result is corporate earnings growth of 25% in the first half of the year.

Ironically, the majority of economists predict a recession within the next two years – perhaps in 2020, certainly in 2021. The logic is as follows:

First, the Federal Reserve is concerned about inflation and will raise short-term interest rates in increments to a level of 3.3% by the end of 2019. This timing will coincide with a weakening impact from the Trump tax cut. Former Fed Chairman Ben Bernanke has called this convergence the “Wile E. Coyote off the cliff” moment.

Second, corporate debt may be something of a bubble. Given low interest rates, corporations have loaded up on debt in the last decade. The value of corporate bonds outstanding is now \$2.6 trillion. That number is 25% of GDP, increased from 16% in 2007. The danger is that higher interest rates will make the cost of that debt an unmanageable burden for corporations

Third, the immediate concern about trade conflicts is muted. Trade comprises only about 8% of U.S. GDP. But other countries are far more reliant on trade. Should trade conflicts widen, the resultant slowdown in the global economy could have an impact on the U.S. larger than what the Trump tariffs create.

The Market: We expect the market to be more subdued in the fourth quarter than it was in the third. The widespread view of the Wall Street analysts is that the S&P 500 index might see another 2 % increase by year-end. The big event that creates uncertainties is the Congressional mid-term elections. Anticipating the outcome and then assessing the outcome should give investors some pause.

We do expect the markets to be positive in 2019 – but with lower growth than 2018. Rich stock prices should create some restraint even if the economy stays healthy. Looking to 2020 and beyond, we are hesitant to make a specific forecast. But we are certain the prospect of economic and market slowdown and reversal will take hold at some point.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 60% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We stagger the time period in which we reach that 60% level. For fully invested clients, we recommend to trim equities to 60-70% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. Some of the sectors getting our attention:

TECHNOLOGY: We are cautious about this sector – especially given how rich the stocks have grown – but areas such as bio technology and semi-conductors have our interest.

FINANCIALS: Rising interest rates will make banks more attractive – and our focus is upon regional banks. Prices are reasonable for many of these bank stocks.

CONSUMER STAPLES: We are looking at companies in this sector because it has value stocks with good future potential.

HEALTH CARE: Medical devices are an interesting area of opportunity.

Other Investments: Our repeated aversion to bonds with long maturities remains firm. We still believe the risk of a sharp decline in prices is too great a risk for our clients. We prefer to find alternative investments such as real estate limited partnerships, demand notes, and municipal tax liens. We also note that interest rates of 2% and higher make cash a more attractive asset class than in recent years.

Dow Jones U.S. Sectors Total Return (Percent Change for YTD, Ending September 30, 2018) <i>Source: Morningstar®</i>			
Oil & Gas	8.33	Consumer Services	19.24
Basic Materials	-2.24	Telecommunications	-2.48
Industrials	7.36	Utilities	3.57
Consumer Goods	-4.05	Financials	3.33
Health Care	17.89	Technology	20.44

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Top 25 Performing Stocks through YTD 9/30/18 - US Listed companies with a market cap above \$5 Billion. Source: Telemet ®

Issue	Name	Last	Mkt Cap	Net Pct YTD	Industry Group
TWLO	Twilio Inc	81.08	7,901	243.56	IT Services
WWE	World Wrestling Entertainment	91.44	7,130	199.02	Entertainment
TTD	Trade Desk, Inc.	134.2	5,759	193.46	IT Services
AMD	Advanced Micro Devices	30.16	29,404	193.4	Semiconductors and Semiconductor Equipment
SQ	Square, Inc. Class A	99.43	40,810	186.8	Consumer Finance
OKTA	Okta, Inc.	71.06	7,575	177.47	IT Services
SRPT	Sarepta Therapeutics Inc	142.43	9,463	155.98	Biotechnology
ETSY	Etsy, Inc.	48.94	5,860	139.3	Catalog Retail
TDOC	Teladoc, Inc.	82.83	5,760	137.68	Health Care Providers & Services
ABMD	Abiomed Inc.	437.08	19,615	133.22	Health Care Equipment & Supplies
DXCM	DexCom, Inc.	131.46	11,615	129.06	Health Care Equipment & Supplies
SWTUY	Swedish Orphan Biovitrum ADR	29.3	7,887	122.48	
ANGI	ANGI Homeservices Inc.	21.94	11,162	109.75	Media & Services
FTNT	Fortinet, Inc.	91.56	15,486	109.57	Software
TEAM	Atlassian Corporation Plc	94.4	22,292	107.38	Software
LULU	Lululemon Athletica Inc.	160.74	19,706	104.53	Textiles & Apparel
ZEN	Zendesk, Inc.	68.53	7,261	102.51	Software
INGN	Inogen, Inc	239.4	5,111	101.04	Health Care Equipment & Supplies
CGC	Canopy Growth Corp.	47.42	9,493	100.47	Pharmaceuticals
HQY	HealthEquity, Inc.	92.72	5,773	98.71	Health Care Providers & Services
HAE	Haemonetics Corporation	115.39	5,965	98.67	Health Care Equipment & Supplies
NFLX	Netflix Inc	380.28	165,596	98.1	Entertainment
LOXO	Loxo Oncology, Inc.	166.75	5,081	98.09	Biotechnology
LGND	Ligand Pharmaceuticals	270.86	5,716	97.81	Biotechnology
WIX	Wix.com Ltd.	113.11	5,394	96.54	Software

Bottom 25 Performing Stocks ytd 9/30/18 - US Listed companies with a market cap above \$5 Billion. Source: Telemet ®

Issue	Name	Last	Mkt Cap	Net Pct YTD	Industry Group
ADT	ADT, Inc.	8.69	6,518	-73.65	Commercial Services & Supplies
LOMA	Loma Negra Compania Industrial	9	5,105	-60.94	Construction Materials
BMA	Banco Macro S.A.	45.53	30,506	-60.71	Commercial Banks
UGP	Ultrapar Participacoes SA	9.81	5,351	-56.84	Oil Gas & Consumable Fuels
LB	L Brands, Inc.	29.88	8,219	-50.38	Specialty Retail
FNMA	Fannie Mae	1.41	8,051	-46.98	Thriffs and Mortgage Finance
SNAP	Snap Inc	8.17	10,572	-44.11	Communications Equipment
XRAY	DENTSPLY SIRONA Inc.	37.38	8,310	-43.22	Health Care Equipment & Supplies
DB	Deutsche Bank AG	11.05	15,236	-41.93	Capital Markets
EXEL	Exelixis Inc.	17.71	5,278	-41.74	Biotechnology
SHCAY	Sharp Corporation	4.98	5,480	-41.48	Household Durables
OC	Owens Corning Inc.	54.19	6,010	-41.06	Building Products
JD	JD.com, Inc. ADS	24.87	35,969	-39.96	Catalog Retail
VEDL	Vedanta Limited	12.82	9,465	-38.45	Metals & Mining
ACH	Aluminum Corp. of China Ltd.	11.09	5,999	-38.15	Metals & Mining
MHK	Mohawk Industries Inc	171.22	12,773	-37.94	Household Durables
IVZ	Invesco Ltd.	22.83	9,380	-37.52	Capital Markets
LPL	LG Display Co. Ltd.	8.65	6,187	-37.17	Electronic Equipment & Instruments
DLAKY	Deutsche Lufthansa	23.4	10,870	-36.41	Airlines
WKCMF	Wacker Chemie Ag	124.8	6,200	-36.26	
COTY	Coty, Inc.	12.78	9,595	-35.75	Personal Products
TI	Telecom Italia S.p.A.	5.57	10,774	-35.52	Diversified Telecommunication Services
NTES	NetEase, Inc. ADS	223.31	29,034	-35.29	IT Services
CTTAY	Continental Ag	35.35	7,070	-34.39	Auto Components
GOL	Gol Linhas Aereas Intelgentes	5.78	10,034	-34.02	Airlines