THIRD QUARTER REVIEW & OUTLOOK:

THE U.S. ECONOMY REVERTING BACK TO A NORMAL CYCLE

AS INTEREST RATES MOVE HIGHER

EXPECT MORE VOLATILITY

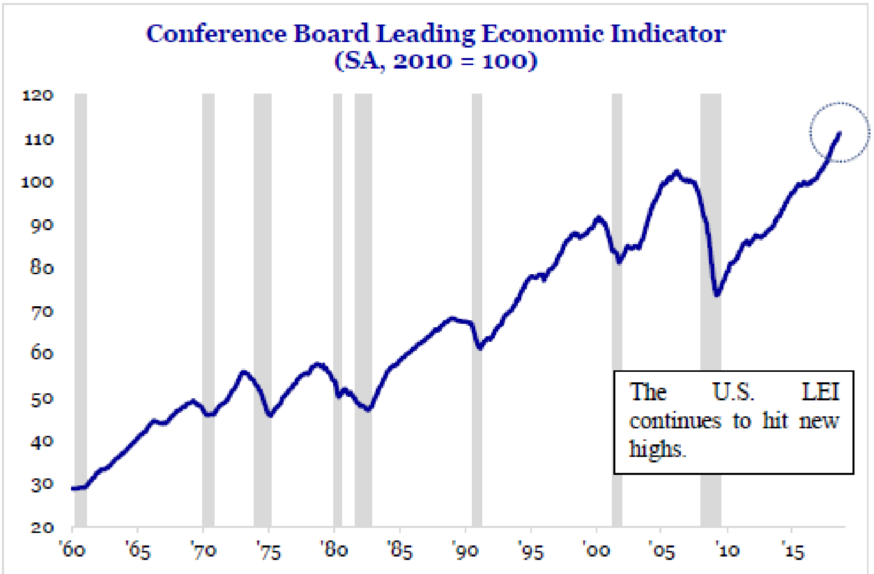
CHART I

Source: Strategas

The U.S. stock market (Chart 1) has benefited from a return to strong economic and corporate profit growth in the last twelve months. The economic expansion has been fueled by an aggressive fiscal policy, which has been moving our economy toward a normal economic cycle and away from the aberrational slow steady GDP growth brought on by six years of quantitative easing. At this part of our economic cycle, earnings, interest rates and inflation (in that order) are the key drivers to equity market expansion over the intermediate term. Due to a significant reduction in corporate tax rates, most financial observers see S&P 500 earnings jumping about 20% this year.

Strong corporate earnings create a more positive environment for business expectations, which in turn leads to more investment and hiring of additional employees. These strengths have accelerated our GDP growth to over 4% last quarter and is likely to be above 3% next quarter as well.

CHART II



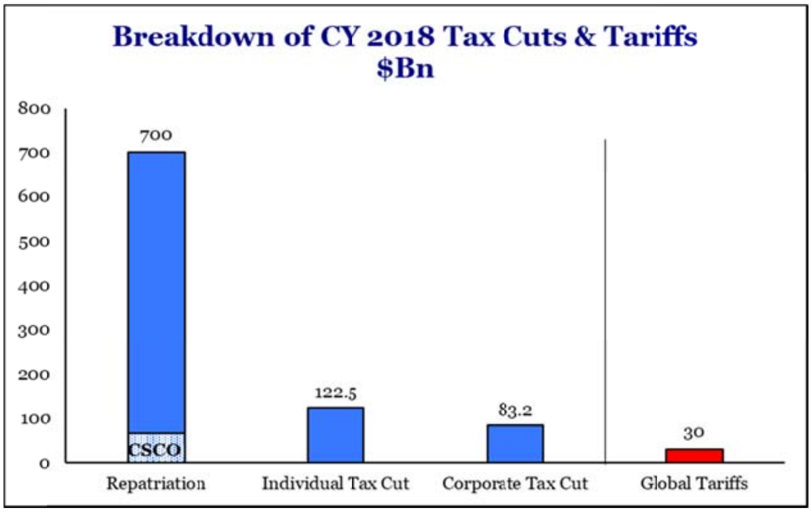
Source: Strategas

As a result, leading economic indicators (Chart II) have moved strongly upward in recent months. Some of the positives near to intermediate-term include:

- Corporate profits are accelerating and are likely to generate another year of (more subdued) growth in 2019. Current expectations suggest 4-8% growth in corporate profits next year.

- Average equity valuations for 2019, at 17-18 times earnings, are not extreme. While some sectors are stretched (particularly in technology), many are still reasonable.

CHART III



Source: Strategas

- The huge $700 billion in profit repatriation back to the U.S. should partially flow into long-term investments over the next 3-5 years (Chart III). Buybacks and dividend increases are also likely to be fueled by repatriation in subsequent years.

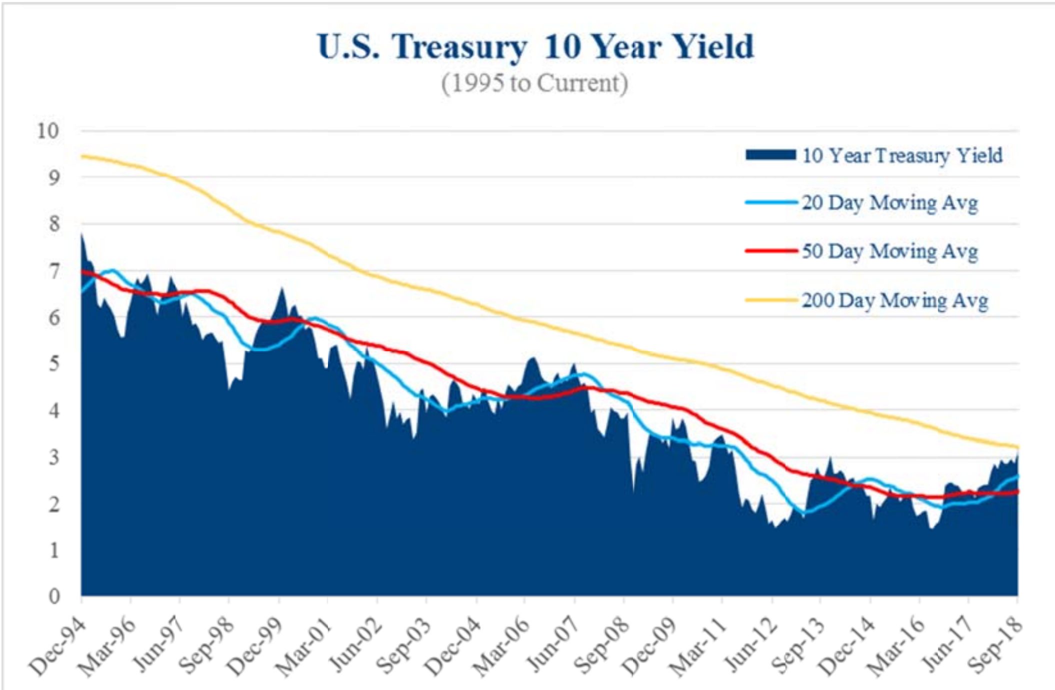
- Tariff disputes, while likely to cause a slowing in GDP growth, should not derail overall GDP growth in 2019 or 2020.

- The economy is at full employment, and wage growth is finally beginning to accelerate. While this can fuel more inflation, the majority of wage increases are likely to be felt in the lower to middle income levels reflecting entry level jobs. Thus, consumer spending should continue to improve.

The last twelve months are in stark contrast to the slow growth (2–2.5% GDP growth) of prior years. However, now that the economy is reverting to a more normal trend, we believe signs are emerging to suggest that future stock market gains will be more modest.

<u>THE "NEW NORMAL" IS MOVING BACK TO THE "OLD NORMAL"</u>

CHART IV



Source: Bloomberg; data plotted on a monthly basis

There are a number of factors that should dampen the degree of equity market appreciation in 2019 going forward. Inflation (particularly in oil) is becoming an issue to watch. As global demand continues to rise, we are beginning to see significant cost pressures building in a number of commodities. With U.S. inflation at +2%, it has reached the target set by the Federal Reserve. An inflationary move above 2.5% would be a negative for stocks. Additionally, interest rates are at a secular breakout (Chart IV), and fear of an interest rate spike could cause the equity markets to sharply correct. Indeed, fear that the Federal Reserve is "too aggressive" in increasing interest rates is probably the biggest concern of all. When we view the 10-year Treasury bond over a long period of time, we can see the potential significance of moves to 3.5% or above. That could push the 10-year Treasury bond above its 200-day moving average for the first time in over two decades. We believe this is likely to occur sometime in 2019.

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Finally, corporate profit growth should slow to 5–10% as the favorable impact from a tax cut diminishes. Rising commodity costs are also a headwind.

All these factors suggest our economy is moving along the historical, normal trends of decades past as the era of quantitative easing (QE) has reversed. This is significant since QE inflated asset prices. Put another way, the stock market will have to focus more on earnings growth than any other factor near term. Rising interest rates also tend to inhibit price earnings ratio expansion since alternative investments, such as bonds, may become more attractive. These are long term trends that should play out in the next 5-10 years. We also believe that the Federal Reserve may be reluctant to aggressively utilize QE in our next recession since the Fed's balance sheet dramatically expanded in the last QE cycle.

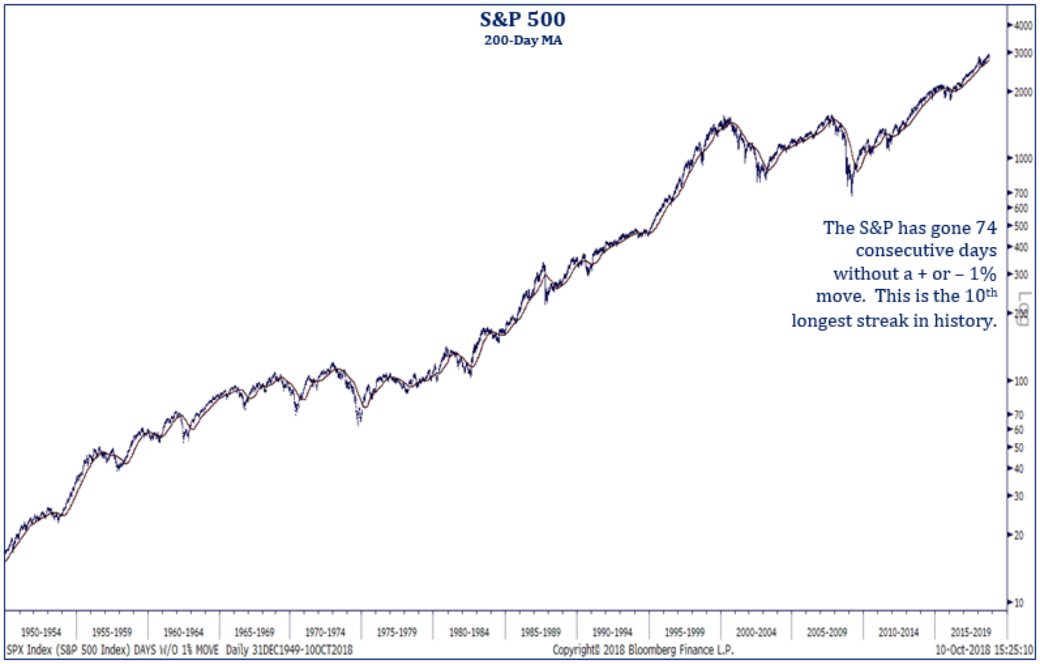
Overall, we have expected the equity market to return 0-10% in 2018. At this juncture, it may be at the higher end of that range by year end. As we enter 2019, we expect 3-7% growth in equities as valuations stabilize and corporate earnings grow at about 5-10%. If interest rates on the 10-year Treasury bond gradually rise to 3.5-4.0%, and GDP can grow at 2.5%, the equity markets should move modestly higher in 2019.

Some factors could also boost this return. First, rest of world growth may finally pick up from the modest expansion currently. In the U.S., the government may move to cut taxes again giving a short-term boost to growth as well. We also believe that the government may want to stimulate the economy by committing to broad-based infrastructure projects. All these factors could extend the economic and corporate profits expansion into 2020.

Nevertheless, the seeds of an economic slowdown are surfacing. At this juncture, it suggests a slowing pace of growth next year.

VOLATILITY SHOULD RETURN

Chart V



Source: Bloomberg / Strategas

With quantitative easing acting as a powerful tailwind to equities in the last few years, the volatility in stock prices became more subdued than in the past. Indeed, a stock market move over or under 1% daily became a very unusual event (Chart V).

We have cautioned in the past that this has lulled investors into believing that severe volatility in stock prices is unusual. Now that we are reverting to a normal economic cycle, the period of reduced equity price volatility is coming to an end. As interest rates climb back up to more normal levels, money that flowed into stocks for income, as well as growth, may well move back to other non-equity asset classes. Additionally, the expansion of ETFs (Exchange Traded Funds) in the last ten years has also acted as a cushion to the market. With a return to normal volatility, these ETFs may add to the down volatility during periods of stock market corrections. We suspect that a return to normal volatility will be viewed very negatively by investors now that they have become accustomed to reduced market gyrations. Nevertheless, as the growth in the economy continues to expand at a +3% pace, concurrent with a global rise in interest rates, we expect a lot more market volatility in the future.

INVESTMENT THEMES FOR 2019 AND BEYOND

As we have written in our prior quarterly, the U.S. and the world have moved to the digital era at a breakneck pace. While still in its infancy, we expect this investment theme to extend for a decade or more. Moreover, the deployment of 5G bandwidth will dramatically increase Internet speeds for the next five years. This will lead to even more innovation in many industries as new software will be written to take advantage of this robust technology. We have positioned our core and dividend growth portfolios to take advantage of this major trend. We hold names in leading software infrastructure (Amazon and Microsoft), transmission (Cisco, American Tower and Crown Castle) and commercial software and consulting (Accenture and DXC) sectors.

However, we have also sought out consumer companies that have embraced the new digital world in various forms. McDonalds now utilizes its digital order system to deliver meals by connecting with Uber. Nike sells 8% of its footwear online. Avery Dennison is a huge player in tracking devices for apparel manufacturers. It is also expanding its technology into baggage tags among other areas of expansion.

More recently, we added Activision to our core portfolio. Activision generates about 75% of revenue online through its games. The company has more recently created a gaming league and has sold team franchises for $20 million each. Since its initial success, it has expanded the number of teams, and the price is now $30 million per franchise. We continue to seek out leaders in this rapidly expanding digital world.

KPCM IN THE NEWS

We have enclosed a *Vision Magazine* interview with Jack Salzman, our Senior Managing Partner. In the interview, he goes over the focus Kings Point tries to bring to all our client portfolios. We hope you enjoy the article.

As always, please contact our offices if you have any questions.

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