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market news

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"Be careful what you wish for..."

Scott Loyek, CFA®, *Managing Director, Portfolio Manager*

For almost 10 years economists, investors, politicians and journalists have bemoaned a sluggish economy, low interest rates, and the potential for deflation. Today we finally have an economy growing near 3%, interest rates moving toward more historically normal levels, and a moderate yet healthy level of inflation. Not surprising, just as market participants appear to have gotten their wishes, they are now concerned the economy is growing too fast, interest rates are too high, and that inflation is becoming a problem.

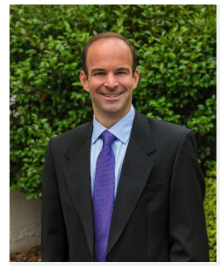
Today's economic environment has a significant number of complex workings. While not historically unusual, the current environment may seem unfamiliar to investors. Periods of change and transition are often stressful and disruptive, and we need to be reminded of the importance of maintaining perspective and objectivity. Many of the market concerns of today can actually be viewed as signposts on the long road back to normal following the financial crisis.

The Economy:

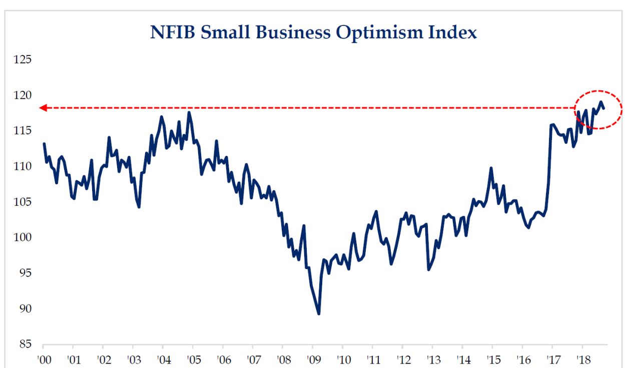
It is hard to dispute that the current health of the US economy is as strong as it has been since the financial crisis. The combination of improving economic growth, low unemployment, and improved consumer and business confidence has created a very strong year for Main Street. However, this strength has been somewhat less evident on Wall Street where markets currently are hovering near the flat line.

When we step back and look beyond the arbitrary calendar year, we see a much more logical and understandable picture. The enthusiasm and optimism surrounding the tax cuts and a strengthening economy led to a very strong end to 2017. It could be argued that some of this performance was pulling forward returns. As we wrote earlier this year, the economy and earnings needed to grow into the market's expectations. This has happened to some degree as the Price Earnings (P/E) Ratio for the S&P 500 which began the year at approximately 18x expected earnings and is now approximately 15.5x expected earnings.

In spite of the modest returns for the equity markets, we have seen very encouraging growth from the economy. Gross Domestic Product (GDP), a key measure of economic growth, continues to advance at the best levels in years. The strength of the US economy has pushed the dollar higher, improving the buying power of consumers. Unemployment is at historically low levels and wages are finally starting to creep higher. Parts of the country that had largely missed out on the recovery to date are finally seeing strength. This increasingly positive feeling can be seen in both the business and consumer confidence indexes.



Scott consults with TSWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TSWM in 2006.



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While continued economic growth is not a certainty, we see little reason in the near-term to expect a recession. The economy, as measured by GDP, can be defined as the sum of Consumption, Investment, Government Spending, and Net Exports (C+I+G+NX). Consumption, by far the largest element, is likely to remain strong as high employment, improved consumer confidence and rising wages should lead to a motivated consumer. Additionally, Government Spending appears most likely to continue to boost the economy at least for the next year. While Net Exports, the smallest component in the GDP equation, are not expected to be materially negative.

The degrees to which we see companies continue to invest or increase their investments in productivity is the ultimate key factor in determining both the magnitude and duration of the current business cycle. This investment and the resulting increase in productivity, is necessary for sustaining a healthy level of growth in the future. To a certain degree, this investment cycle was a strong long-term economic argument in support of the tax cut. We will continue to monitor rising trade tensions that could potentially short-circuit this investment cycle.

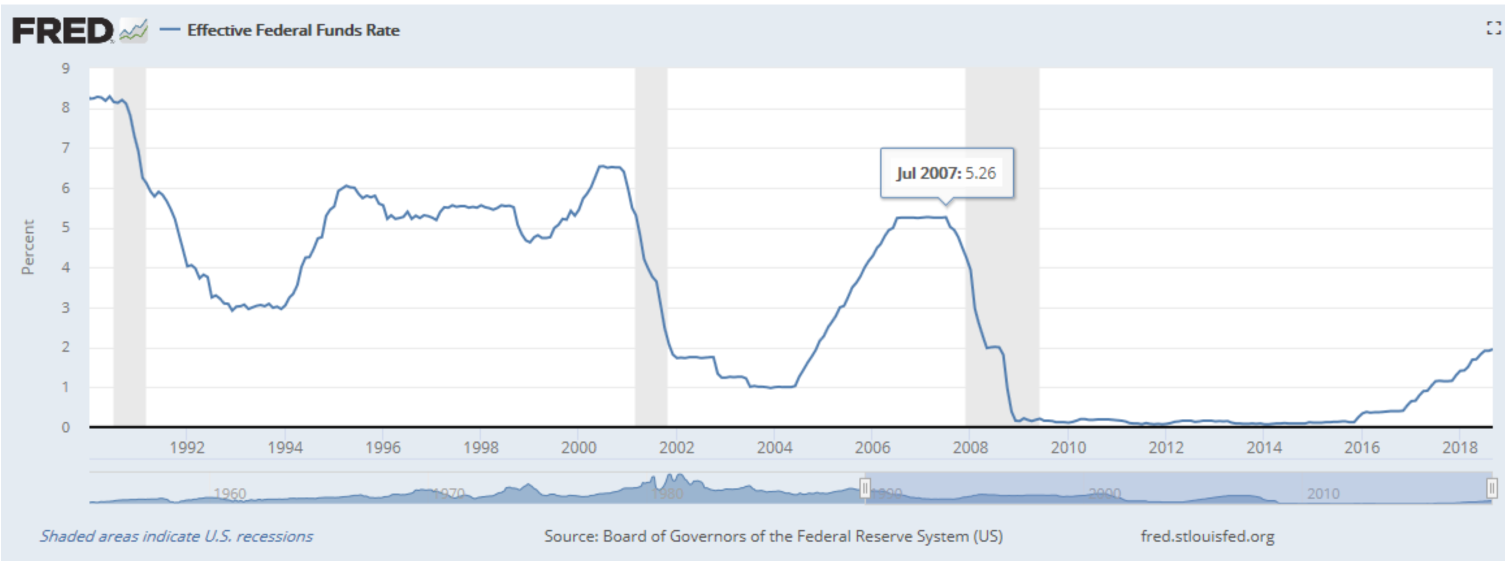
Continued on Page 2

Continued from Page 1

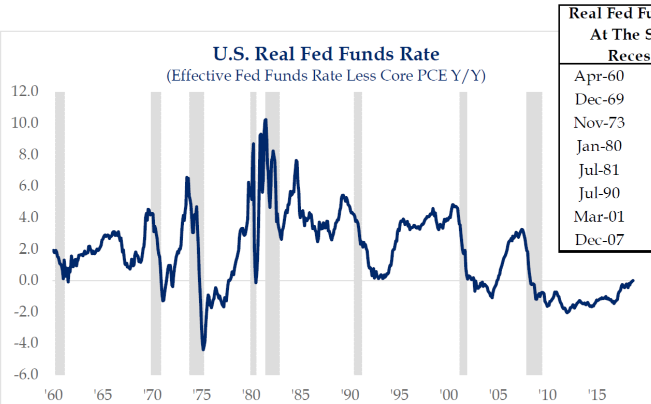
Low Interest Rates:

After several years of extraordinarily accommodative monetary policy, the Federal Reserve has embarked on the road to normalization. This entails two steps that are being attempted simultaneously. First, the Federal Reserve has been gradually raising the Federal Funds Rate. Second, though less publicized, they are also reducing the size of their balance sheet by selling bonds and/or not reinvesting proceeds from maturating bonds. These measures represent both a tightening of financial conditions and liquidity being taken out of the market. Both steps are necessary for bringing monetary policy back from the extremes of the financial crisis. In fact, each rate increase and asset sold will provide the Fed extra flexibility the next time the economy requires their assistance.

As the graph below shows, the Federal Funds Rate has gradually been rising for the last few years and perhaps is approaching more normal levels. It has been nearly ten years since market participants have had to think about rising rates. While historically the current level around 2% would be considered very low, it does mark a change with recent history.



More importantly the correct way to view the level of interest rates is to look at what is called the "Real Rate". The Real Rate takes the Fed Funds Rate and subtracts the rate of inflation from it.



Real Fed Funds Rate At The Start of Recession	
Apr-60	1.91
Dec-69	4.22
Nov-73	5.18
Jan-80	5.58
Jul-81	10.25
Jul-90	4.08
Mar-01	3.54
Dec-07	1.91

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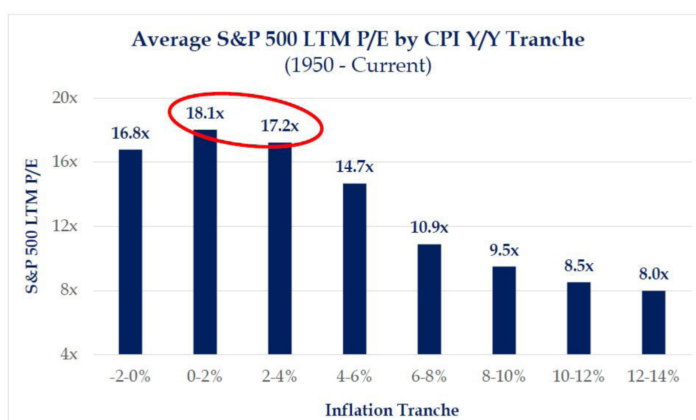
As the chart to the left shows, the "Real Fed Funds Rate" is basically zero. Historically, we have not seen recessions start until this rate is at much higher levels. The main concern of higher interest rates is the mathematical relationship between interest rates and asset prices. When valuing the future cash flows of an asset, the interest rate is a key variable. Generally speaking as interest rates rise, the valuation of financial assets declines.

In the case of the stock market, this means that we would expect the P/E ratio of the market to decline as rates rise. While this is generally true, the figure on the right, indicates with interest rates now around 2%, we are actually trading at a P/E multiple consistent with the long term average for the current level.



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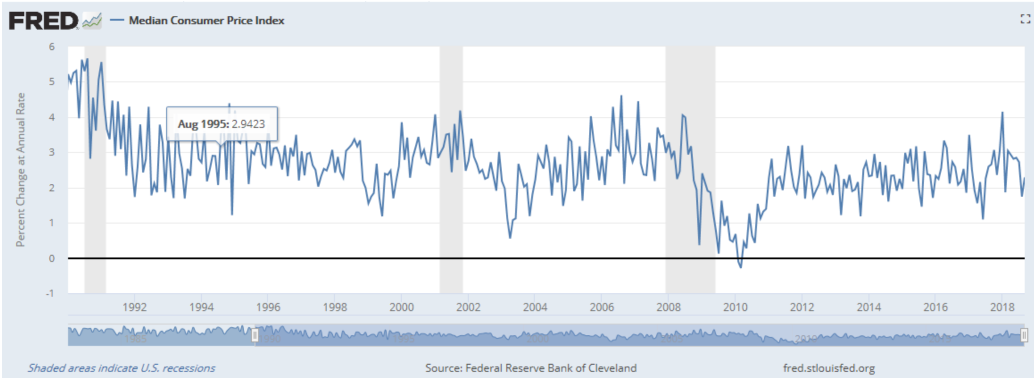
Continued from Page 2

Inflation:

Those who lived through the 1970's and early 1980's will remember inflation as a major economic force, as high inflation drove interest rates to extreme levels. Eventually, the Federal Reserve under Paul Volcker undertook very aggressive monetary policy to tame this high level of inflation. As a result of this painful memory, many people are quite scared of the risks posed by inflation. We agree that a return to an inflationary period like the 1970's would be a huge concern; however, the situation we face today is quite far from this scenario.

In contrast, for much of the period following the financial crisis, our primary fear has not been inflation but rather the specter of deflation. Today inflation as measured by CPI is around the 2% level. As the graphic to the right shows, this is a historically modest level. Inflation is not necessarily bad, in fact, over time the Federal Reserve has targeted inflation of around 3%.



We monitor inflation because of its impact on interest rates and thereby the prices of financial assets, as previously discussed, and an important distinction should be made between problematic inflation levels and a return to normal historical levels of inflation. We would expect that most economists would much rather see inflation in the current range than flirting with deflation as we were years ago. It is not an irrational concern that, in the long run, our tight labor market and trade tensions could lead to problematic levels of inflation in the future. However, this would take time and a somewhat unlikely combination of events for this risk to materialize.

The hawkish argument on inflation is basically that a tight labor market, driven by low unemployment, will push wages higher causing inflation. There is also some potential that tariffs and trade tensions will lead to inflation as higher input and production costs are passed through to consumers. In a vacuum, this could happen but there are many components that must be considered. For example, while disruptive it seems most likely that tariffs will be temporary in nature and not represent a permanent change in policy. Similarly, employers will likely respond to labor shortages and wage inflation by investing in improvements to enhance productivity. This growth in productivity, should it materialize, would be a positive that allows for a longer and healthier period of economic growth.

Even if we get only the negative side of this story with none of the positive possibilities, it appears there is time before we reach levels of real concern. Currently wages are rising at a 3% rate. Historically we have generally seen wage growth need to get closer to 4% before it correlates with economic problems. Other potential sources of inflation might include rising commodity prices or a decline in the value of the dollar, which are not present at this time. In our opinion, inflation will trend back toward more historically normal levels and will not reach excessive levels in the near future.

What we are watching:

While our opinion of the current environment is largely positive, there are several factors that could become problematic. With partisanship as high as it is, the risk of a major political shock is heightened. This shock could come in many forms, the most concerning in the near-term would be a showdown over the debt ceiling. Also as we move toward the 2020 election, the potential for two ideologically extreme candidates could lead to considerable uncertainty.

Another factor that we will be watching is the Federal Reserve. The challenge the Fed is currently confronted with is one that no other central bank has ever faced. The simultaneous attempts to both raise rates and reduce the balance sheet will almost certainly hit some bumps along the way. The success thus far has been nothing short of remarkable, but the Fed will need to continue to walk a fine line with little history to guide their decisions.

What we are doing:

While we are humble enough to know we are not capable of out-guessing any of these outcomes, we are working to provide our clients with the best risk/return profile possible. We are doing this in a number of ways. First and foremost, we are continuing to rebalance portfolios and ensure that the mix of stocks and bonds is not drifting. I have become fond of telling clients that their portfolios are not riskier, they just have more money. The reason for this rebalancing is as the equity markets continue to rise, we keep trimming those gains and adding to fixed income as appropriate.

Similarly, we are taking advantage of changing market conditions to add value. One of the most noticeable ways we have done this is by taking advantage of the rising returns on cash. We have been able to increase returns for those clients with cash allocations significantly as we have taken advantage of the changing landscape.

Continued on Page 4

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Continued from Page 3

Lastly, we are continuing to acknowledge the changing risk/return environment. For much of the last 10 years, we have generally had client portfolios underweight their long-term fixed income targets. This was based on both historically low bond interest rates and relatively attractive equity valuations. As both bond rates and equity prices have normalized over the last year or so, we find our allocations normalizing as well. Our allocations to fixed income are gradually approaching their neutral target levels.

What we expect:

While I think it is fair to say investing over the next several years will be more challenging, we remain relatively optimistic. This optimism is driven primarily by a moderate and apparently sustainable economic environment. The stock market is trading at a valuation level consistent with both the long-term average and the current level of interest rates. The fundamentals of the economy appear healthy and are not showing significant signs of overheating. Interest rates are nearing normal levels and have not reached levels that are likely to be problematic. Should we have a shock to the system, the Federal Reserve once again has some levers to pull to aid the economy.

We expect political instability to remain something of the norm; however, it appears the market is getting used to this drama. The 2020 presidential race began on November 7th and we will view the political happenings from this perspective. Historically, the third year of a presidential term produces the best equity returns as political focus turns to getting reelected. As such, we are hopeful that we will see some of the trade tensions ease as the election approaches. In the next 6 months, potential risks exist around the debt ceiling and NAFTA votes. While these or many other political surprises could cause short-term disruptions, we think they will be manageable.

The rest of the world has become somewhat weaker throughout the last 12 months. We think there is a potential for fiscal stimulus outside the US this year as foreign governments seek to replicate the economic successes of the United States. Should this occur, particularly in an environment where trade progress is being made, we once again have the potential for synchronized global growth. Should this outcome occur it could provide a new leg to the economic expansion.

It is often said that the cause of most recessions is overly aggressive Fed tightening, and we certainly hope that is not the case anytime soon. We think the pace of rate hikes will slow this year. Even if the Fed does slow down, we still expect to see some impact from the decline of liquidity in the financial system. We think this leads to more variance in the returns of financial assets as the tide of liquidity that has lifted all investments begins to recede.

Looking forward, we see a very average risk/return environment based on the current fundamentals. However, we are certain that we are one day closer to the next recession than we were yesterday, so we will continue to focus on those things we can control and the unique circumstances of each family we help. We welcome the opportunity to discuss any questions or concerns you may have.

Where Families Invest

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