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Despite political uncertainty, a deepening partisan divide, and rising concern about escalating trade tensions, the S&P500 advanced more in the last three months than any quarter in the last five years. The "tit-for-tat tariff war" between the U.S. and China continues to capture the attention of market observers and the media. News outlets ranging from The New York Times to RVBusiness have reported on specific potential dangers that might result from trade restrictions. Additionally, concerns over the possibility of Italy's disrupting the eurozone, nascent signs of inflation and the impact of rising U.S. interest rates have left many skeptical about equity valuations – and indeed those concerns are showing themselves thus far in the fourth quarter.

In previous commentaries, we have expressed the view that low interest rates have been the primary fuel for the post-crisis bull market in U.S. equities. It has been our belief that stock prices have benefitted from the strong and consistent demand of corporations taking advantage of cheap borrowing costs to buy back their own stock, acquire other companies or take themselves (or be taken) private. Yet, in the third quarter, stocks prices advanced despite higher rates for U.S. government debt ranging from short (Fed Funds) to long (10 and 30-year Treasuries). We believe this apparent anomaly can be explained by two factors stemming from overall confidence in the state of the economy.

First, yields on corporate debt (and therefore the cost to borrowers), especially lower quality junk bonds, actually went down. Yields on higher quality, investment-grade corporate debt were roughly unchanged during the quarter, while the cost of funds for C-rated borrowers dropped from 6.7% to 6.5%. At the same time, investors have shown a greatly increased appetite for loan funds, which offer financing with fewer restrictions. According to Bank of America Merrill Lynch, the so-called leveraged loan market reached $1 trillion earlier this year. We believe we are still in a borrower's market.

While cheap and available credit has benefitted stock prices, it has not been the only factor recently. Corporations continued to announce impressive earnings during the quarter, albeit with a substantial assist from the tax reform package that took effect at the beginning of 2018.

The technology sector continued to attract investor interest, as has been the case throughout most of the post-crisis environment. Pharmaceutical companies, poor performers over the first six months of the year, returned to favor.

Conversely, investors shied away from certain more cyclical industries, particularly automotive and energy. Though crude oil prices finished the quarter at or near their highest level in four years, the shares of certain producers and service companies languished. Auto and auto parts manufacturers underperformed, with investors wary that car sales will fail to maintain the torrid pace of the last few years. Additionally, these types of companies were punished for having meaningful exposure to trade hotspots China, Mexico and Canada. We believe that investors are overly pessimistic and do not fully appreciate the structural improvements made by the automotive industry in the wake of the financial crisis. The pace of technological change that is taking place in the automobile industry is without precedent in the history of the industry and will create clear winners and losers.

Looking Forward

As always, it is crucial to recognize the limits of the analytical tools at hand. Simply because an event or variable is important does not guarantee that it can be accurately or profitably predicted. Several such economic wild cards are in the mix today. The shape of future trade policy with China is one. We can only hope that some form of rational discourse prevails, resulting in a trade structure that corrects some structural inequities without destroying important commercial relationships. Failure to compromise could have serious consequences. We won't know until we know.

Much the same could be said about Italy and its future in the eurozone. Recent history is a poor guide. Grexit (Greece leaving the zone) was widely predicted and feared, but it never happened. Brexit surprised virtually every prognosticator. It has had a variety of unforeseen impacts but has yet to actually occur. There have been dire and not so dire predictions about the implications of an Italian exit (there is no catchy shorthand for this, yet), but we feel there is no way to gauge the likelihood of a breakup.

Closer to home, mid-term elections may or may not have an impact on investor optimism, business confidence or the economy. Political experts did not cover themselves with glory the last time around. We will not hazard a guess until election night.

There are issues that merit close attention. First and foremost among them is the U.S. interest rate environment. If cheap and available credit have fueled the stock market advance, it will be critical to observe changing conditions, if any. Our current view is that U.S. rates are unlikely to continue rising at the pace they already had over the last 12 months. We believe the Federal Reserve is coming closer to reaching its goal for the overnight Fed Funds rates. We do not believe inflationary pressures will expand dramatically. While the U.S. economy is strong, we do not believe it is in imminent danger of overheating, and the Federal Reserve's short-term rate increases are more about preparing for the next recession than trying to normalize the current environment. Major global economies are certainly softer. The dollar is still the world's safe haven currency, and therefore it is likely that longer term U.S. Treasury yields will retrace some of the recent move upward. Credit conditions are somewhat more difficult to predict because the willingness to lend has a significant psychological component. It appears there is still plenty of available capital in search of yield-bearing investments. This should continue to enable corporate buying of stocks.

This does not mean that we are blindly optimistic. Though market averages have posted stellar year-to-date and third quarter returns, the rising tide has not lifted all ships. One out of three stocks in the S&P 500 generated a negative return in 2018; more than one out of four were negative in the otherwise powerful third quarter.

In the somewhat higher interest-rate environment that exists today, we can expect wider swings in asset prices. Investors are more likely to react strongly to unexpected or adverse events. It is more important than ever to have a margin of safety in portfolios. We believe that we do hold this margin in both stock and bond asset classes.

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