Yanni & Associates
Investment Advisors, LLC

**YAIA Firm Update:**
**Camille Simon, our Administrative Assistant, passed her Pennsylvania Notary exam and is now fully certified to provide these services to our clients.**

**Newspaper Quotes – We want to thank and congratulate a long-time friend and business acquaintance, Len Boselovic, who announced his retirement from the Post-Gazette. My Father partnered with Len for many years, then myself on many news articles. Sometimes, we contributed with a quote, an educational discussion, or even as an anonymous source. It's always a pleasure to work with people who share a similar passion. Len, we wish you well as you transition into your retirement phase of life.**

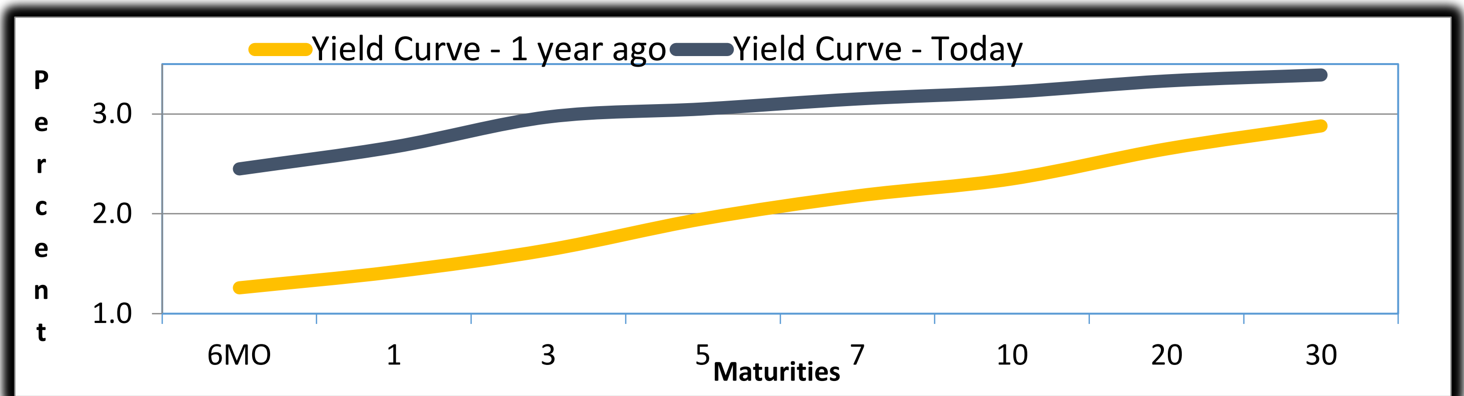
## THIRD QUARTER – 2018 CLIENT NEWSLETTER
## REVIEW OF THE MARKETS:

| Index: | 3Q18 | 2018 |
|---|---|---|
| **S&P 500** | 7.71% | 10.56% |
| **S&P Mid-Cap** | 3.86% | 7.49% |
| **S&P Small Cap** | 4.71% | 14.54% |
| **Morgan Stanley's EAFE (International Stocks)** | 1.35% | -1.43% |
| **Barclay's US Aggregate (Bonds)** | 0.02% | -1.60% |

## ECONOMY & MARKETS:

The stock market rose to new levels in the third quarter of this year, but suffered extreme volatility in early October. With the upcoming election a month away and after reaching a new high for the S&P 500 in September, this volatility may continue. The final report for second quarter GDP came in at a healthy 4.2%. Unemployment continues to remain low at 3.7%. Inflation continues to gradually rise, but it's not at unacceptable levels. Corporate earnings growth remains exceptional projecting to be up 19.2% in the third quarter. Currently, the S&P 500 is trading about 16 times its forward P/E Ratio, which is not considered over-valued. The talk of a trade war with China was a major topic for the quarter. As for now, it's been merely a "chest-pounding" situation, rather than significant actions by either country. The ongoing news about how much each country planned to levy in tariffs created volatility on a daily basis. In early October, a different trade deal between the U.S., Mexico, and Canada replaced NAFTA with "USMCA".

As was widely anticipated, in September the Federal Reserve (The Fed) announced its third interest rate increase for the year and eighth time since December, 2015. Future projections continue to be it is inclined to raise rates five more times; one more in December, three more times in 2019, and once in 2020. Thus, it appears we are in the latter stages of an interest rate hiking scenario and thus far, the economy has remained resoundingly resilient! As the Fed's interest rate increases tend to have a more immediate impact on short-term rates, heading into the quarter we have yet to see longer-term rates rise by the same magnitude. As discussed in the past, if the Fed continues raising short-term rates faster than long-term rates adjust upwards, the yield curve could "invert" (which is a strong indicator of an upcoming recession). The graph below illustrates how interest rates over the last year went from a positively sloped yield curve (yellow line) to one that is more of a flat in nature (blue line):




As noted before, the Fed has been reducing its debt obligations (aka "unwinding its balance sheet") and such actions could help longer-term interest rates gradually rise as well. With all of the publicity this potential inverted yield curve concept has received, we find it difficult to believe the Fed would cause this to occur. If it were to happen, the timing would likely be somewhere late 2019 or beyond. Coincidently, that is a similar time frame where many economists have discussed (1) the benefits of the 2017 tax cuts would have worked their way through the economy, (2) Potentially, government deficit spending will be at levels to where it will become a greater issue, (3) Corporate earnings growth could slow from recent robust levels with projections up 20.3% for calendar year 2018 and then only up 10.4% in 2019. (4) More baby boomers retiring could lead to a shortage of workers. While we are not yet forecasting a recession will occur in 2019 or 2020, these are internal items which we are monitoring. As for now, corporate earnings growth and most economic statistics remain strong. **As we noted last quarter, our two biggest concerns still remain a potential trade war and the Fed's path of interest rate increases and its effect on the economy.**

# Defining the different indexes! Which one is the best to use?

We often get questions from clients as to what is the best way to follow the stock market. Most commonly, personal investors follow the Dow Jones Industrial Average or the Standard & Poor's 500. While both of these Indexes are probably the most appropriate to use, they both are constructed significantly differently and each has distinct drawbacks as well. Outlined below are the most common stock and bond indexes used by professional advisors:

**1. Dow Jones Industrial Average ("DJIA")** – Being over 100 years old, the DJIA is one of the oldest indexes in the world. Given its history, many people consider it to be a very good barometer for the overall health of the U.S. stock market. The DJIA is made up of 30 large capitalization ("cap" which means size) companies that are considered leaders of the economy and hand-picked by editors of the Wall Street Journal. To calculate the DJIA, the current prices of the 30 stocks are added up and then divided by a divisor, which is constantly modified for stock splits, spin-offs, etc… Since the DJIA is based on share price, the most expensive stock measured simply by its price will have the highest weight. It's most recent change was removing a historic company, General Electric, and replacing it with Walgreens.

**2. Standard & Poor's 500 ("S&P 500)** – The S&P 500 is larger and more diverse than the Dow; it represents about 80% of the total value of the U.S. stock market. This Index is made up of 500 stocks weighted by capitalization, in contrast to the DJIA's price-weighted system, and also has a divisor that is a proprietary figure developed by Standard & Poors. This Index is much more broad-based and covers all major sectors. Given the method of its construction, a noted drawback is that its top 50 stocks make up 80% of its overall value. This point couldn't have been more noticeable than back in 2015 when the S&P 500 was up 1.38%. If it were not for the substantial returns of a few large companies coined the "FANG" stocks (Facebook, Amazon, Netflix, & Google), the Index would have been down about -3.8% that year. This stock Index is periodically updated as well. Recent changes include the telecommunications sector (previously home to only three stocks) being expanded to include most notably other stocks namely Facebook and Alphabet (Google) moving from the technology sector, while Netflix and Disney will move in from the consumer discretionary sector. The other drawback to this Index is it is very heavily weighted to large cap domestic stocks. In essence, it has either small or no exposure to mid-cap, small-cap, or international stocks.

Through back-dated studies in the Chartered Financial Analyst (CFA) program, utilizing a diversified portfolio consisting of large-cap, mid-cap, small-cap, and international stocks tends to outperform an undiversified domestic index with less volatility over the long-term.

**3. Russell Indexes** – Frank Russell is another company that publishes stock indexes also based on market capitalization. Its most common benchmarks are the Russell 1000 (large-cap), Russell Mid-Cap, Russell 2000 (small-cap), and Russell 3000 (all-cap) though it has other indexes beyond these. The Russell 3000 index captures about 98% of the domestic equity market. Its top 1000 stocks make up the Russell 1000 and bottom 2000 make up the Russell 2000 indexes. These indexes are reconstructed only once a year (with minor exceptions) and it is also possible the Russell 1000 may not own exactly 1000 stocks.

**4. Morgan Stanley Indexes** – Morgan Stanley (MSCI) also produces numerous capitalization weighted indexes as well, which are rebalanced twice a year. While the domestic indexes are utilized by many mutual fund companies, Morgan Stanley's international stock indexes most notably the MSCI EAFE (developed international stock markets) and MSCI Emerging Markets are much more widely used for those two international segments. Given many constraints of attempting to properly capture international markets including the sheer number of stocks, international trading constraints, among others, makes properly measuring international stock performance a challenge at times. Despite these drawbacks, we commonly monitor the MSCI EAFE Index as the barometer for International stock performance.

**5. Bloomberg Barclays U.S. Aggregate Bond Index** – The "Agg" is the most common bond market benchmark. It has changed ownership a few times and was once called the Lehman Aggregate. The Index includes 37.6% Treasuries, 6.7% government-related, 25.1% corporate securities, and 30.6% asset-backed and various mortgage backed securities. While it is the most common benchmark for the bond market, drawbacks include the difficulty of replicating all existing bond holdings, it primarily captures domestic investment grade bonds, very little to no positions in floating-rate bonds or municipal bonds, a high degree of interest rate risk, and others. Despite these drawbacks, we commonly monitor the Agg as strong indicator of the overall bond market.