Dixon, Hubard, Feinour & Brown, Inc. investment counsel

Third Quarter 2018 Review & Outlook
by Whitney Brown

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INVESTMENT OUTLOOK

- U.S. growth stocks lead market.
- Market focused on fundamentals, not politics.
- Peak earnings, China trade, and Federal Reserve top investor concerns.

Large cap U.S. stocks were the clear winners in the third quarter. Small cap U.S. stocks managed a solid return, but just about every other asset class from bonds and international stocks to commodities and gold struggled to break even. Growth stocks continued to dominate U.S. returns with technology and healthcare issues leading the way joined by consumer discretionary and industrials. Flattening of the yield curve has kept the financials from breaking out, and the Fed's raising of rates at the short end of the curve has kept pressure on the rate-sensitive utilities and real estate sectors.

For almost two years since the last presidential election, the stock market has done a remarkable job of ignoring the political front and focusing on things that matter in the investment world. Corporate earnings in the U.S. have surged on lower taxes and strong consumer spending. Economic growth has accelerated as businesses, seeing easing regulatory burdens and lower taxes, have increased hiring and capital expenditures, and as consumers buoyed by a strong labor market have gained confidence. Meanwhile, inflation has remained under control.

This sounds like a great set up; but when things are just right, you have to wonder what may change. Perhaps the jolt to earnings growth from the tax cuts has been used up, and corporate earnings have peaked. On the other hand, the tax cuts may have goosed the economy enough to unleash the "animal spirits" needed to help it finally reach its natural stride.

Now that revisions to NAFTA have been agreed to by the U.S., Canada, and Mexico, attention has refocused on how long the U.S. and China will remain at loggerheads over trade and what the longer term impacts may be. China has more at stake than the U.S. in terms of pain the tariffs will inflict domestically, but they also have an authoritarian government with deep pockets and a point to make about not getting pushed around. Damage the tariffs cause to the Chinese economy can spread to its other trading partners and ultimately have some effect on the U.S. if the trade impasse continues unabated.

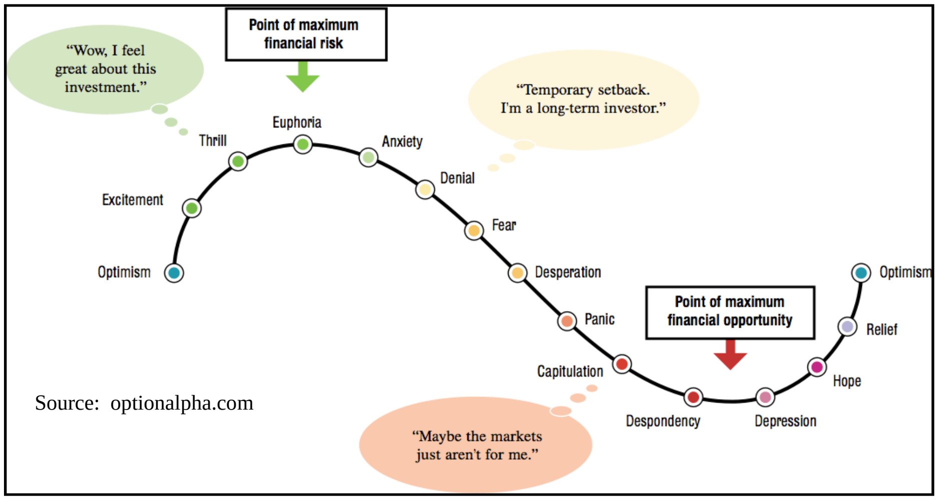
Federal Reserve policy is also a top-of-mind concern for investors. If the current uptick in economic growth is not as durable as it seems, the Fed may be raising interest rates too much and hastening recession. If inflation is not as benign as it appears and emerges in unexpected ways, they could find themselves behind the curve and needing to tighten more aggressively, again risking recession.

There will always be a long list of if's and but's to concern ourselves with, and the best way to manage uncertainty is to watch, and follow, the markets. For now, we see a U.S. stock market that is in a fairly broad long-term uptrend. We do not see the indexes being dragged higher by a handful of mega cap stocks while everything else is going down. We also see international markets that offer value but need some relief from the strong U.S. dollar and global trade uncertainties. Hopefully, the U.S. can lead its parade of one long enough for the rest of the world to join in again.

Market Measures	3rd QTR 2018	YTD 2018
S & P 500 (price)	7.2%	9.0%
Dow Jones Industrial Average	9.0%	7.0%
NASDAQ Composite	7.1%	16.6%
Russell 2000	3.3%	10.5%
MSCI EAFE	0.8%	-3.8%
Barclays Capital Inter Gov't/Credit Bond Index	0.2%	-0.8%
	9/30/18	9/30/17
10-Year US Treasury Bond Yield	3.07%	2.33%
Three-month US Treasury Bill Yield	2.21%	1.06%

Cycle of Investor Emotions by Watt Dixon

The stock market moves in cycles. We have bull markets, bear markets, and times when the stock market just moves sideways. Many investors in stocks, or any investment, experience different emotions along the way with their investments. While we cannot always control our emotions, being aware of the stages of investor emotions can be beneficial to one's portfolio goals and objectives.



Source: optionalpha.com

The chart on the right relates not only to the stock market, but to real estate speculation, gold, Bitcoin, and any other investment. All are subject to investor emotions. Emotions are applicable, to varying degrees, to both long and short term investment

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The Latest Hype? by Jim Hall

The frequently asked question of last year "What do you think about Bitcoin?" has been replaced this year with "What do you think about 'pot' stocks?" As we have discussed before, the stock market's direction and trading activity are constantly being analyzed and debated by business news "experts" throughout each trading day. The anchors and reporters are always trying to feature a story that will grab and hold the attention of their viewers. Consistently, the most compelling stories involve featuring investments that have soared in value over a short window of time. They delight in pointing out the examples of a small investment turning into a small fortune in a matter of days or weeks.

Unfortunately, this sort of reporting feeds upon the idea that buying the correct magic stock will result in overnight riches. In reality, it only serves to create a passing euphoria that usually results in disappointing losses for the investors who weren't able to sell in time.

You may recall in 2017 Bitcoin soared from just under $1,000/coin to more than $19,000/coin only to plummet in 2018. The business news anchors were obsessed with discussing the topic and always chose to feature Bitcoin news at the expense of the more mundane quarterly profit reports from various companies. The idea behind Bitcoin and other digital currencies is to try to create an alternative that could replace paper currencies issued by various governments. The idea is noble but the application has proven challenging as these exchanges have offered a place for the criminal element to launder money. The SEC is studying the idea and has so far denied every proposal that would bring Bitcoin into a more formally recognized status. If the SEC is able to attain some level of comfort, at the very least, these digital exchanges will be heavily regulated and much more transparent.

One crucial fact missed or conveniently overlooked by the reporters is Bitcoin doesn't generate any sort of cash flow. There is no operating business whose profits or outlook for profits can be assessed and allow for some sort of valuation based on a market multiple. The only trigger to value is the scarcity of the coins and the hope demand for coins would continue to increase.

This year, marijuana or "pot" stock reporting has been dominating the business news. At least the marijuana industry is an actual business for medical and recreational uses. Canada has legalized recreational use, and more U.S. states are doing so. Because it is newly recognized as a legal business, many of the companies in the industry are just starting but are hoping to become leading players in the future. Most have little to no cash flow now.

A company called Tilray seems to represent the most extreme example of euphoria in this industry. Even though it has negative cash flow and generates no profits, during the past few months it has traded between $20/share and $300/share.

It is always fun to look for the next "Apple" or "Amazon" but be aware of unusual market euphoria that may focus on enthusiasm rather than value.

Healthcare Costs: U.S. vs. Other Developed Nations **by Stebbins Hubard**

Healthcare costs in the United States are about twice as high as in other developed nations. The U.S. spent 17.8% of its GDP on healthcare in 2016. Meanwhile a report published in the Journal of the American Medical Association (AMA) reported the average spending of eleven developed nations (Canada, Germany, Australia, the U.K., Japan, Sweden, France, the Netherlands, Switzerland, Denmark and the U.S.) as only 11.5 percent. Per capita, the U.S. spent $9,403, nearly double what the others spent. Even with all this money being spent on healthcare the Commonwealth Fund placed the U.S. last among these eleven developed nations in overall healthcare.

Why is the U.S. paying so much more for healthcare, failing to provide adequate healthcare at reasonable prices, and not appearing at the top of the rankings?

Among the reasons is that few people in U.S. healthcare, from physicians, hospitals, insurers and consumers, know the real cost of what they are buying and selling. In many cases, costs are mostly hidden. Providers, manufacturers and middlemen operate in an opaque market that can conceal their role and their portion of revenue. As insurers negotiate most prices with providers, it is next to impossible for consumers to know the real costs and little incentive exists to understand underlying costs.

One reason our healthcare costs are so high is that the administrative costs of running our healthcare system are astronomical. Administrative costs accounted for 8% of total national health expenditures in the U.S. For other developed nations, it ranged from 1% to 3%. Health care professionals in America also reported a higher level of "administrative burden." A survey showed that a significant portion of doctors call the time they spend on issues surrounding insurance claims and reporting clinical data as a major problem.

Another difference in healthcare costs between the U.S. and the other developed nations is the cost of drugs. In most countries the government negotiates drug prices with the drug makers, but when Congress created Medicare Part D, it specifically denied Medicare the right to use its power to negotiate drug prices. The Veteran's Administration and Medicaid, which can negotiate drug prices, pay the lowest drug prices. The Congressional Budget Office has found that just by giving the low-income beneficiaries of Medicare Part D the same discount Medicaid recipients get, the federal government would save $116 billion over 10 years. The U.S. spends $1,443 per capita on pharmaceuticals. The average pharmaceutical spending of the other developed nations came to $749 per capita. Total spending on generic drugs in the U.S. is less than 30 percent of the total dollars spent on pharmaceuticals, suggesting that brand name medications are a major driver of costs for the U.S. healthcare system.

Defensive medicine is another cause for higher healthcare costs. Doctors are afraid of being sued, so they order multiple tests, even when they are confident in their diagnosis. A Gallup survey estimated that $650 billion annually could be attributed to defensive medicine. Everyone pays the bill on this with higher insurance premiums, co-pays, and out-of-pocket costs, as well as taxes that go toward paying for governmental healthcare programs.

U.S. medical practitioners also tend to use a more expensive mix of treatments. When compared with other developed countries, for example, the U.S. uses three times as many mammograms, two-and-a-half times the number of MRIs and 31% more Caesarean sections. Another key part is the overutilization of specialists through the current process of referral decision-making which drives healthcare costs higher than when the same types of treatments are done at the primary-care level in other developed nations. Specialists command higher pay reflecting the additional time and higher educational costs U.S. specialists must incur. Salaries paid to doctors and nurses in the U.S. are higher than the other developed nations. However, the number of physicians in the U.S. is comparatively low, offsetting the effect of high salaries. For example, despite Germany having almost twice as many doctors as in the United States (4.1 doctors per 1,000 people, versus 2.6 in the U.S.) the amount spent on their salaries is essentially the same.

According to the AMA Journal study, the cost of a hospital stay and services is 60 percent higher in the U.S. than the other developed nations. Hospitals are becoming more consolidated and are using their market clout to negotiate higher prices from insurers. Another reason may be too many hospitals with empty beds, which the staff try to mitigate by charging higher fees, keeping patients longer than is necessary, or running unnecessary tests. The U.S. performs more CT scans than any other country (1.3 million per year). Each scan costs 10 times more than in the Netherlands. Even a procedure like a cesarean section costs, on average, seven times more in U.S. than in The Netherlands. In 2013, the average cost in the U.S. was $75,345 for coronary bypass surgery, whereas the cost in the Netherlands was $15,742. Similarly, the mean payment for an MRI in the United States was $1,145 compared with $461 in the Netherlands. Also, when a procedure such as a colonoscopy is performed at a U.S. hospital, it costs 2 to 3 times more than if performed in a physician's office. Also, most U.S. hospitals are obligated to care for patients who have no insurance, whether or not they can pay. Unpaid fees are passed on to the other paying and insured patients.

Most other developed nations control costs, in part, by having the government play a stronger role in negotiating prices for healthcare. Their healthcare systems don't require the high administrative costs that drive up pricing in the U.S.; these governments have the ability to negotiate lower drug, medical equipment and hospital costs. Plus, they have more control and knowledge of the real cost of their purchased healthcare services. They can influence the mix of treatments used and patients' ability to go to specialists or seek more expensive treatments.

So far in the U.S., there has been a lack of political support for the government taking a larger role in controlling healthcare costs. The most recent legislation, the Affordable Care Act, focused on ensuring access to healthcare, but maintained the status quo to encourage competition among insurers and healthcare providers. If the U.S. were to embrace similar policies as the other developed nations, costs per individual would go down, but there may be other negative consequences. Even though the U.S. is paying more for the same services than the other developed nations, a sudden correction could have a damaging impact on the healthcare market. Hospitals might shut down, and patients might have to wait three to four times as long for some procedures or to see a specialist. Taxes could increase. Workers who currently get medical insurance through their employers might see their premiums and co-pays increase.

Cycle of Investor Emotions (Continued)

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horizons. These emotional stages follow bull and bear market cycles over and over again. By understanding this cycle of investor emotions, one can hopefully limit knee jerk reactions and thus better adhere to one's long term goals.

While this chart is fairly self-explanatory, determining where we are in the cycle is subject to interpretation. With this 10-year-old bull market still seemingly healthy, one would think we would still be somewhere along that first leg up in the emotional cycle, somewhere between optimism and euphoria. However, where we are in the emotional roller coaster cycle with Bitcoin is different. It would seem that the "euphoria level" in the cycle of Bitcoin may have been reached some time in December of 2017. Of course, mini-cycles of up and down emotions exist within a more secular, long term view of the stock market, or any investment.

Patience is also a very important factor in reaching a one's investment goals. The news media is now a constant and immediate source of information in our lives. Economic statistics, world events, and political happenings are all immediately relayed through TV and the Internet. All of this information creates the feeling that we must act immediately or we will miss out on a major price move in the market. Our long term goals and objectives are often pushed aside by the day-to-day "important news" that constantly inundates our lives.

Staying in sync with the longer term trend of the market is very important. Trying to time every intermediate and short term market turn can lead to disastrous results and missing out on some of the major market moves. It is important to remember that even if an opportunity is missed, there will always be another opportunity that comes along.