Insights: January 2019

Market Overview and Performance

Without question, 2018 ended on a very sour note. After reaching all-time highs in September, the major stock indices collapsed in the fourth quarter falling by roughly -14 percent with over 9 percent of that decline coming in December alone. This unfortunately resulted in the first negative annual return since 2008, a run of nine straight positive years for stocks. To make matters worse, the historical tools used to combat market corrections failed to provide cover. During the Global Financial Crisis, US Treasuries returned 14 percent and Gold returned over 4 percent. This year, the only asset with a positive return was cash which delivered 1.8 percent. Importantly, unlike 2008 when there were serious fundamental problems with the global economy, the recent sell–off was driven by sentiment. While it is clear that global growth is slowing, the sudden erosion of investor sentiment can largely be blamed on what can be termed “unforced errors”. During its December conference call, economic bell-weather Fed Ex ended the meeting with this comment from their CEO, Frederick Smith; “I'll just conclude by saying most of the issues that we're dealing with today are induced by bad political choices, making a bad decision about a new tax, creating tremendously difficult situation with Brexit, the immigration crisis in Germany, the mercantilism and state-owned enterprise initiatives in China, the tariffs that the United States put in unilaterally. So you just go down the list and they are all things that have created macroeconomic slowdowns. The good news is, with the change in policy they could turn it around pretty quick too.”

As always, thank you for reading our latest Insights.

	Month to Date	*Year to Date*
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**-9.03**	-4.38
Russell 2000 Index	**-11.88**	**-11.01**
MSCI EAFE Index	-4.85	**-13.79**
MSCI Emerging Markets Index	-2.66	**-14.58**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**1.84**	**0.01**
Barclay's U.S. Aggregate Credit Index	2.45	**-6.76**
Barclay's U.S. Aggregate Corporate High Yield Index	-2.14	-2.08
Barclay's Municipal Bond Index	1.20	**1.28**
Macro Measures		
Gold	4.32	-2.19
Crude Oil	-12.16	**-33.05**
CBOE Volatility Index	**28.91**	**56.57**
USD Dollar Index	-1.14	4.21

Current Theme – Large Equity Declines, Slowing Global Growth and Little Progress on Trade War Resolution Lead Top Investors Concerns for 2019

While Downside Impact of These Factors is Likely Priced Into the Equity Markets, Solid Earning Results and a Trade War Solution Could Clear the Way Forward

It's still a bit surprising just how quickly US equity markets deteriorated during the last quarter, when in fact nothing had fundamentally changed. There was no tangible catalyst - no bank failure, no all out escalation of trade tariffs, no geo-political crisis, just a change in sentiment. To put it simply, the market seemed to latch onto the idea that the Fed would be raising rates aggressively while the pace of global growth was slowing from elevated levels in 2018.

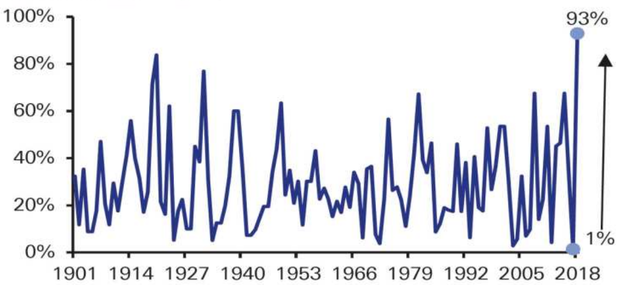
S&P Fell -19.8% from September 20th – December 24th

Source: Bloomberg; Jeroen Blokland

As a result, the S&P 50 collapsed -19.8 percent from September 20th through December 24th. By the time the dust settled on the calendar year, investors were looking at an environment where virtually every asset class other than cash posted a negative annual return.

The "Worst" Year on Record, 93% Assets Negative 2018

Figure 2: Percentage of Assets with a Negative Total Return in USD terms

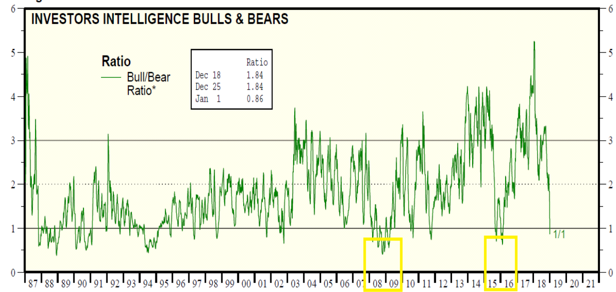


Source: Deutsche Bank; Bloomberg; GFD.

Based off of sentiment readings alone, investors had been displaying wildly optimist views about potential outcomes starting in 2017 and through most of 2018 before reality set in. General consensus would have told you to expect a pull-back to more normalized levels. Instead, by the end of the year we saw a full capitulation of investor sentiment to the levels only seen at previous market bottoms in 2009 and 2015.

Capitulation – Bull/Bear Sentiment at Previous Lows

Figure 9.



Source: Investors Intelligence; Yardeni Research

This is a good thing. When pessimism is at its highest, it has historically shown that a bottom has formed in the market. Generally speaking, forward returns from these inflection points tend to be encouraging. As seen below, when the S&P 500 experiences a quarterly decline of greater than -10 percent, the following quarter, the following 6 months and the following 12 months all average positive returns with around 75 percent certainty. The average returns over those periods has been +5.1, +11.3 and +15.9 percent respectively. While no guarantee, it's constructive.

-10% Decline Quarters Typically Followed by Pos. Periods

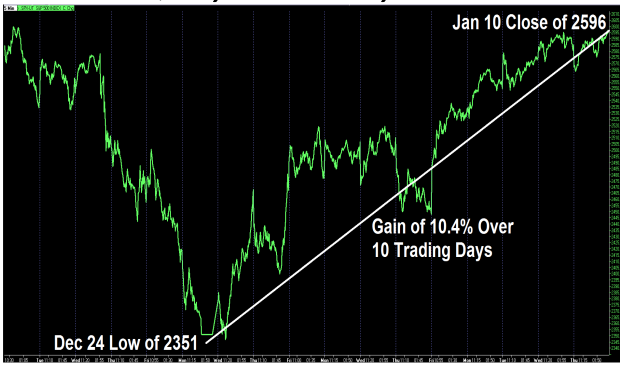
S&P 500 10%+ Down Quarters Post WWII

Quarter	% Chg	Next Qtr %	Next 2 Qtrs %	Next Year %
9/30/1946	-18.83	2.27	1.40	1.00
9/30/1957	-10.45	-5.73	-0.75	18.01
6/29/1962	-21.28	2.78	15.25	26.70
6/30/1970	-18.87	15.80	26.72	37.10
12/31/1973	-10.03	-3.66	-11.84	-29.72
9/30/1974	-26.12	7.90	31.19	32.00
9/30/1975	-11.89	7.54	22.53	25.48
9/30/1981	-11.45	5.48	-3.63	3.65
12/31/1987	-23.23	4.78	10.69	12.40
9/28/1990	-14.52	7.90	22.60	26.73
9/30/1998	-10.30	20.87	26.49	26.13
3/30/2001	-12.11	5.52	-10.29	-1.12
9/28/2001	-14.99	10.29	10.23	-21.68
6/28/2002	-13.73	-17.63	-11.11	-1.55
9/30/2002	-17.63	7.92	4.04	22.16
12/31/2008	-22.56	-11.67	1.78	23.45
3/31/2009	-11.67	15.22	32.49	46.57
6/30/2010	-11.86	10.72	22.02	28.13
9/30/2011	-14.33	11.15	24.49	27.33
12/31/2018	-15.55	?	?	?
	Average	5.13	11.28	15.94
	Median	7.54	10.69	23.45
	% Positive	78.9%	73.7%	73.7%

Source: Bespoke Invetement Group

And in fact, we have already experienced a fairly subdued +10 percent rally in the ten consecutive trading days since the low on December 24th.

S&P 500 Has Quickly Rallied Back by Over 10 Percent



Source: Thomson One

While this rally has not recouped all of the losses experienced during the last quarter, it is a good first step in building a recovery from very oversold conditions. That being said, it is likely that a full recovery back to previous highs will take some time. If we look to history as a guide, Bloomberg suggests that the path of the previous five corrections since 2009 took about four months before a full recovery was achieved. As of this writing, the S&P 500 was roughly 11 percent below its high from September 2018. This would place it's path close to the one charted below. Note that data below is from 12/18, about one week before the real bottom on 12/24 which was another -7 percent lower for the S&P 500.

Previous Corrections Point to Recovery by April 2019

Source: Zero Hedge; Bloomberg

While some might suggest that a further rally of 11 percent over the next four months is optimistic, there is reason to believe that it is achievable without having to make unrealistic assumptions.

Consider the table below which we have constructed using data from Factset. Following tremendous earnings growth of 20 percent and revenue growth of 9 percent in 2018, as of January 8th, 2019 earnings growth was estimated to be 7.4 percent (revenue growth is estimated to be 6 percent). That translates into a dollar earnings figure of $173.45. At present, the S&P 500 is trading at a price to earnings ratio of about 15 times, right in line with its 10 year average. However, assuming the earnings estimate is accurate, a return to the 5 year average P/E of 16.5 times would yield an S&P 500 price of 2862, some 10 percent higher than current levels.

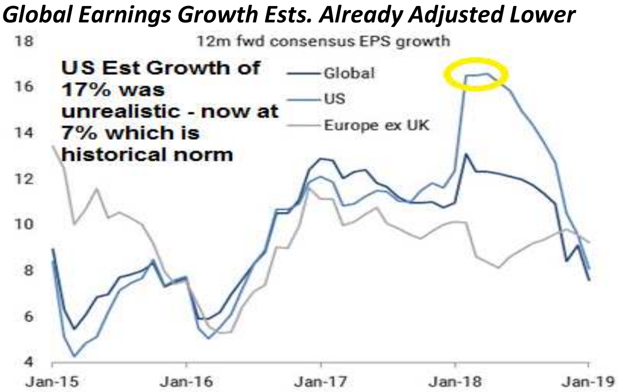
Revisit of 5 Year Average PE Would Produce +10% Return

P/E Ratio	Aggregate Dollar Earnings: 165	170	173.45	180	185
13.5	2228	2295	2342	2430	2498
14	2310	2380	2428	2520	2590
14.1	2327	2397	2446	2538	2609
14.5	2393	2465	2515	2610	2683
15	2475	2550	**2602**	2700	2775
15.5	2558	2635	2688	2790	2868
16	2640	2720	2775	2880	2960
16.5	2723	2805	***2862***	2970	3053
17	2805	2890	2949	3060	3145

Source: Factset; Standard & Poor's

A logical counter argument to this suggestion is that the 2019 earnings growth estimate will be adjusted down after data from final quarter of 2018 pours in. However, as one can see below, that re-rating of growth expectations has largely already occurred. The current 7 percent expectation is down from a wholly unrealistic 17 percent growth estimate that was being priced in at this time last year. That is a reduction of almost -60 percent. The slowdown in growth has already been priced into the market in other words.

Global Earnings Growth Ests. Already Adjusted Lower



Source: Goldman Sachs Global Investment Research

Additionally, the price required to purchase those earnings has come down substantially as well. As the chart below illustrates, as of the end of December, the price to earnings ratios for large, mid and small cap US stocks had all fallen to levels last seen in 2012. That is a significant amount of multiple contraction and makes the current level of earnings reasonably priced.

Equity Valuations Have Contracted Back to 2012 Levels

Source: Wall Street Journal Daily Shot; Yardeni Research

And while these factors are encouraging, there are those who will say that prices can always go lower. This is certainly true, but we find very little evidence to suggest that we are entering a bear market as some suggest. Consider the "Bear Market Checklist" below from Citi Research. Very few of the 18 metrics that heralded the last two Bear markets would currently prove cause for concern as of early January.

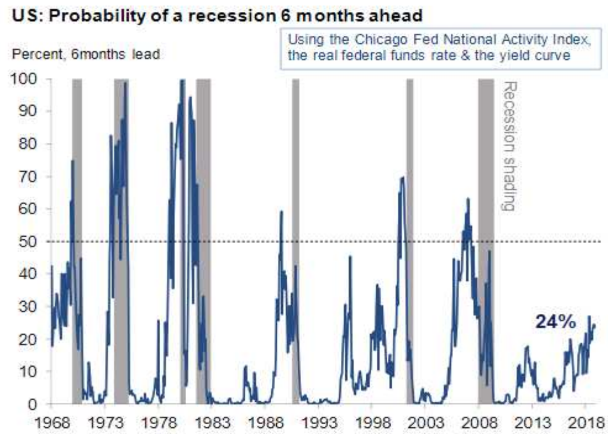
Few Indicators of Past Bear Market Starts Now Present

	Start Of Proper Bear Markets		Recent Peak	
	Mar-00	Oct-07	September	Now
Global Equity Valuations				
Trailing PE	33	17	18	15
Fwd PE	24	14	15	13
DY	1.3	2.1	2.4	2.8
CAPE	48	30	25	22
Global Equity Risk Premium	1.0%	3.3%	3.1%	3.9%
US Yield Curve (10Y minus 2Y)	-0.5	0.0	0.2	0.2
Sentiment				
Global Analyst Bullishness (std dev)	1.7	1.0	1.1	1.2
US Panic Euphoria Model	1.09	0.42	0.39	-0.28
Global Equity Fund Flows (3y as % of Mkt cap)	2.9%	0.7%	0.4%	0.2%
Corporate Behaviour				
Global Capex Growth (YoY)	8% (1999)	11% (2007)	8% (2018e)	1% (2019e)
M&A (Previous 12m as % of Mkt cap)	11.4%	8.1%	5.3%	5.2%
IPOs (Previous 12m as % of DM Mkt cap)	0.70%	0.40%	0.2%	0.2%
Profitability				
Global RoE	12.2%	16.1%	12.8%	13.3%
Global EPS ($, % from previous peak)	35%	117%	10%	13%
Balance sheets / credit markets				
Asset/Equity (US Financials)	16x	16x	10x	10x
Net Debt/EBITDA (US ex Fins)	1.8x	1.4x	1.6x	1.6x
US HY Bond Spread	600bp	600bp	350bp	555bp
US IG Bond Spread	175bp	175bp	109bp	155bp
# of sell signals	17.5/18	13/18	4/18	3.5/18

Source: Citi Research

There has also been quite a lot discussion in the media about the potential emergence of a recession in the US. Again, there is very little data to suggest that this is the case. The Recession Model from the New York Federal Reserve takes many economic factors into account and now shows just a 24 percent likelihood of recession in the next six months. To be a legitimate concern, a reading above a 50 would be required.

Probability of Recession Far From Past Indication Levels



Source: New York Federal Reserve; Oxford Economics

Given the current worries in the market about declining growth in China and Europe along with the US, it is worth noting that fundamentals across the globe remain sound. Yes, growth is slowing from the elevated pace spurred by the tax stimulus of 2018 in the US, but looking at the largest economies around the world, one finds that the data is encouraging. Without even focusing on the specific numbers, virtually all economies are displaying positive GDP growth, retail sales and industrial production, while inflation levels remain contained at a healthy level.

Top 15 World Economies Displaying Solid Fundamentals

World Economic Dashboard

Country	GDP (USD)	GDP QoQ	GDP YoY	CPI YoY	Core CPI YoY	Retail Sales	Industrial Prod.
United States	19,391	3.40%	3.00%	2.20%	2.20%	4.20%	3.90%
Euro Zone	12,590	0.20%	1.60%	1.60%	1.00%	1.70%	1.20%
China	12,238	1.60%	6.50%	2.20%	1.80%	8.10%	5.40%
Japan	4,872	-0.60%	0.00%	0.80%	0.90%	1.40%	1.40%
Germany	3,677	-0.20%	1.10%	1.70%	1.46%	5.00%	1.60%
United Kingdom	2,622	0.60%	1.50%	2.30%	1.80%	3.60%	-0.80%
India	2,597	1.90%	7.10%	2.33%			8.10%
France	2,583	0.30%	1.40%	1.60%	0.70%	2.60%	-0.70%
Brazil	2,056	0.80%	1.30%	4.05%	3.20%	1.90%	1.10%
Italy	1,935	-0.10%	0.70%	1.10%	0.70%	1.50%	1.00%
Canada	1,653	0.50%	1.90%	1.70%	1.50%	0.60%	4.20%
Russia	1,578	0.90%	1.50%	3.80%	3.40%	3.00%	2.40%
South Korea	1,531	0.60%	2.00%	1.30%	1.10%	1.00%	0.10%
Australia	1,323	0.30%	2.80%	1.90%	1.80%	3.50%	2.80%
Spain	1,311	0.60%	2.40%	1.20%	0.90%	1.40%	0.80%

Source: Koyfin

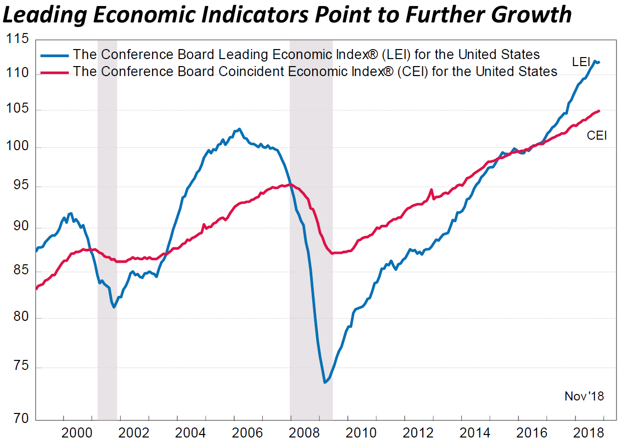
More specifically regarding the US, economic activity in both the manufacturing and non-manufacturing sectors remain solid, and GDP growth is far away from being in contraction as a true recession would suggest.

US Economic Data Continues to Show Strength

Source: Robin Brooks; IIF

To be fair, the data highlighted above reflects conditions that occurred in the past. Perhaps even more importantly, forward looking indicators also provide reason for optimism. The chart below from The Conference Board plots both coincident indicators (red) like industrial production and payroll data, and also leading indicators (blue) like new orders, money supply and interest rates. What's clear is that while both measures have risen meaningfully since the Global Financial Crisis, the leading indicators continue to point to robust expansion. While we certainly recognize the fact that data in the fourth quarter softened somewhat, the growth trend was unaltered.

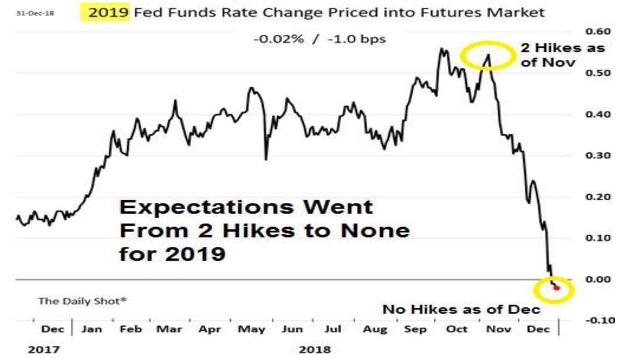
Leading Economic Indicators Point to Further Growth



Source: The Conference Board

One important factor that did change during the last quarter was the outlook for interest rates. As we wrote about in the past, many pundits point to Fed Chairman Jerome Powell's comments on October 3rd suggesting the need for aggressive rate hikes in 2019 as the impetus behind the sharp downdraft that we experienced. As the equity decline gained steam, worries about US and global growth intensified which likely motivated Chairman Powell to make more dovish comments in December which suggested a moderation in future rate hikes. As a result, the market went from pricing in 2 rate hikes as recently as November to NO hikes for all of 2019.

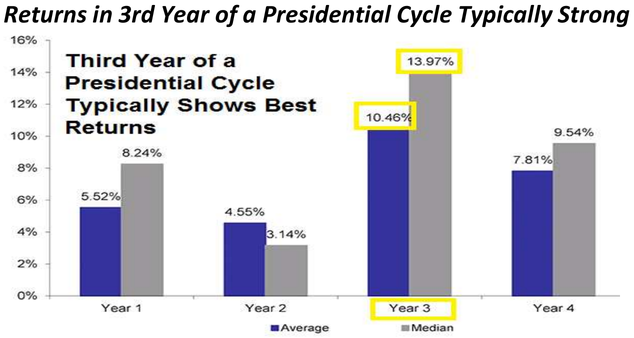
Market is Anticipating No Rate Hikes for All of 2019



Source: The Wall Street Journal Daily Shot

If that in fact proves to be the case, the market would welcome such an accommodative environment. We also have the benefit of entering what is historically the most market friendly period of a presidential cycle. If we get an end to the government shutdown impasse in the US, a resolution to the trade war and Brexit deal sometime this Spring, market sentiment, which drove sell-off, could quickly turn into a strong tailwind for the remainder of this year.

Returns in 3rd Year of a Presidential Cycle Typically Strong



Source: Citi Research

Going Forward

As we have discussed over the past three months since the October 3rd peak in equity prices, despite the market sell-off, little has fundamentally changed. Rather, most of the decline has been sentiment driven, or merely the perception that things are getting worse. Fortunately, the major risks are well known and likely already priced into markets. As such, we are constructive on the near-term outlook for risk assets. However, there is strong evidence that 2019 may prove more challenging as both the US and global growth rates are in decline at a time when we still face a relentlessly flattening yield curve, rising interest rates, and a trade war with no obvious resolution in sight. Therefore, we remain focused on our base case scenario which calls for gains in US equities while the downside risk increases as growth slows throughout 2019. A resolution of trade disputes combined with confirmation of a more dovish interest rate policy for 2019, could however lead to a more bullish shift at any given period.

With that outlook in mind, we would emphasize the technology, financial and healthcare sectors as we look toward the next twelve months. The technology sector continues to display very strong sales growth and profitability with valuation levels that are much more compelling after the 4th quarter declines. Financial names are very reasonably priced after substantially underperforming the S&P 500 Index for much of the year. We feel that this is overdone, and many valuation metrics reaching multiyear lows make several quality large cap names attractive. We also see an opportunity in select healthcare companies. These names are less impacted by trade issues, display high levels of cash flow and also trade at reasonable valuations.

Small and mid-cap stocks were hit particularly hard during the recent sell-off and are attractive in our view. Importantly, smaller non-global companies are generally less impacted by trade tariffs, making them a good counterbalance to internationally exposed companies. In a very short time period, the Russell 2000 Index of small cap companies surrendered its significant advantage over the S&P 500 for the year. As a result, the Russell 2000 finished the year roughly 3 percent behind the S&P 500. We believe that this move is overdone and may likely reverse in the near-term. In fact, the Russell 2000 Index has already rebounded sharply, moving up 14 percent from the December 24 low.

With the recent weakness in the US, equity markets outside of the US are even more compelling in our view. Regardless of uncertain political issues, non-US markets remain much more accommodative in their monetary policy endeavors. Valuations are lower than the US, and due to coming headwinds, growth outside of the US is expected to outpace US gains in 2019. We have favored emerging markets equites for much of this year. The asset class has suffered in 2018 from both a strong US dollar and trade tensions. Looking to 2019, their valuation and growth levels are attractive, particularly if a weaker US dollar theme plays out throughout the year as many have suggested.

The flattening yield curve is far and away the fundamental concern to many investors. With the yield curve inverting in early December, concerns over a dramatic slowdown in growth and even a recession sometime in 2019 have come to the forefront. We have written about these concerns for much of the year and are also wary to a certain degree. However, at this time, we do not see the eminent worries as valid. The data simply does not support that scenario just yet. For our fixed income exposure, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value.

Although gold trailed other assets for the first 9 months of 2018, we continue to hold exposure as a diversifier. The metal proved its merit in a portfolio during the sell-off, rallying over 7 percent and outpacing the S&P 500 by over 21 percent.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.