Insights: May 2018

Market Overview and Performance

As you well know, the first three months of 2018 were volatile. The S&P 500 gained almost 6 percent in January, tumbled -3.7 percent in February, and then proceeded to fall an additional -2.5 percent in March. Pension Partners has calculated that this has resulted in an annualized volatility measure of 18.8 percent, the highest reading since 2009. That number might not mean a lot in isolation, but it was *three times* the level of volatility recorded in 2017, an incredible change in only a few months. And April was choppy too, but with little progress either way. In fact, as we will discuss, the market is desperately looking for direction. On the plus side, we saw outstanding earnings results reported for the first quarter with the growth rate coming in at an eye-popping 24 percent. On the negative side, we still have all the rest to deal with. Global growth is slowing, the yield curve is flattening, inflation is shooting higher, geopolitical tensions in the Middle East have gone from bad to worse, and finally, trade tariffs threaten to bring global trade to a grinding halt. Undeniably, there are a lot of unknowns. However for the time being, all eyes are on the price of crude oil which continues to march higher with the price of WTI climbing above $71. As Charlie McElligott at Nomura Securities framed it, "Crude is the straw that stirs the drink" since higher crude leads to higher inflation expectations. Typically, this would favor cyclical growth equities like energy, financials and materials as well as commodities while hurting bonds. However, with all of the current uncertainty, there is no guarantee that the old play book will work this time.

As always, thank you for reading our latest Insights.

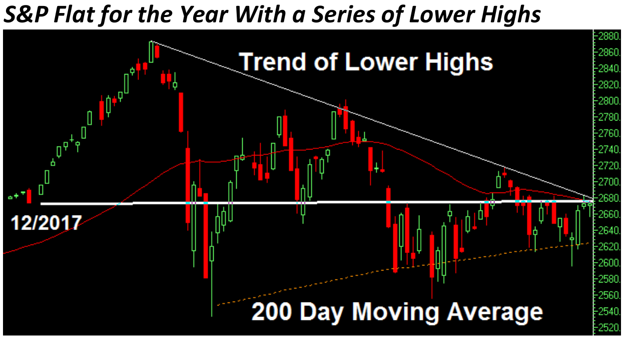
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.38	-0.38
Russell 2000 Index	0.86	0.78
MSCI EAFE Index	**2.28**	0.72
MSCI Emerging Markets Index	-0.44	**0.97**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.74	-2.19
Barclay's U.S. Aggregate Credit Index	**-1.94**	**-5.69**
Barclay's U.S. Aggregate Corporate High Yield Index	0.65	-0.21
Barclay's Municipal Bond Index	-0.36	-1.46
Macro Measures		
Gold	-0.61	0.75
Crude Oil	**5.29**	**11.89**
CBOE Volatility Index	-25.36	**30.70**
USD Dollar Index	**1.84**	-0.30

Current Theme – Markets Make Little Progress in Either Direction – Trade Tariff Rhetoric and Worsening Geopolitical Conditions Tempering Growth While Inflation Climbs = Stagflation

Misguided Trade Tariffs Threats Already Negatively Impacting the Global Growth Regime

Equity returns in April were mostly characterized by a wait-and-see attitude. One would have guessed that the two biggest influences during the month, earnings results and trade tariff negotiations, would have pushed the needle in one direction or the other, but that proved to not be the case. As you can see from the chart below, the S&P 500 is flat for the year, being supported by its 200 day moving average while at the same time, stalling at each attempt to make new highs. This is typically a sign of fatigue.

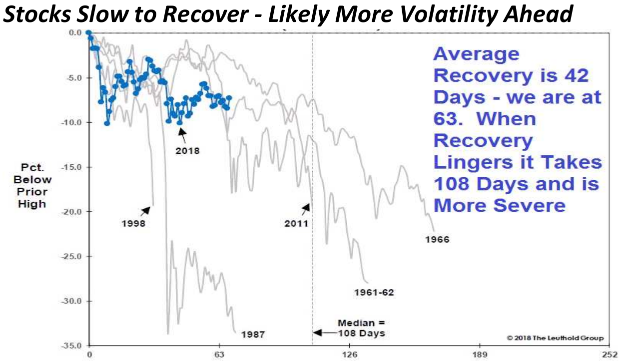
S&P Flat for the Year With a Series of Lower Highs



Source: Thomson One

In fact, as the Leuthold Group claims, since 1950, intermediate declines of between 7-12 percent have typical recovered back to new highs within 42 days.

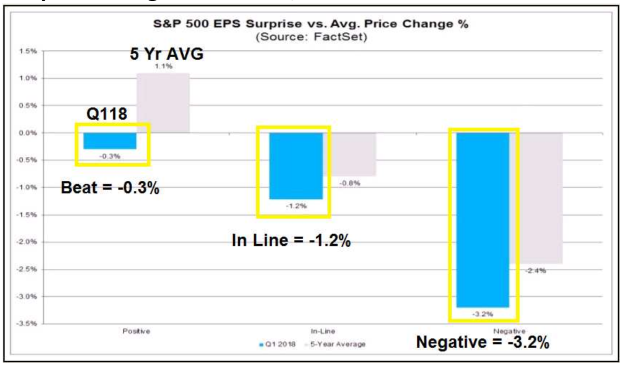
Stocks Slow to Recover - Likely More Volatility Ahead



Source: Leuthold Group

As the blue line marking 2018 indicates, it's been 63 days since the market peaked in late January. Leuthold also points out that their research suggests if the market languishes on without regaining prior peaks as we have seen this year, the decline period widens out to a median of 108 days, and unfortunately, often leads to sharper losses.

Despite Strong EPS Growth, Market Reaction Was Poor



Source: Factset

One factor that many were adamantly hoping would serve as a catalyst to break out of this trading pattern was first quarter earnings. And they did come through as anticipated, growing an astonishing 24 percent in aggregate. However, as the chart above highlights, the market did not reward that performance whatsoever. The argument to this might be that these results were well telegraphed due to tax cuts impacting results. But as you can see below, the market is a forward looking mechanism. When growth is greater than 20 percent, 12 month forward returns have been muted since the rate is likely to decline. The opposite is true when growth rates are low or even negative.

Market Rewards "What's to Come" Not "What Happened" - Earnings Above 20% Lead to Tepid Returns

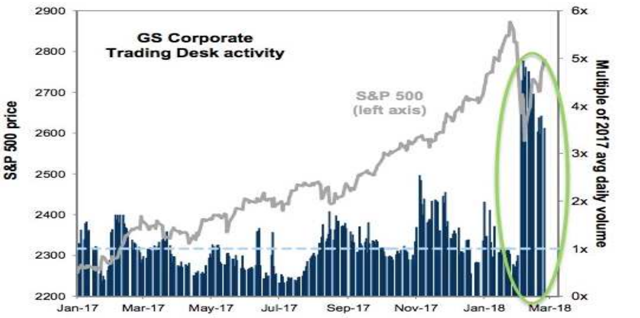
S&P 500 GAAP earnings (3/31/1927-3/31/2018)

Y/Y growth	Annualized gain
> 20%	2.6%
10% to 20%	7.4%
-10% to 10%	9.2%
-25% to -10%	25.0%
< -25%	-23.7%

Source: Charles Schwab; Ned Davis Research

What is a bit more concerning, is the fact that the impressive results from companies (particularly the revenue growth of the big tech companies) were met with indifference, it seems that the only real buyers was coming from the companies themselves. The chart below from Goldman Sachs illustrates that the volume on their corporate trading desk exploded to roughly 5 times the average volume seen in 2017. Without these corporations buying their own shares, index levels would likely have fallen much further than they did.

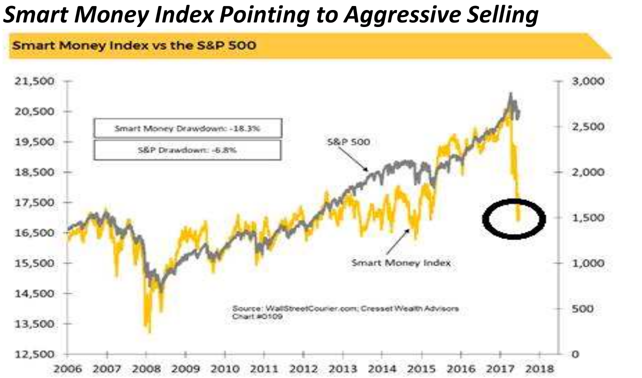
Corporate Stock Buy-Backs Surged in Q1 – 5x 2017 Level



Source: Goldman Sachs

What's more, there has been a notable pattern of late day selling occurring on the majority of trading days. There is a way to measure this – the so called Smart Money Index. Large institutional traders typically wait until the last half hour of the day to execute near closing prices. When you subtract this activity from the first half hour, typically retail investors, patterns emerge. As one can clearly see below, the Smart Money has been aggressively selling as of late. This has historically been a leading indicator of declines in the broader index. No guarantee, but it is troubling.

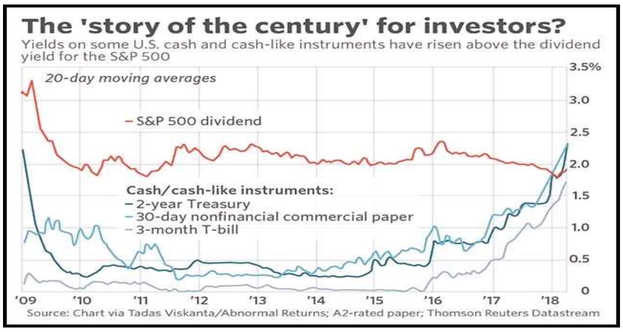
Smart Money Index Pointing to Aggressive Selling



Source: @LanceRoberts; Cresset Wealth

The other big development this spring has been the huge increase in short term interest rates. In plain terms, the market believes that The Fed will raise rates at a fairly substantial rate to keep inflation in check. This has consequences of course.

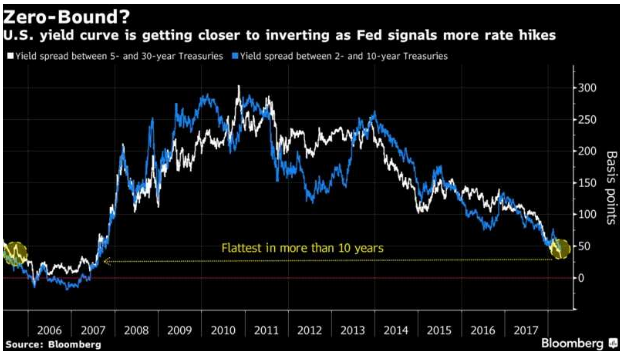
Short-Term Instruments Now Yield More than Stocks



Source: Abnormal Returns; Thomson Reuters

First, as one can see above, short term cash substitutes now yield more than the S&P dividend yield. The yield on the 2 year treasury is approaching 2.5 percent and even the 3-month T-bill yields are at 1.65 percent. This has not occurred since the Global Financial Crisis and could easily shift the "demand for yield" dynamic away from stocks and back into bonds.

Yield Curve Continues to Flatten - Back to 2007 Level

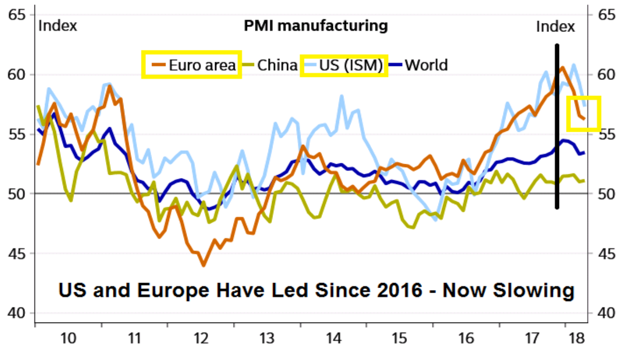


Source: Bloomberg

We also have a yield curve that continues to collapse. The difference between the 2 year and 10 year treasuries is only about 46 basis points right now. It is certainly true that the rise in short-term rates is playing a significant role here, but as we have pointed out for months, concerns over a slow-down in global growth have been increasing as the evidence continues to mount that the momentum seen in 2017 is now fading away.

As evidence of this, the decline in global PMIs that we have highlighted earlier this year continues unabated. As a reminder, PMIs are an aggregate measure of economic activity including new orders, factory orders, employment levels, inventories, etc. This is the so called "hard" economic data.

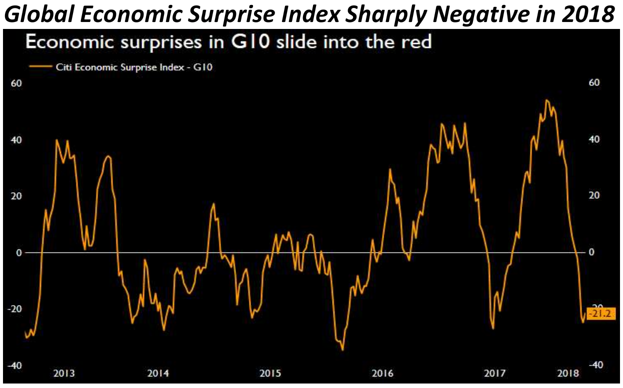
Global Economic Momentum Fading for all of 2018



Source: Nordea Markets; Macrobond

This is a clear sign that the market run-up in 2017 was in anticipation of what a de-regulatory environment and tax cuts might do for global trade. The reality is, not that much. And as global industrial bell-weather Caterpillar phrased it, "we have seen the high water mark for the year." This was after they grew earnings by 120% and revenue by 31 percent year over year, notably their stock declined -12 percent as a result.

Global Economic Surprise Index Sharply Negative in 2018

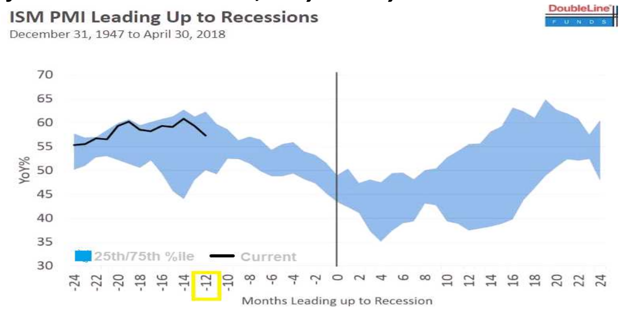


Source: Thomason Reuters; Ritvak Carvalha

And it's not just the selected items in the hard data measures either. Now the "soft" data which is generally comprised of survey results is disappointing as well. The Economic Surprise Index for the G10 economies has moved sharply lower this year as one can see in the chart above.

Some, like Jeffrey GundLach the CEO of $118 billion fund manager DoubleLine, have pointed out that in the past, these patterns in indicators have signaled a recession some twelve months out. Goldman Sachs suggested a similar timeline earlier this month.

If ISM PMI Path Persists, Maybe Only 12 mths to Recession



Source: DoubleLine Funds

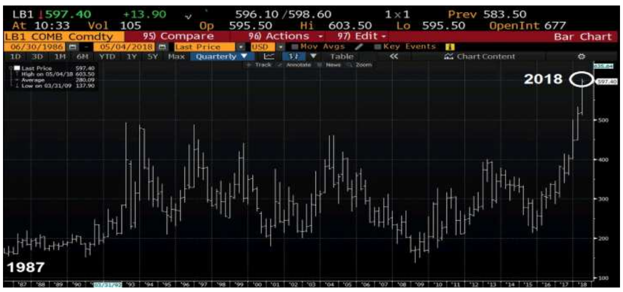
Even if one discounts those views, we are facing an environment where costs are going up. This slows growth as increases in input costs hamper investment.

Oil and Inflation Expectations Moving Hand in Hand

Source: Charlie Biello

Oil is now above $70, and as the above shows, inflation expectations have climbed higher in tandem. Other inputs like lumber are at generational highs.

Lumber Costs are the Highest in Over 30 Years



Source: Bloomberg

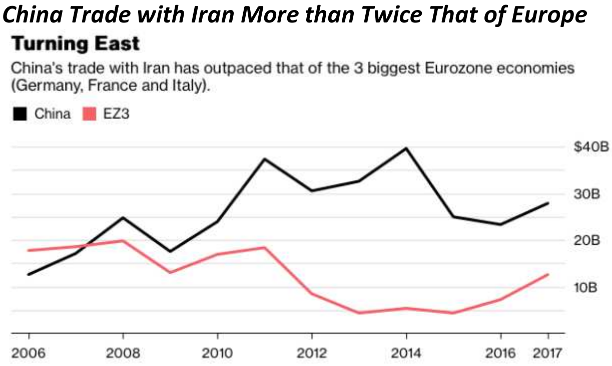
This all comes around to trade in the end. Oil is higher in part because of concerns over supply disruptions due to sanctions in the Middle East. Trade tariffs on Canadian lumber are the culprit behind that increase. As we have said in the past, it is the consumer who bears the burden of these actions. The price of retail gasoline is up over 19 percent over the past year. The National Association of Homebuilders estimates that the higher cost of lumber raises the price of the average home by almost 3 percent. This is a "tax". And now the global supply chain is showing cracks as well.

European countries stand to lose a not insignificant amount of trade if European companies cease operations in Iran immediately as the US requests. In response, France's finance minister said this week, that European countries will not "act as vassals" to the US. Macron followed by saying Europe needs to unite and exert "European sovereignty". Without getting into the political motives, all this is to say, that decisions regarding trade are rarely black and white and all parties involved will react, particularly if they view one of their avenues of trade becoming increasingly destabilized without an equal voice in decision making.

South Korean Exports as Indicator Suggests Weakness

Source: BoAML Investment Research

China Trade with Iran More than Twice That of Europe

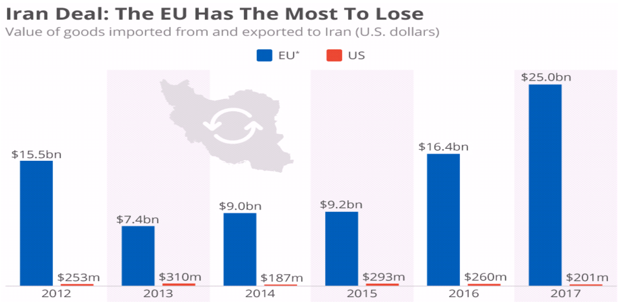


Source: Bloomberg

Although it may sound esoteric, South Korean exports have long been considered a leading indicator of global trade. As you can see above, they are tightly correlated with global EPS (and industrial production per OECD). Korea's location, vast port capabilities and role as component maker for everything from semiconductors to cars makes them uniquely qualified to reflect the pulse of trade, and it is weak at the moment. While the US continues to back away from unilateral efforts to promote growth like the TPP and NAFTA, other players are objecting. Consider the chart below.

And if you think Europe cares about Iran, consider that China trade with Iran is more than double what the largest European economies do. China is also the leading importer of Iranian oil, followed by India and Korea. In fact, China has been doing business in Iran for over three decades largely via infrastructure development. And unlike Europe, China has work arounds to sanctions via state owned special purpose vehicles. Also do not forget, Iran remains a key piece of China's intended new trade route with Europe.

EU More Dependent on Iran for Trade of Goods



Source: Statista

Iran a Key Hub in China's Belt and Road Initiative

Source: CSIS Reconnecting Asia Project

Going Forward

As we mentioned in our opening comments, the market continues to look for direction as conflicting influences swirl onto the scene almost daily. As we stated in the past, the stock market price correction in February and March was certainly not unexpected and was justified in our view. However, it did little to change much of the fundamental narrative. With stocks only being flat for the year, this feels like a "win" in the view of many market observers. However, it is difficult to not be concerned about the continuing evidence of slowing global growth, a relentlessly flattening yield curve and the very real impact that just the threat of trade tariffs is already having on global trade. And with inflation signs flaring up, we are wary that a period of stagflation may be on the horizon.

Assuming a benign environment for the time being, within US equities, we favor the information technology, financial and energy sectors in particular and added to these areas on a selective basis during the correction in February and March. The technology sector continues to display very strong sales growth and profitability. Financial names are still reasonably priced and will benefit from a raising rate environment and a reduction in their tax rates. The energy sector is riding a wave of strong momentum from its price bottom in 2016 and the Iran sanctions are now likely to push prices even higher. Energy stocks were hit particularly hard during the first quarter sell-off, providing compelling entry points. We also look to selected industrial and material names to outperform in 2018 as the demand dynamics and global growth look to be a tailwind for 2018 under the current non-trade war scenario.

With the potential damage to global trade that tariffs represent, domestically focused small and mid-cap stocks have become more attractive in our view. Small cap stocks in the Russell 2000 Index experienced considerable multiple compression during the sell-off making their valuation levels compelling versus their large-cap counterparts. Importantly, smaller non-global companies are generally less impacted by trade tariffs, making them a good counterbalance to internationally exposed companies when revenue streams from abroad are in question. We saw evidence of their benefits during both March and April when the Russell 2000 outperformed the S&P 500 by over 4 percent during the two month period.

As the protectionist stance of the U.S. becomes more entrenched, equity markets outside of the US are compelling in our view. After years of lagging the US market, International equities now display faster economic growth than the U.S., combined with reasonable valuation levels and stimulative fiscal policies. Europe and Japan in particular are attractive relative to other regions. Even in the face of recent US dollar strength, we also see long-term opportunity in emerging markets. As a group they are demonstrating strong profit growth, improved balance sheet stability, and very attractive valuation levels. Significantly however, emerging markets are perhaps most susceptible to interruptions in global trade so we remain vigilant.

Our biggest concern in the fixed income market is the flattening yield curve. With the yield curve at its lowest level since 2007, the bond market is suggesting that apprehensions about future growth are justified and that the Fed will continue to push rates higher. Additionally, the supply of bonds this year will be substantial, pushing yields even higher. As a result, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to focus our exposure on municipal bonds and short-term corporate bonds and believe that the opportunity in these segments provides a better relative value.

Given the continued unsettled environment thus far in 2018, we have maintained a position in gold in many of our portfolios as a non-correlated asset and continue to do so, adding when appropriate. Until there is more clarity on the global macro trajectory, we are likely to add opportunistically.

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.