Insights: September 2018

Market Overview and Performance

For US equity investors, August was a strong month. For more diversified investors, not so much. The typically slow late summer period when many global market participants are thinking of the beach was surprisingly upbeat in the US equity market. More surprising in fact since concerns over contagion from certain challenged emerging market economies only grew more intense during the month and the outlook for a resolution regarding trade tariffs only deteriorated into more murkiness. It has also been a curious year due the market behavior that has not played along with the historical seasonal patterns. The S&P 500 soared 5.7 percent in January only to fall by 10 percent two weeks later. The Index made its way back to a small gain for the year by May, but instead of stalling out until the autumn period, US stocks marched steadily higher throughout the summer, capped by a robust August. This is unusual. As LPL Research claims, the S&P 500 has been higher each month from April through August only five times since 1950. In the subsequent final four months, the returns ranged from 8.2 to 15.6 percent higher. That is encouraging, however as we have written about for much of the summer, the potential impact from escalating trade tariffs remains a significant risk as neither the US nor China show any inclination to back down. As Cui Tiankai, China's Ambassador to the US stated recently, "I wish to advise people to give up the illusion that another Plaza Accord could be imposed on China. They should give up the illusion that China will ever give in to intimidation, coercion or groundless accusation."

As always, thank you for reading our latest Insights.

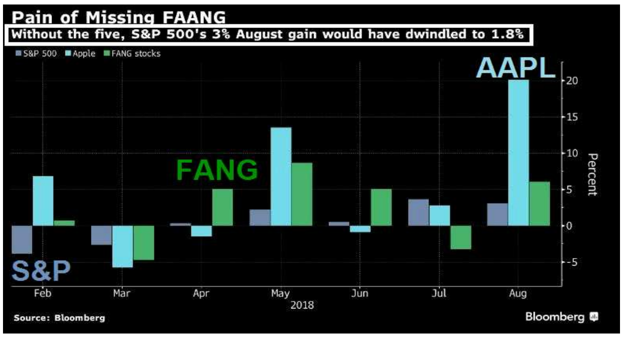
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	3.26	9.94
Russell 2000 Index	**4.31**	**14.26**
MSCI EAFE Index	-1.93	-2.28
MSCI Emerging Markets Index	-2.70	**-7.18**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.64	-0.96
Barclay's U.S. Aggregate Credit Index	0.33	**-4.67**
Barclay's U.S. Aggregate Corporate High Yield Index	0.74	2.00
Barclay's Municipal Bond Index	0.26	0.25
Macro Measures		
Gold	-2.23	**-8.50**
Crude Oil	1.49	**13.44**
CBOE Volatility Index	0.23	14.15
USD Dollar Index	0.68	3.17

Current Theme – US Equities Diverge from other Global Markets as Concern over Emerging Markets Contagion Swirls – Global Trade Already Slowing Notably Before Full Brunt of Tariffs Are Implemented

Seasonality Working in Favor of US Equity Markets but Slowing Global Growth and EM Issues Threaten to Disrupt the Upward Trend

As we have highlighted throughout the year, technology stocks have unquestionably led the market's advance thus far this year. Although large cap technology names pulled back somewhat in the first week of September as speculation over government regulation increased, the trend forward shows few signs of abating.

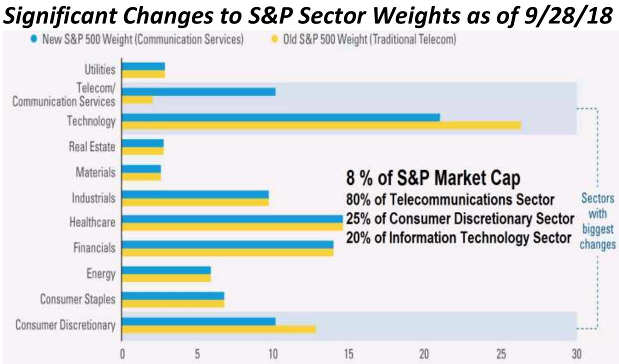
FANG Stocks Continue to Dominate 2018 Performance



Source: Bloomberg

But there is an important change coming at the end of this month which will change the definition of "Tech". As you can see below, MSCI is creating a new Telecomm/Communication Services sector and will populate it with names from several other sectors.

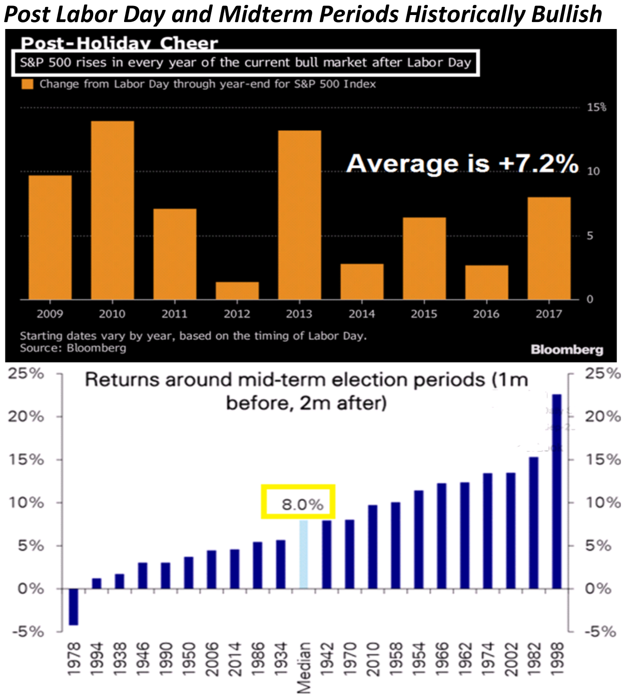
Significant Changes to S&P Sector Weights as of 9/28/18



Source: LPL Research; S&P Dow Jones; MSCI; Factset

The shift will involve eight percent of the Index's market cap and notably, will shift 25 percent of the consumer discretionary sector and 20 percent of the information technology sector. This is important because many of the recent highfliers (Facebook, Google, Netflix, etc.) will be out of tech and now part of the Communications sector. What this translates too is less "high-octane" growth in the tech sector and more growth in the Tele/Communications sector. As a result, we may begin see some alteration in market leadership and hence, the attraction of capital.

Post Labor Day and Midterm Periods Historically Bullish



Source: Bloomberg; Haver; Deutsche Bank

Fortunately, as the chart above demonstrates, we are entering a period of historically good returns for US equities. Over the last 9 years, the average return for the S&P 500 after Labor Day until the end of the calendar year is 7.2 percent. Additionally, despite what would generally be perceived to be a rocky period around mid-term elections, especially in a year like this, historically, the cumulative returns from one month before until two months after has averaged around eight percent according to Deutsche Bank. While this pattern is certainly no guarantee of future success, it does paint the backdrop as we enter what has traditionally been a bullish period for US stocks. Investors have become conditioned to this and tend to act according with their allocation of capital.

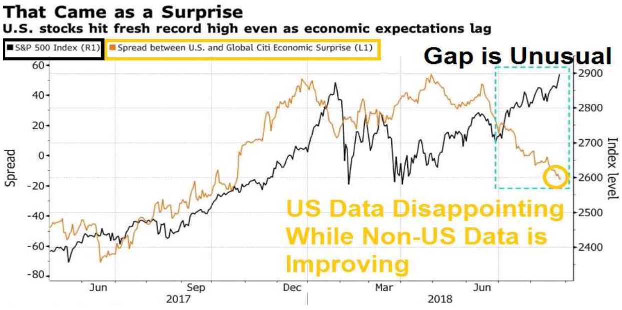
What investors have not become conditioned to is divergence – and we are certainly seeing that now.

US Equities Have Diverged From Rest of the World

Source: Bloomberg; FTSE

As you can see above, since the US presidential election in 2016, both US stocks and global stocks have moved in tandem. However, there has been a sharp divergence since May. This is somewhat surprising given the fact that economic data in the US has been missing expectations while those abroad have been exceeding estimates since around May as well.

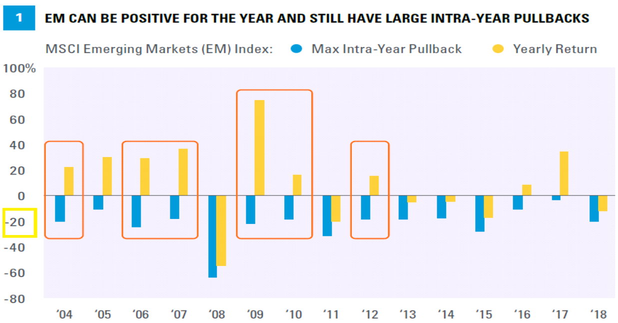
US Econ Data is Doing Worse than Global, Yet Stocks Up



Source: Bloomberg; Citigroup Inc.

There are several factors at play here, but the main culprit is the perceived turmoil in emerging markets at present, which is actually a fairly regular occurrence.

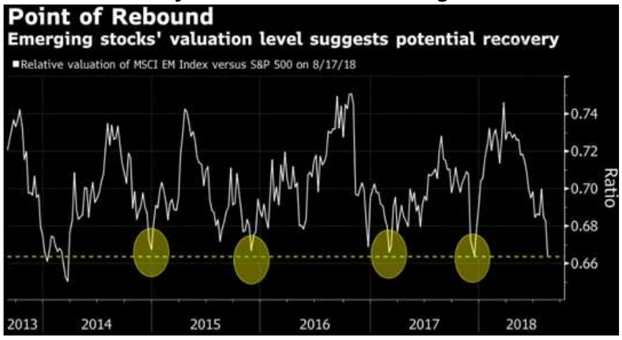
20% Intra-Year Declines and Positive Returns in EM



Source: LPL Research; Factset

As the previous chart illustrates, -20 percent declines have been a yearly occurrence over the past 15 years, however, the full year return has also frequently been positive. What's more, we would argue that the most recent sell-off in emerging markets have brought valuations measures down to compelling levels.

Relative Value of EM Stocks at Past Trough Levels



Source: Bloomberg

The obvious response to those observations on volatility and valuation would be that there are still problems, so why would you risk capital?

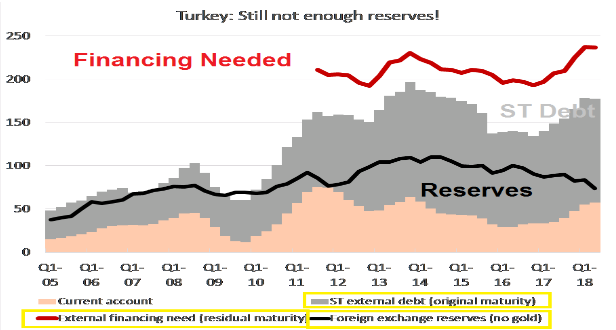
Lending Markets are Signaling that Caution Has Passed

Source: The Daily Shot; Bloomberg

The answer to that question lies in the lending markets. Above is the spread between LIBOR and the Overnight Indexed Swap (OIS) rate. LIBOR is what banks charge each other to lend money and the OIS is what central banks charge to lend. Traditionally, these rates have been virtually identical, but when LIBOR increases relative to the "risk-free" OIS as it did in 2007, it signals that credit risk in the banking sector is rising. While the finances of countries like Turkey and Argentina are not good, the lending market is telling us the perceived risk to overall banking system is declining.

So while we view the current risk in EM as not a major threat to the overall system, we would be remiss if we did not update the current status of Argentina and Turkey in particular.

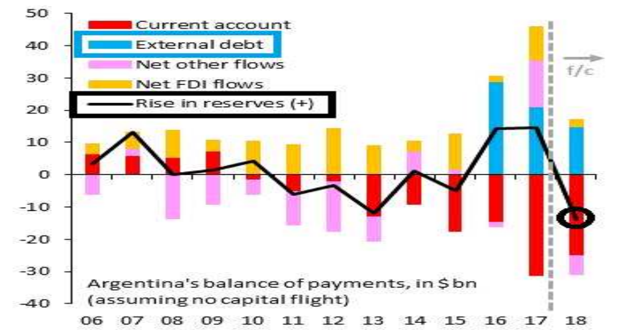
Turkey Remains Unable to Satisfy Financing Needs



Source: Council on Foreign Relations

The situation in both countries is unsettled. Reserve levels and debt obligations are largely unaligned. To remedy the situation, Argentina has secured $15 billion per year from the IMF for the next three years, but that leaves very little margin for error. Turkey is still attempting the right the ship on their own.

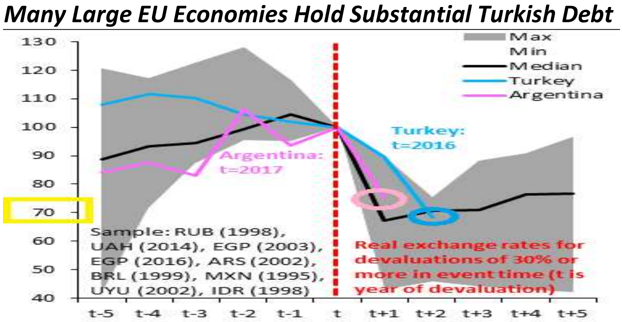
Argentina Has Turned to the IMF to Meet Funding Needs



Source: Institute of International Finance

Both currencies have suffered -30 percent declines.

Many Large EU Economies Hold Substantial Turkish Debt



Source: Thomson Reuters; BIS; Capital Economics

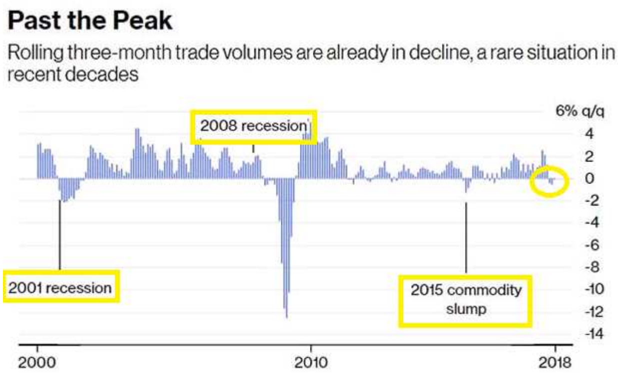
A strengthening US dollar will increase the pressure on these countries until there is more clarity. In the meantime, a strong US dollar makes US exports less attractive at a time when trade imbalances are labeled as "unfair" by the Trump administration.

Strong US Dollar Reducing Appeal for US Exports

Source: Thomson Reuters

This only reinforces the notion by some that more tariffs are the way to change behaviors regarding trade. However, as we have discussed at length this year, global participants simply do not like this course of action and business activity globally is being curtailed as result. Consider the following.

Very Unusual to Have Global Trade Volumes Decline

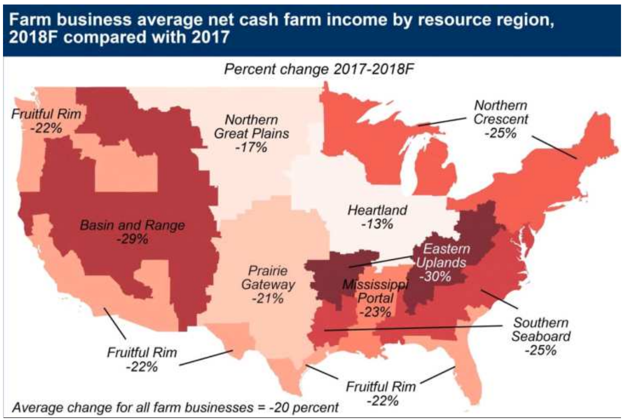


Source: CFB Netherlands; Bloomberg

As Bloomberg points out, for the past 18 years or so, it's been extraordinarily unusual for the momentum of global commerce to be negative. We have only seen it during past episodes of stress, yet here we are once again. As we have stated in the past, there is no need for this – it is a self-inflicted wound. Time and again, when looked at historically, tariffs have only served to create an extra "tax" on consumers and to slow the pace of economic growth for all parties involved.

Consumers in US are not oblivious to this because they have already seen the impact that just the rhetoric and a small collection of actual imposed tariffs has had on their current situations.

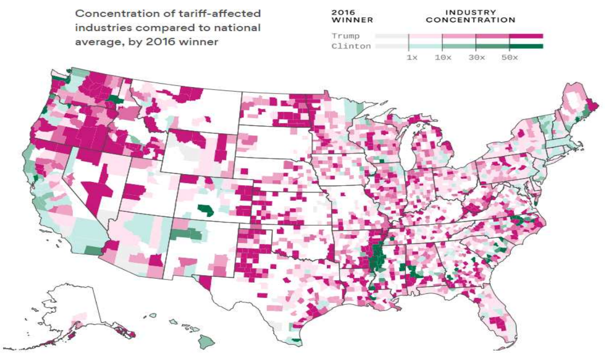
Farm Income Has Declined by -20% on Average in 2018



Source: USDA; Economic Research Service; Farm Income and Wealth

The chart above illustrates the stark impact that the first round of tariffs, which were mostly agriculturally based, have had on US farmers. On average across the nation incomes have decreased -20 percent since this time last year, but some regions have seen their livelihood fall by as much as -30 percent this year. And it is not just one year's worth of paychecks that are in danger. There is also the very real possibility that jobs themselves may be in jeopardy. As news service Axios has estimated, the next round of tariffs to be implemented shortly could cost as many as 11 million jobs spread widely across the country in many areas that voted for the current administration.

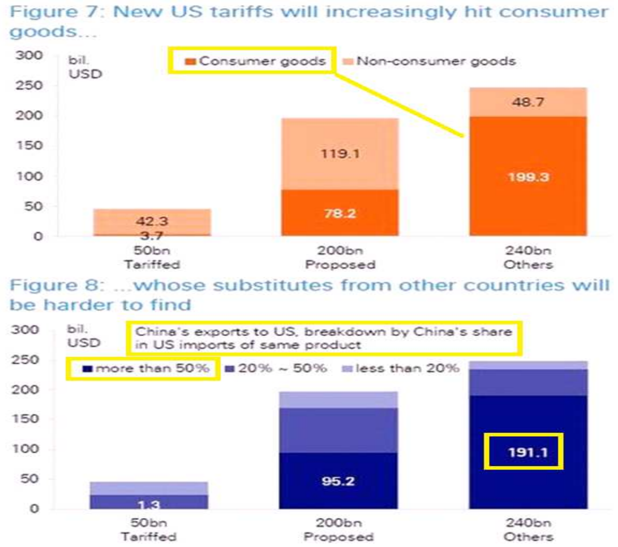
Further Tariffs Estimated to Cost up to 11 Million Jobs



Source: Axios

As we noted, many of the actual tariffs that have been enacted were purposefully crafted to avoid hitting the average American consumer directly. However, that is no longer possible. The latest round of tariff slated to be levied against China will hit the consumer squarely in the pocketbook. As the charts from Deutsche Bank below highlight, consumer goods make up the bulk of the Chinese imports targeted by the US. What's more, there are very few substitutes for these goods as the overwhelming bulk of them are manufactured in China. Unfortunately, the consequence of these circumstances is that prices will go up immediately.

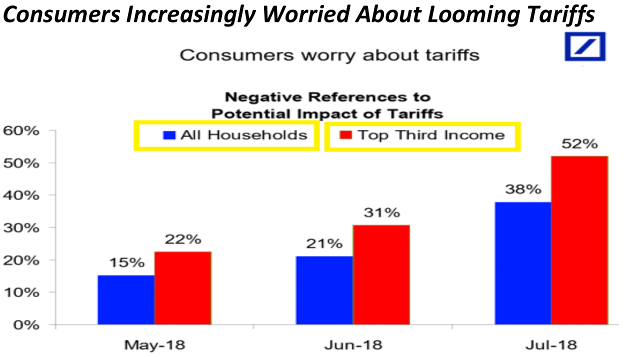
US Consumer Will Feel the Next Round of Tariffed Goods



Source: Deutsche Bank; Zero Hedge

Up to this point, the general attitude adopted by most seems to have been that trade disputes and tariff rhetoric are largely just for show and a compromise will inevitably be reached. Increasingly though, we are seeing evidence that this complacency has faded. As the chart below clearly shows, consumers, and particularly high earners, are beginning to worry.

Consumers Increasingly Worried About Looming Tariffs



Source: Deutsche Bank; The Daily Shot

Going Forward

As we stated last month, ironically, the difficulties created by the disruptive nature of the trade tariffs and the potential of contagion spilling over from Argentina and Turkey (not to mention South Africa, Italy, etc.) have only made US equities more attractive in the eyes of many. With the US dollar spiking to multi-year highs and interest rates climbing higher, traditional safe havens like gold and bonds are not appealing to investors, while big cash-rich US tech companies certainly are. However, as we have written about for much of the year, evidence of slowing global growth, a relentlessly flattening yield curve and the reverberating impact of trade tariffs, now combined with a potential emerging markets crisis, could lead to a very challenging path moving forward. That being said, our base case scenario would be further gains in the US for the remainder of the year while the downside risk looks to be even more heightened looking out to 2019. A resolution of trade disputes could however, lead to a very bullish advance in the near term.

With that outlook in mind, we would emphasize the technology, financial and industrials sectors as we look to the last few months of this year and beyond. The technology sector continues to display very strong sales growth and profitability. Financial names are reasonably priced after lagging for much of the summer and will benefit from a raising rate environment. Industrials have lagged this summer as well and attractive opportunities with reasonable valuation and solid growth prospects are available. A new area of interest for us is healthcare. In general, these names are less impacted by trade issues, and after trailing for much of the year, health care names are now outperforming the S&P 500 in 2018. With valuations still reasonable in many areas of the sector, we will be adding where appropriate.

With the potential damage to global trade that tariffs represent, domestically focused small and mid-cap stocks 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. As evidence of their beneficial characteristics, the Russell 2000 Index has outperformed the S&P 500 by 5.4 percent since the low in early February of this year.

As the protectionist stance of the US becomes more entrenched, equity markets outside of the US are compelling in our view. Even with the political and EM oriented issues, Europe and Japan are seeing their past stimulative policies now bearing fruit in terms of economic growth and inflation. This has directly translated into better earnings for companies located in these regions. They remain particularly attractive since valuations are lower than the U.S. and expectations are much more reasonable. Japan especially is seeing inflation and wage growth improvements that have been absent for decades. We have favored emerging markets equites for much of this year. As this summer has demonstrated, they are the most vulnerable to interruptions in global trade and US dollar strength and have suffered as result. Despite this, we continue to view their valuation and growth as attractive and would be adding exposure where appropriate.

With the yield curve at its flattest level since 2007, the bond market is suggesting that apprehensions about the future are justified. Additionally, the new supply of treasury bonds during the remainder of this year and into 2019 will be a challenge to digest for global investors. Keep in mind that this trend will continue unabated with the US deficit now approaching $1 trillion. The logical results of this action will be a push higher in yields with an increasing dependence on foreign buyers. With that in mind, 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.

Gold has been hampered this year by the strong move up in the US dollar. While we continue to hold some exposure as a diversifier, other areas of the commodity complex are more appealing given rising inflation.

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.