Insights: March 2019

Market Overview and Performance

Human beings tend to like using metaphors when explaining various concepts and the behavior of financial markets certainly falls into this category - bulls and bears being the most obvious in this regard. However, when looking back at the remarkable developments over the last three months in equity markets, the well worn allusion to a pendulum is appropriate. Howard Marks, Chairman of Oaktree Capital, summarized the notion well in his recent book, *Mastering the Market Cycle*. As he states, "In business, financial and market cycles, most excesses on the upside — and the inevitable reactions to the downside, which also tend to overshoot —are the result of exaggerated swings of the pendulum of psychology." As we wrote in the opening of our January letter, the severe sell-off experienced in December was clearly driven by a rapid erosion of investor sentiment as signs of a slowdown in global growth emerged. As we said then and continue to believe now, a slowing trend in growth does not herald the immediate onset of a recession. Yet remarkably, that became the prevailing narrative late last year. That was the overshoot – extrapolating recent weak data out for the foreseeable future. That is until December 24th, when for no obvious reason, the momentum of "the pendulum" begun to swing in the opposite direction resulting in an almost unheard of 10 straight weeks of gains for stocks. As we begin the month of March, there are legitimate reasons for both optimism and pessimism after an almost 12 percent rally in just the first two months of the year. Generally speaking, we believe that a high degree of skepticism surrounding the recent rally remains which could provide a solid foundation for gains going forward.

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	3.21	**11.48**
Russell 2000 Index	**5.20**	**17.03**
MSCI EAFE Index	2.55	9.29
MSCI Emerging Markets Index	0.22	9.00
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.06	1.00
Barclay's U.S. Aggregate Credit Index	-0.07	3.38
Barclay's U.S. Aggregate Corporate High Yield Index	1.66	**6.26**
Barclay's Municipal Bond Index	0.54	1.30
Macro Measures		
Gold	3.43	2.72
Crude Oil	18.45	**26.01**
CBOE Volatility Index	**-34.82**	**-41.86**
USD Dollar Index	-0.61	-0.01

Current Theme – Rally from the December 24 Low Took Many by Surprise But Has Been Remarkably Broad and Consistent

To Build Further on These Gains will Require a New Catalyst Which is Expected to Come in the Form of a Trade War Resolution

While the ending days of 2018 were not merry for many people, December 24th represented a definitive pivot point in market behavior.

S&P Largely Reversed 4Q Decline in Jan and Feb 2019

Source: Thomson One

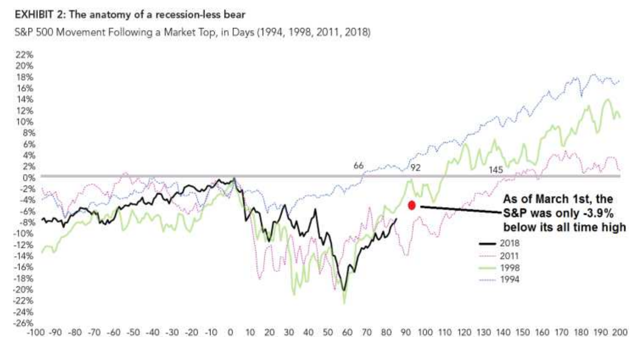
After falling by almost 20 percent in the fourth quarter, the chart above clearly demonstrates the "V" shaped recovery experienced by the S&P 500 Index since the Christmas Eve low. Other equity indices both in the US and abroad saw similar reversals. While it's always difficult to try to pinpoint the exact motivating factor behind the shift, in general, it's accurate to simply say that the negative sentiment was overdone. Nothing fundamental had really changed in the 90 days or so between the September high and December low.

Positive Start to 2019 Among the Best on Record

Source: MacroTechnicals; Thomson Reuters

A series of disappointing global economic data was likely the biggest impetus behind the cascading declines, particularly in December. However, perhaps more surprising was the strength of the gains seen in January and February – a time when the concerns of slowing global growth never really went away. As the previous chart highlights, stocks climbed for ten straight weeks, logging a gain of almost 12 percent. This is a dramatically high return for such a short time period and well outside of historical patterns.

20% Declines in Non-Recession Periods: 1994, 1998, 2011



Source: Fidelity; Bloomberg Finance LP.

If we stick to the assumption that we are not currently in a recession, we can look at past similar declines. As the chart above shows, the declines experienced in 1994, 1998 and 2011 were fully recouped in anywhere from 66 to 145 days. The black line in the chart shows the path of the current market which appears to be right in line with these patterns. There is also reason for optimism regarding further gains given the strong market internals we have seen. Volatility for example, collapsed -55 percent, the largest 10 week decrease on record according to Pension Partners.

Volatility Collapsed by -55% Over the Past 10 Weeks

Volatility Index (VIX): Largest 10-Week % Declines (1990 - 2019)

Rank	Start Week	End Week	VIX Start	VIX End	% Change
1	12/17/2018	2/25/2019	30.1	13.6	-54.9%
2	6/20/2016	8/29/2016	25.8	12.0	-53.5%
3	10/20/2008	12/29/2008	79.1	39.2	-50.5%
4	11/21/2011	1/30/2012	34.5	17.1	-50.4%
5	10/31/2016	1/9/2017	22.5	11.2	-50.1%
6	1/7/1991	3/18/1991	32.6	16.5	-49.5%
7	9/8/1998	11/16/1998	43.7	22.5	-48.6%
8	1/4/2016	3/14/2016	27.0	14.0	-48.1%
9	2/8/2016	4/18/2016	25.4	13.2	-48.0%
10	8/17/2015	10/26/2015	28.0	15.1	-46.2%
11	3/19/2018	5/29/2018	24.9	13.5	-45.9%
12	1/11/2016	3/21/2016	27.0	14.7	-45.4%
13	12/31/1990	3/11/1991	27.2	14.9	-45.2%
14	8/24/2015	11/2/2015	26.1	14.3	-45.0%
15	5/29/2012	8/6/2012	26.7	14.7	-44.7%

Source: Pension Partners

We also saw a breakout to new all time highs by the Advance/Decline line of the S&P 500. This is a measure of market breadth which simply tracks the number of advancing stocks minus the number of decliners. When the line is moving higher, it is a signal of broad market strength since many diversified stocks are increasing rather than just a few names elevating indices. For many investors, this indicator provided a higher level of confidence in the sustainability of the two month rally.

S&P 500 Advance/Decline Line at New All Time Highs

Source: Stockcharts

Conversely, investors are also keenly aware that the 2800 level on the S&P 500 has been a number of some significance. As one can see in the chart below, 2800 has served as both support and resistance over the past 14 months. Notably, since the autumn decline, that number has clearly been a barrier preventing the Index from achieving new highs. The four recent attempts to break that level have failed, so it appears that we are going to need a new positive catalyst to shift shares higher. While this is likely to come in the form of a trade deal resolution, the timing of that event remains elusive and far from a certainty.

2800 Level for S&P 500 Has Been a Line in the Sand

Source: Instinet; Stockcharts

Fortunately, there are other factors present which point to a constructive backdrop going forward.

If Jan/Feb Positive, Rest of the Year Up 93% of the Time

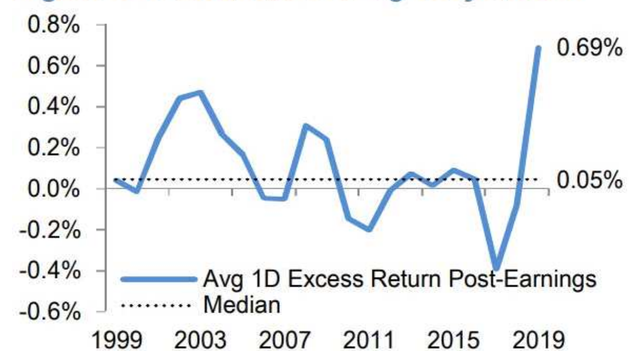
S&P 500 Index When Both January and February Are Green

Year	January Return	February Return	Final 10 Months
1950	1.5%	1.0%	18.6%
1951	6.0%	0.6%	9.0%
1954	5.1%	0.3%	37.6%
1955	1.8%	0.4%	23.7%
1961	6.3%	2.7%	12.8%
1964	2.7%	1.0%	8.9%
1967	7.8%	0.2%	11.2%
1971	4.2%	0.9%	5.4%
1972	2.0%	2.5%	10.8%
1975	12.3%	6.0%	10.5%
1983	3.3%	1.9%	11.4%
1985	7.4%	0.9%	16.6%
1986	0.2%	7.1%	6.7%
1987	13.2%	3.7%	-13.1%
1988	4.0%	4.2%	3.7%
1991	4.2%	6.7%	13.6%
1993	0.7%	1.0%	5.2%
1995	2.4%	3.6%	26.4%
1996	3.3%	0.7%	15.7%
1997	6.1%	0.6%	22.7%
1998	1.0%	7.0%	17.1%
2004	1.7%	1.2%	5.8%
2006	2.5%	0.0%	10.7%
2011	2.3%	3.2%	-5.2%
2012	4.4%	4.1%	4.4%
2013	5.0%	1.1%	22.0%
2017	1.8%	3.7%	13.1%
2019	7.9%	3.3%*	?
		Average	12.1%
		Median	11.2%
		% High	92.6%

Source: LPL Research

According to LPL Research, the S&P 500 has risen in both January and February 27 times since 1950. Incredibly, the final 10 months of the year were positive in 25 of those years. Furthermore, the gains over those next 10 months have averaged 12.1 percent. Past history is of course no guarantee, but that is a powerful pattern of a positive market trend.

4Q Earnings Not as Bad as Feared - Record Pos. Reaction

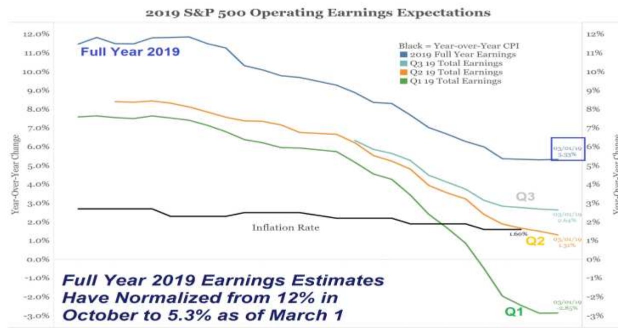


Source: Zero Hedge; Barclay's Research

The declines in the fourth quarter were also fueled by the notion that corporate earnings growth was

somehow going to evaporate. In reality, 4Q growth of roughly 13 percent brought a welcome sigh of relief to some who had feared the worst and reporting stocks were rewarded as the previous chart shows. To be clear, earnings growth will certainly slow in 2019, but as we have discussed in the past, it is largely due to the fact that 2018 earnings were artificially inflated by the corporate tax cut. In fact, for the full year 2018 earnings grew by over 20 percent. It is virtually impossible to replicate that level of growth two years in a row. At the beginning of October, 2019 estimates were still around 12 percent. Those estimates have now stabilized a little above 5 percent, a much more attainable target. And for those who are concerned about the potential of negative growth in 1Q of 2019, it is helpful to note that 1Q 2018 growth was 24 percent – a very difficult comparison to beat.

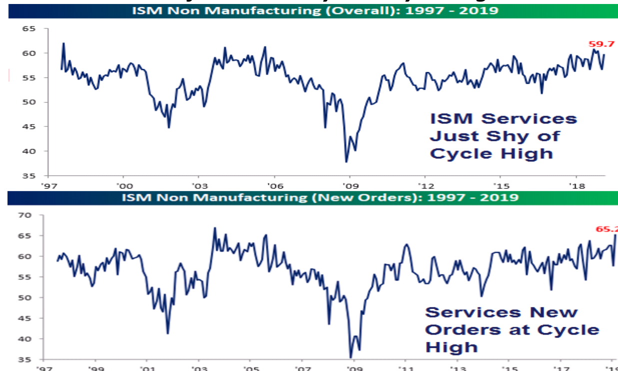
2019 Earnings Growth Estimates Have Normalized



Source: Bianco Research

Admittedly, we are seeing some disappointing data as of late, but just last week we received confirmation that one of the key drivers of the US economy, the service sector, remains near cyclically high levels. This is an important data trend for several reasons.

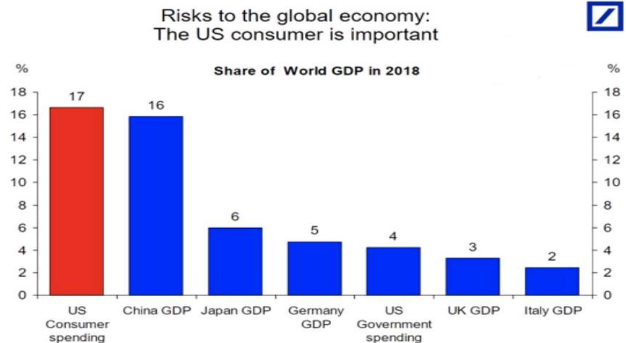
Service Portion of US Economy is at Cycle Highs



Source: Bespoke Investment Group

First, according to the Bureau of Economic Analysis, services make up about 80 percent of US GDP. Second, more than two thirds of consumer spending in the US is committed to services. And as the chart below shows, US spending plays an enormous role in the health of the global economy – bigger than China GDP.

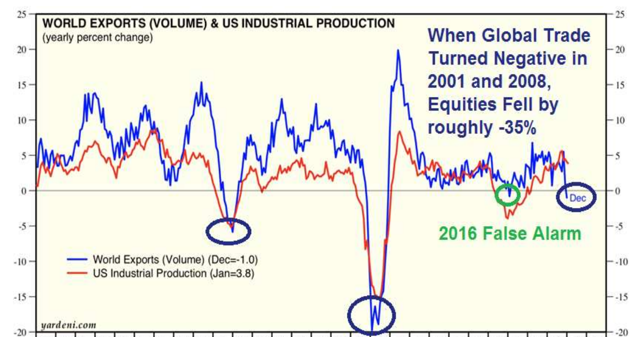
US Consumer Spending Fuels Global GDP Growth



Source: Deutsche Bank Global Research; IMF; BEA; Haver Analytics

What is really weighing on the market right now though, is the growing evidence that the trade war and resulting tariffs are starting to bite and may actually be enough to swamp the positive effects of the services economy noted above. For example, global trade as measured by trade export volume has now turned negative on a year over year basis.

Negative Global Trade has Been Ominous in the Past

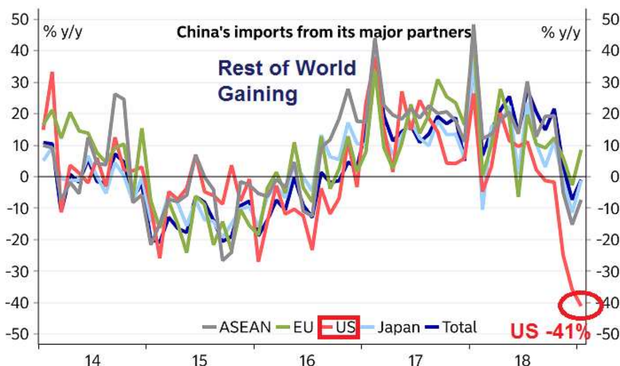


Source: Dr. Ed Yardeni

As the chart above highlights, this has proved to be a very negative development in the past. When it occurred in 2001 and 2008, equity prices fell by more than -35 percent on both occasions. For now, investors are betting that this episode is more like 2016, when global growth slowed, but did not devolve into a full blown contraction in the global economy. China played a large role during that time period and

obviously does so in 2019 as well. In fact, when discussing global trade volume, China plays a key role. Unfortunately, due to the US tariffs both currently implemented and threatened, China has reduced its imports from the US by an astounding -41 percent – a far bigger contraction than seen even during the Global Financial Crisis of 2008 and 2009.

China Cut US Imports by -41% - Other Regions Gaining



Source: Nordea Markets and MacroBond

This is no accident. China is well aware of US pressure points within their trade relationship. The US imports a huge amount (roughly $510 billion) of consumer goods like computers, phones and apparel from China each year. Conversely, the US exports about $130 billion worth of durable goods items to China – things like aircraft and autos. The Chinese do not possess world-class expertise in manufacturing these types of capital intensive businesses, and don't care to. As the chart above demonstrates, global substitutes for these goods are widely available from The EU, Japan and the rest of Asia. However, as the chart below highlights, US manufacturing of durable goods is closely tied to China imports. When China chooses to meaningfully

US Manufacturing Closely Tied to China US Imports

Source: Nordea Markets and MacroBond

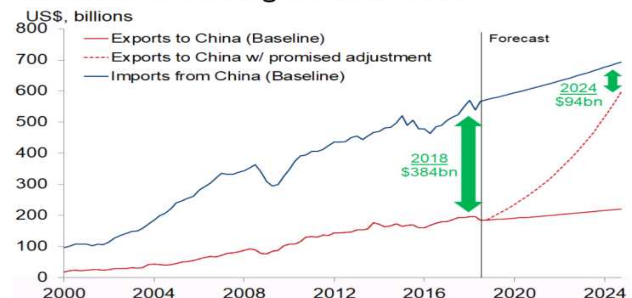
decrease their purchases of goods, US manufacturing is acutely impacted. We are seeing this in the aggregate data. As we mentioned previously, while the services component of the US economy remains quite robust, manufacturing data had been consistently disappointing. It is important to note that China, despite reforms that have helped open up their system, largely exists as a command economy heavily controlled by the government. As such, the Central Bank can inject liquidity into the system at will which provides instant support to their economy. And they have done so at record levels recently to combat any slowdown in trade.

China Has No Apprehension About Boosting Liquidity

Source: Bloomberg

As we have discussed for most of 2018, tariffs are simply the wrong instrument to drive structural reforms in trade. In fact, since the end of 2016, the US trade deficit with the rest of the world has ballooned 25 percent to $621 billion. Even if all the parties involved found meaningful alterations to trade rules evasive for the time being and settled for just an increase in goods purchases, the gap is just too big. A strong US consumer, which the world needs, will continue to buy other countries' goods.

Trade Gap with China Will Always Be Difficult to Eliminate



Source: Oxford Economics

Going Forward

As we have discussed over the recent 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 barrage of headwinds, but most notably a trade war with no obvious resolution in sight. Therefore, we remain focused on our base case scenario which calls for additional gains in US equities while the downside risk increases as growth slows throughout 2019. However, a resolution of trade disputes combined with the December pivot by the Fed to an extremely dovish stance toward interest rate policy, could clearly lead to a more bullish shift as the year progresses.

With that outlook in mind, we would emphasize the technology, financial and industrials as we look out for the remainder of the year. We view the 4th quarter declines as a benefit to the technology sector in 2019 as valuations and earnings expectations were both notably reduced. Financial names are very reasonably priced after substantially underperforming the S&P 500 Index for much of 2018 and trailing thus far in 2019. We feel that this is overdone, and many valuation metrics reaching multiyear lows make several quality large cap names attractive. The industrial sector stands to benefit from a likely positive outcome to the trade disputes which have handicapped global growth. In fact, the mere messaging of progress has proved enough to push the sector almost 20 percent higher year to date.

After sharp declines at the end of last year, small and mid-cap stocks remain attractive in our view despite outperforming their large cap counterparts by a wide margin thus far in 2019. These companies are generally less impacted by trade tariffs, making them a good counterbalance to companies exposed to the global supply chain. Further improvements in the global fundamental economy would help solidify the positive outlook for this segment of the market.

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. This has been made even more impactful given the recent commitment of the ECB to remain extremely accommodative for the remainder of 2019. Valuations are broadly lower than the US and growth outside of the US is expected to outpace the US rate for 2019. We have favored emerging markets equites for quite some time. The asset class suffered in 2018 from both a strong US dollar and trade tensions. However, their valuation and growth levels are attractive, and PMIs (a reflection of economic health) across emerging markets as group are now expected to exceed developed markets for the first time in many years.

The flattening yield curve is far and away the biggest fundamental concern to many investors. While this trend has moderated somewhat, concerns over a dramatic slowdown in growth and even a recession sometime in 2019 are still top of mind for many. 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, the metal proved its merit as a diversifier within a portfolio during the sell-off, climbing over 7 percent while the S&P 500 fell by almost 20 percent during the fourth quarter decline.

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.

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