Insights: November 2018

Market Overview and Performance

Well, that was a rough one. Even when measured against the notoriously checkered past of the month of October, this recent episode was a difficult one to watch unfold. Globally speaking, this October was the worst 30 day period for stocks since 2012. Adding to the pain was the fact that most other asset classes, including bonds, declined as well. There was simply no solace from the storm. Consider the following facts about this October: S&P 500 worst month since February 2009; China stocks worst month since January 2016; European stocks worst month since January 2016; High Yield Bonds worst month since 2008; Oil worst month since July 2016; FANG stocks down -21%. The list could go on and on, but the point is clear. Traditional safe havens also proved to be of little help. Although Gold was up marginally for the month, the commodity is down almost eight percent for the year. More importantly, the Barclay's Aggregate Bond Index, a proxy for the broad bond market, is down roughly -2.6 percent so far in 2018, the worst annual return in the 40 plus year history of the index. As a result, diversified investors are now experiencing a very difficult 2018, with double digit equity gains just a month ago now having evaporated in a very short time frame. On a positive note, we are actually more constructive than we were earlier in the year due to the fact that some of the looming risks have been allayed (NAFTA, US elections, etc) and we are now entering what is a historically robust period for US equities in particular. While concerns of slowing global growth and rising inflation are legitimate, we feel that the current declines have "overshot" fundamental justification. As always, thank you for reading our latest Insights.

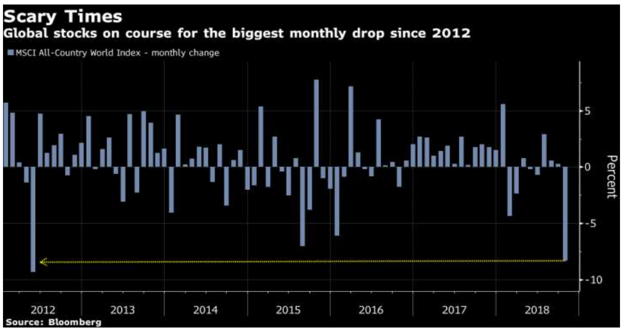
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	-6.84	3.01
Russell 2000 Index	**-10.86**	-0.60
MSCI EAFE Index	-7.96	**-9.28**
MSCI Emerging Markets Index	-8.71	**-15.72**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.79	**-2.38**
Barclay's U.S. Aggregate Credit Index	**-3.61**	**-8.62**
Barclay's U.S. Aggregate Corporate High Yield Index	-1.60	0.93
Barclay's Municipal Bond Index	-0.62	-1.01
Macro Measures		
Gold	1.55	-7.76
Crude Oil	**-12.16**	7.49
CBOE Volatility Index	**42.91**	**48.00**
USD Dollar Index	2.06	5.16

Current Theme – Nowhere to Hide During October's Swift Downdraft – Despite Recent Declines, Post Midterm Periods Have Historically Proven to be Very Positive for US Equities

Historical Patterns Working in Favor of US Equity Markets but Slowing Global Growth, Rising Rates and a Strong US Dollar Still Remain as the Largest Threats

While the sudden negative price moves seen in October were unpleasant, in reality, they have simply brought about a return to normal market behavior. As we have written about in the past, 2017 was notable for its extraordinary lack of volatility. As we approach the end of 2018, the year is displaying gyrations that are to be expected for risk assets. For example, the S&P 500 has now had three instances of -5 percent moves this year. The long-term average is 3.3 per annum. There have also been 49 one percent moves (either up or down) this year, again right on the long-term average of 50. There were only 8 in all of 2017.

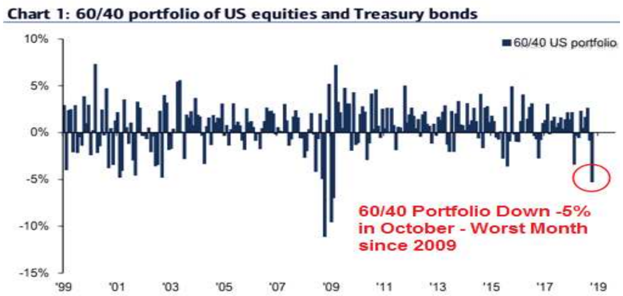
Global Equities Fell Almost -8% in Oct – Worst Since 2012



Source: Bloomberg

The monthly shift feels sharp however, because it's been quite some time since we have seen a decline of this magnitude – early 2012 to be exact.

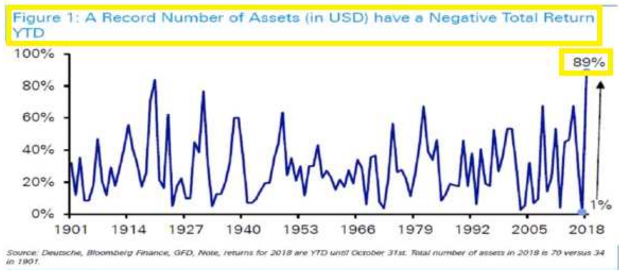
Diversification Was No Help; 60/40 Portfolio Down -5%



Source: BofA Merrill Lynch; Bloomberg; ICE Data Indices

Six and half years is quite a long time in the mind of investors who in general tend to have short memories. The impact was made worse by the fact that a typical portfolio comprised of 60 percent equities and 40 percent bonds did not fare well with both assets classes moving down in tandem during the month. As BofA Merrill Lynch calculates, the 60/40 portfolio fell more than -5 percent on October, the worst performance since 2009.

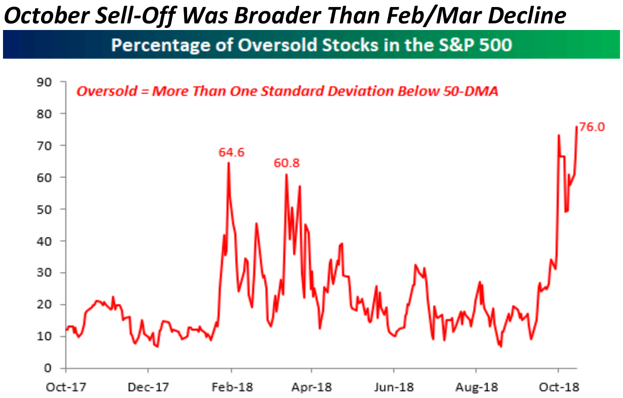
Incredibly, 89% of Assets Now Negative for 2018 in USD



Source: Deutsche Bank AG; Bloomberg; GFD

Not only were 70 percent of the trading days negative in October (third worst ratio since 1970), the losses were actually quite large in some areas and very wide spread. As the chart above from Deutsche Banks highlights, by their measure, an amazing 89 percent of global assets now have negative return for the year, a level not seen in more than 100 years.

October Sell-Off Was Broader Than Feb/Mar Decline



Source: Bespoke Investment Group

Looking specifically at US stocks, the October sell-off was more widespread than the previous two episodes earlier in the year. As you can see above, 76 percent of stocks were below their 50 day moving average which eclipsed the roughly 60 percent seen in Spring.

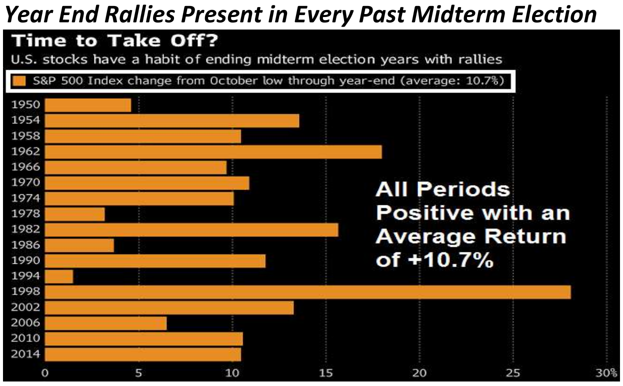
All that being said, there is reason for optimism as we look forward. One benefit we see after market pullbacks is simply the notion that assets become cheaper. In fact, US equities are now very reasonable valued which was not the case for much of 2017.

S&P 500 Forward P/E Now Below Long-term Averages

Source: LPL Financial Research

Additionally, we are also entering a period that has historical displayed a very consistently positive pattern. While negative October returns are not uncommon in any given year, they tend to occur very frequently during US midterm election years, largely driven by the uncertainty of the resulting outcome.

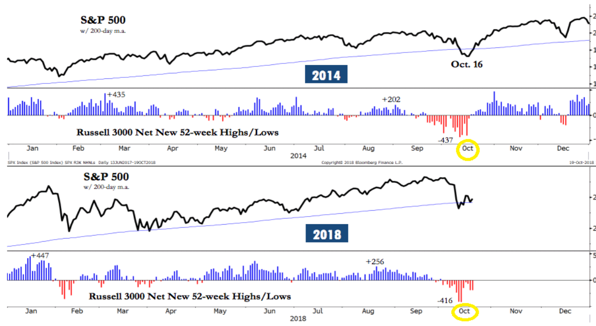
Year End Rallies Present in Every Past Midterm Election



Source: Bloomberg

As you can see in the chart above, every single midterm year going back to 1950 has seen a rally off of an October low through the end of the year. According to Bloomberg, the average return during the year end rally over those 17 selected years is 10.7 percent. Clearly, not every year is the same, however, we do see evidence that 2018 may play out in a similar way to past election years. Consider the following chart from Oppenheimer which shows that the S&P 500 in 2018 is moving almost in lockstep to the path it took during the last midterm election year of 2014.

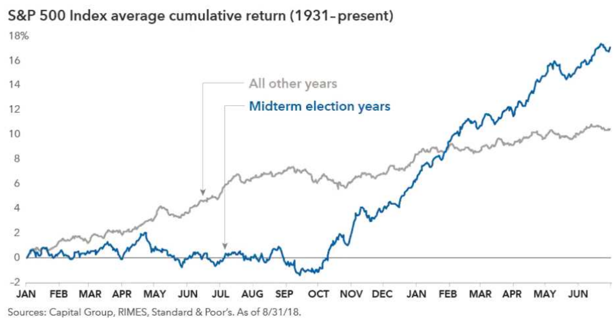
2018 Market Path Following 2014 Midterm Year



Source: Marketwatch; Oppenheimer; Bloomberg

Even more encouraging is the chart below from the Capital Group which tracks the paths of every year since 1931 versus midterm years. The pivot from an October low toward a steady march higher over the coming months is hard to miss.

Path for US Equities Post-Midterm Shifts Markedly



Source: Capital Group; RIMES; Standard & Poor's

Building off of the year end rally theme during midterms, LPL Financial finds that if one looks out a full 12 months past the election, the market has been positive a perfect 18 out of 18 years with an average twelve month return of 14.5 percent.

Forward 12 Month Return Positive in Every Midterm Year

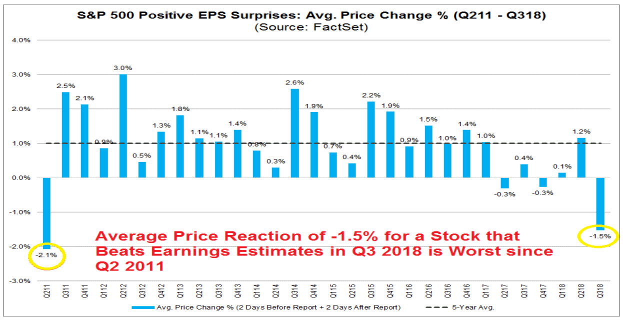
STOCKS ARE USUALLY STRONG AFTER A MIDTERM ELECTION

		Result of Midterm Election			
Date of Midterm Election	President	Senate	House	Congress Makeup	S&P 500 Return 1 Year Later
11/05/46	Harry Truman	Democratic	Democratic	Democratic	0.1%
11/07/50	Harry Truman	Democratic	Democratic	Democratic	16.2%
11/02/54	Dwight D. Eisenhower	Republican	Republican	Republican	33.2%
11/04/58	Dwight D. Eisenhower	Democratic	Democratic	Democratic	11.1%
11/06/62	John F. Kennedy	Democratic	Democratic	Democratic	24.8%
11/08/66	Lyndon B. Johnson	Democratic	Democratic	Democratic	12.9%
11/03/70	Richard Nixon	Democratic	Democratic	Democratic	12.7%
11/05/74	Gerald Ford	Democratic	Democratic	Democratic	18.7%
11/07/78	Jimmy Carter	Democratic	Democratic	Democratic	6.4%
11/02/82	Ronald Reagan	Republican	Democratic	Split	19.9%
11/04/86	Ronald Reagan	Democratic	Democratic	Democratic	1.1%
11/06/90	George H.W. Bush	Democratic	Democratic	Democratic	25.1%
11/08/94	Bill Clinton	Republican	Republican	Republican	27.1%
11/03/98	Bill Clinton	Republican	Republican	Republican	22.0%
11/05/02	George W. Bush	Republican	Republican	Republican	14.9%
11/07/06	George W. Bush	Democratic	Democratic	Democratic	6.7%
11/02/10	Barack Obama	Democratic	Republican	Split	3.7%
11/04/14	Barack Obama	Republican	Republican	Republican	4.5%
11/06/18	Donald Trump	?	?	?	?
				Average	14.5%
				Median	13.9%
				Count	18
				%Higher	18

Source: LPL Financial

It's worth noting in the previous table that the market is more or less oblivious to the results of midterm election, they simply seem to want it to be over and done with. The focus then would seem to shift to the next catalyst which, given the calendar, would naturally be earnings season.

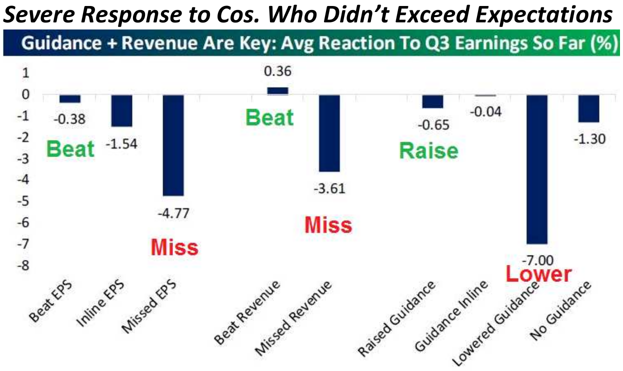
Even Companies Beating EPS Estimates are Punished



Source: Factset

And with overall earnings growing at an astounding 25 percent this quarter, one would think that investors would be overjoyed. However, that is not the case. As the chart below illustrates, investors aren't convinced that this level of growth has any chance of continuing. Generally, the consensus view is that this bump is an aberration driven by a one time tax benefit. Even companies that beat on earnings and raised guidance are being punished which is virtually unheard of during past earnings seasons. And if a company missed on their results in the current "wind at your back" economic environment, or even worse – guided down expectations for future results, the response was sharp and painfully negative, down -7 percent on average.

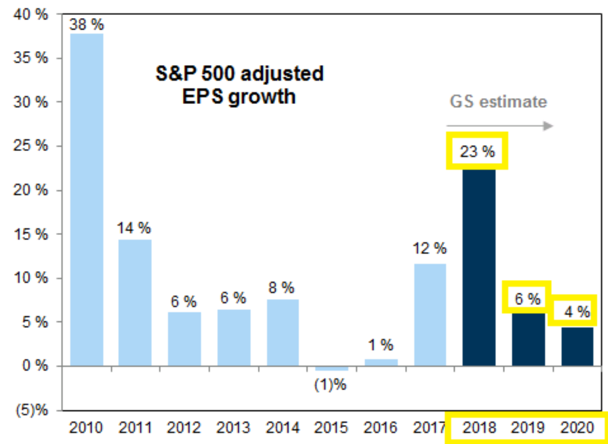
Severe Response to Cos. Who Didn't Exceed Expectations



Source: Bespoke Invetement Group

More than just the inevitable fading of the corporate tax cut benefit, it is now becoming apparent that investors are increasingly concerned about a lack of growth moving forward. As Goldman Sachs highlights below, that 20-plus percent earnings growth is a bit of a mirage, and the US economy will likely return to a much more muted level of growth in 2019 and 2020. While 6 and 4 percent growth is not terrible, it would represent a huge deceleration.

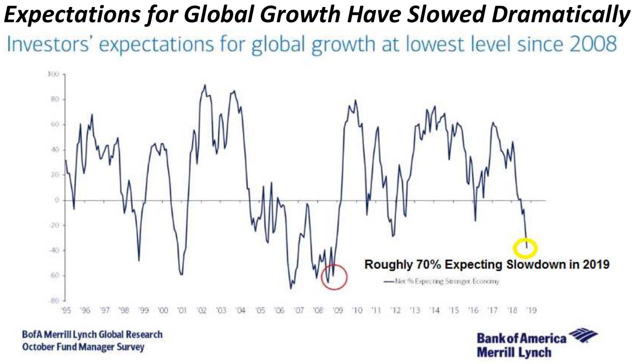
Sharp Slowdown in Earnings Growth Anticipated



Source: Goldman Sachs Global Investment Research

Arguably the more legitimate concerns are surrounding future overall economic growth. As one can see below, BofA Merrill Lynch has found in their most recent Global Fund Managers Survey that 70 percent of managers are expecting a slowdown in global growth for 2019, a sharp reversal from the beginning of 2018 when hopes were robust.

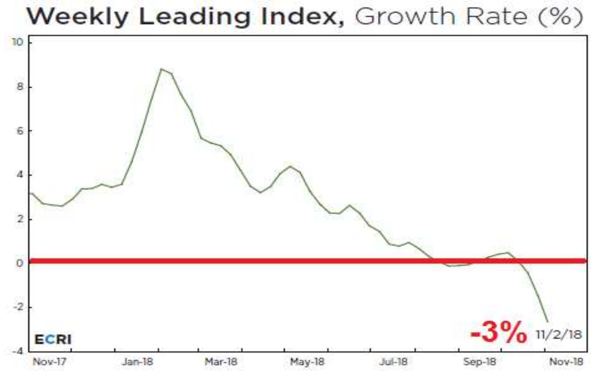
Expectations for Global Growth Have Slowed Dramatically



Source: BofA Merrill Lynch

It's difficult to point to the exact reasoning behind this sudden shift but it's easy to compile a list of worries; trade wars, inflation, rising interest rates, poor geo-political environment, etc. All these factors together are probably more powerful than any single one, but if we were to draw your attention to just one item, it would be the following. Momentum in the US economy has slowed dramatically and somewhat surprisingly. As the graph from the Economic Cycle Research Institute shows, their measure of leading indicators which draws from all sectors of the economy including risk assets, credit, real estate, money supply, etc., has now turned negative at minus -3 percent versus what was once an indication of an +8 percent growth rate at the start of the year.

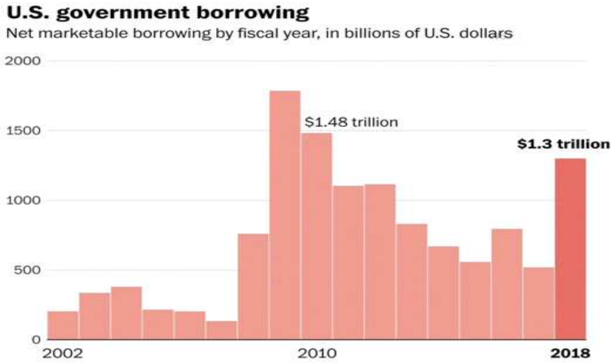
US Leading Economic Indicators Have Turned Negative



Source: ECRI

The US is the undisputed driver of the global economy so this is not a welcome development. Additionally, it comes at a time when the US has put fiscal policies in place which require growth to be sustainable. Given that the federal tax revenues have been substantially reduced via the corporate tax cut, the US now needs to borrow more money to keep the economy flowing. A lot of it. As you can see below, treasury issuance in 2018 has spiked to a crisis like level of $1.34 *Trillion*.

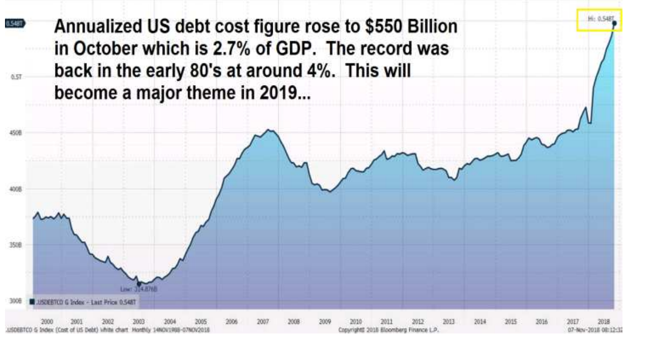
US Forced to Borrow Large Amounts to Fund Economy



Source: Wall Street Journal

Problematically, the costs of all of this debt has grown to around $550 billion or about 2.7% of GDP. That is a significant increase with no end in sight. On the current trajectory, interest expense on US debt will potentially outstrip the amounts spent on healthcare and the military over the next five years according to the Congressional Budget Office. The magnitude of this problem is not lost on investors since there is no obvious solution. Worse still, the more supply issued, the lower the demand and the higher interest rate required by investors – this just compounds the problem.

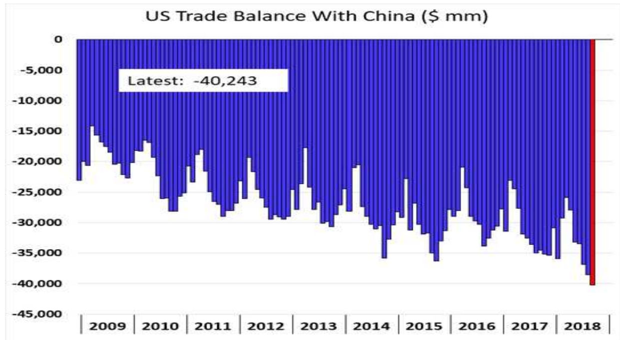
US Cost of Debt is Exploding with Rates Also Moving Higher



Source: Bloomberg

Adding to worries is the fact that relations with the largest buyer of US debt, China, are not particularly good at the moment. Ideally, the US would be working in conjunction with China to spur global growth; instead we are left with the unfortunate situation of a stand-off regarding tariffs that simply aren't working - the trade deficit with China is currently at an all time record. What would really help alleviate a good deal of the concerns we discussed would be a swift resolution with China. Look for clues at the coming G20 summit.

US Trade Deficit with China Continues to Expand



Source: The Daily Shot

Going Forward

As we discussed last month, despite the market sell-off, little has fundamentally changed and we are entering some of the most historically bullish period for equities. One notable change that has occurred is the -25 percent reduction in the price of oil, which should in theory help alleviate inflation concerns and boost profitability. 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, a strong US dollar, and a trade war with no obvious resolution in sight. Therefore, we remain focused on our base case scenario which calls for further gains in the US for the remainder of the year while the downside risk increases as growth slows throughout 2019. A resolution of trade disputes could however, lead to a very bullish shift at any given period.

With that outlook in mind, we would emphasize the technology, financial and healthcare 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 and is now essentially "on sale" after October's declines. Financial names are very reasonably priced after underperforming the S&P 500 Index for much of the year. We also see an opportunity in select healthcare companies. These names are less impacted by trade issues, and after trailing for the first half of the year, the healthcare sector is now outperforming the S&P 500 by a wide margin in 2018 (+11 percent versus +3 percent). With valuations still reasonable in many areas of the sector, we will be adding where appropriate.

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 has surrendered its 500 basis point advantage over the S&P 500 for the year. Small cap stocks are particularly sensitive to investors' perception of economic growth which has been in decline. As a result, the Russell 2000 now trails the S&P 500 by 360 basis points this year. We believe that this move is overdone and may likely reverse in the near-term.

With the recent weakness in the US, equity markets outside of the US are even more 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. Additionally, both regions are much earlier in their economic cycle than the US. Valuations are lower than the US and expectations are much more reasonable. Japan especially is seeing inflation and wage growth and the Nikkei Index is at its highest level since 1991. We have favored emerging markets equites for much of this year. The asset class has suffered this year from both a strong US dollar and trade tensions. Despite this, we continue to view their valuation and growth as attractive and would be adding exposure with a long-term allocation view.

After marching higher from August to October, the 10 year treasury yield retreated in October. With the Fed signaling its commitment to raising interest rates, (the next hike almost certainly coming in December) a flattening yield curve remains the consensus view and a fundamental concern to many investors. Bloomberg's survey of the 20 largest banks shows an expectation of the spread between the 2 year and 10 year treasury bonds to narrow to just 11 basis points by June 2019. 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 possible 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.