Insights: October 2018

Market Overview and Performance

When we sat down to write this month's letter during the first few days of October, there was a great deal of optimism virtually across the board. And for good reason. All in all, 2018 was proving to be another year of growth and appreciation in risk assets and the third quarter only seemed to have built on that momentum. The S&P 500 rose 7.7 percent during the third quarter, the 21st positive period out of the last 23 going back to 2013. In fact, the S&P 500 has been up in 32 of the 38 quarters dating back to Q2 2009. Furthermore, the road has been pretty smooth with no either +/- 1 percent days during the entire quarter – very low volatility in other words. As regular readers of our letter will know, we tend to focus on various risks that could potentially upset this long-term positive trend, but even we were a bit surprised to see the sudden reversal in US equity prices during the first several days in October. To be fair, equity markets outside of the US had begun to show weakness earlier in the summer, and to some extent, the move lower was simply a move reigning in that divergence in markets. We will discuss some of the reasoning behind the decline in more detail, but the key takeaway here is that this was simply a price correction. The fundamentals remain unchanged. And this is a very normal occurrence, even in very healthy markets. As Pension Partners calculated, the recent pullback in the S&P 500 equated to -7.8 over 20 days. Since 2009, pullbacks of at least -5 percent have lasted 26 days and resulted in a median decline of -8.4 percent. So while unpleasant, shallow sell-offs generally do not signal a true "shift" in markets and will certainly flare up again.

As always, thank you for reading our latest Insights.

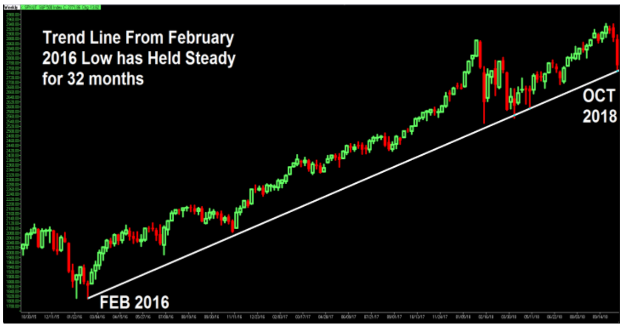
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.57	10.56
Russell 2000 Index	**-2.41**	11.51
MSCI EAFE Index	0.87	**-1.43**
MSCI Emerging Markets Index	-0.53	**-7.68**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.64	-1.60
Barclay's U.S. Aggregate Credit Index	-0.56	**-5.20**
Barclay's U.S. Aggregate Corporate High Yield Index	0.56	2.57
Barclay's Municipal Bond Index	-0.65	-0.40
Macro Measures		
Gold	-0.88	**-9.45**
Crude Oil	**4.71**	**17.52**
CBOE Volatility Index	-6.11	8.91
USD Dollar Index	-0.01	3.16

Current Theme – October Volatility Makes an Appearance Once Again – Despite Recent Declines, US Equities are Heading into a Historically Bullish Period

Seasonality Working in Favor of US Equity Markets but Slowing Global Growth, Rising Rates and a Strong US Dollar Could Disrupt the Upward Trend

As we said at the outset, 2018 has generally been very constructive. While equity markets outside of the US have posted moderate gains for the year, the S&P 500 was up almost 11 percent by the end of September. However, the recent experience of declining prices simply overwhelms the feeling of "being ahead" for the year, so a little perspective can be helpful.

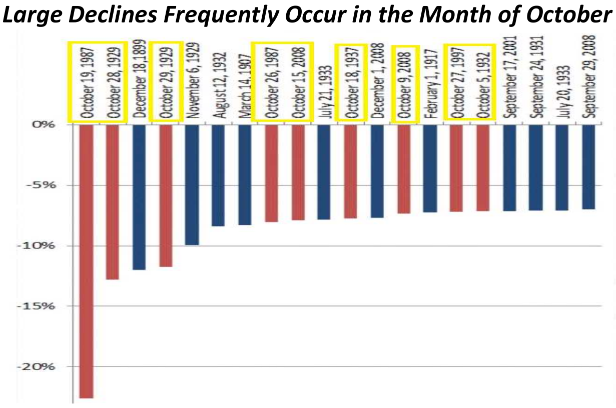
Recent S&P Price Moves Have Not Broken Longer Trend



Source: Thomson Reuters

As the chart above highlights, the current 7 percent decline merely brings the S&P back to the upward trend line that has been in place since early 2016. Since February of that year, the S&P 500 is up 49 percent. And to be honest, the market has come to somewhat expect these type of moves during October.

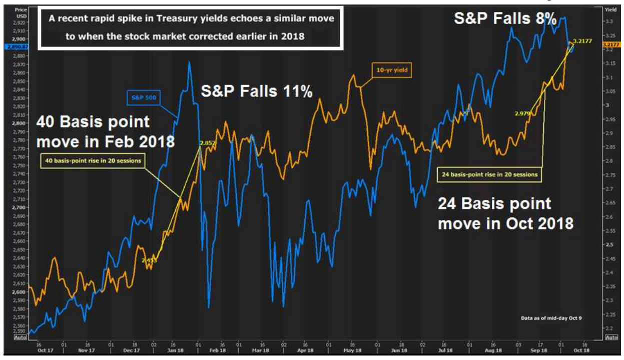
Large Declines Frequently Occur in the Month of October



Source: Zero Hedge

But why now? As always, there is never one single impetus accounting for the shift in market sentiment, but generally speaking, a sharp move higher in treasury yields served as the initial driver. The predominant reason yields tilted higher were the comments made by Federal Reserve Chairman Jerome Powell on September 26th that were interpreted as being a confirmation that the Fed plans to faithfully pursue its intentions of continued gradual rate hikes. For whatever reason, the market seemed to take him at his word this time (previous statements had been met with skepticism) and the yield on the 10 year Treasury bond quickly moved from around 3 percent to around 3.25 percent.

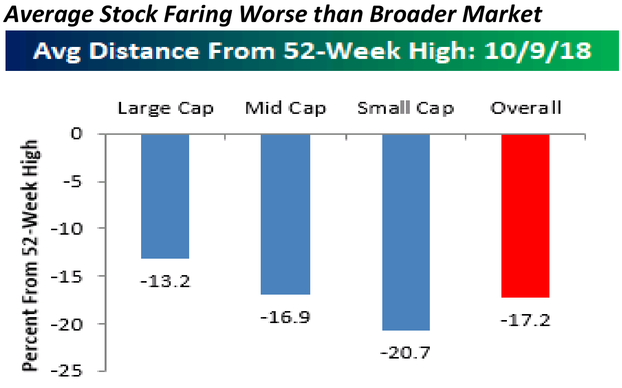
Yield Increase and Stock Decline Similar to February 2018



Source: Zero Hedge; Thomson Reuters

If this sounds familiar, that's because we saw the exact same pattern in February of this year when a 40 basis point move in yields sent the S&P 500 down by almost 11 percent over 9 trading days. Again, these are quick moves over short time frames (the 10 year yield is back to 3.13) but as seen below, the damage has been done, particularly if one looks below just the headline level of the large indices.

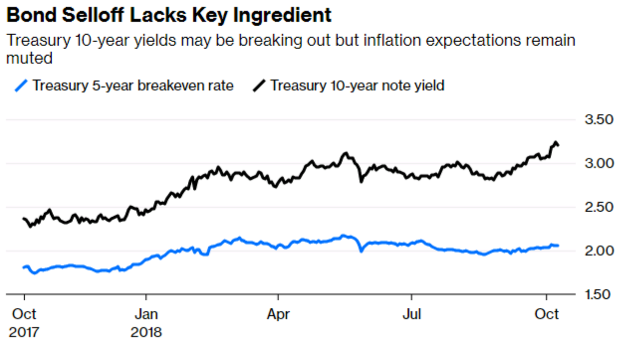
Average Stock Faring Worse than Broader Market



Source: Bespoke Investment Group

The chart above speaks to two themes really. First, the average stock is actually down substantially more than the S&P 500 or Dow Jones Average which represent the aggregate. As the chart shows, the average stock is in now at correction (or even Bear market in the case of small caps) level meaning down more than 10 percent. As of the close on October 11th, 66 percent of the names in the S&P 500 had corrected by at least 10 percent. That gets to the second theme which we have discussed at length this year – narrow breadth – meaning a handful of large components of the various indexes (think Apple) having been holding up overall index level performance. While that trend is not ideal, it is not a true concern since it does provide for some better active stock picking opportunities. What would be a bigger concern is if we thought the rise in rates was a permanent shift. We don't.

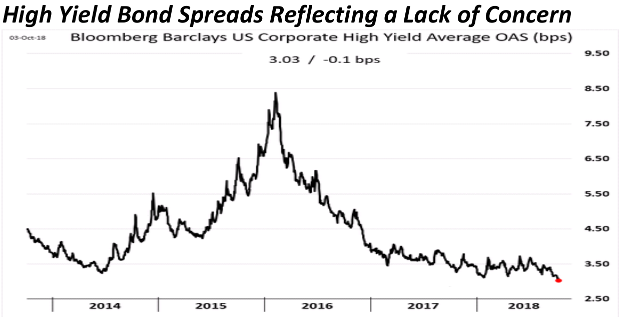
Move Higher in Rates Not Spurred by Inflation Worries



Source: Bloomberg

While we do think rates will trend higher over time, it is important to distinguish the "why". As you can see above, the rise in rates is coming from real yields and not inflation expectations. That is important because with recent core PCE inflation numbers falling from 2.2 to 1.8 percent in August, investors think the Fed will have less and less incentive to keep raising rates.

High Yield Bond Spreads Reflecting a Lack of Concern



Source: Bloomberg; The Daily Shot

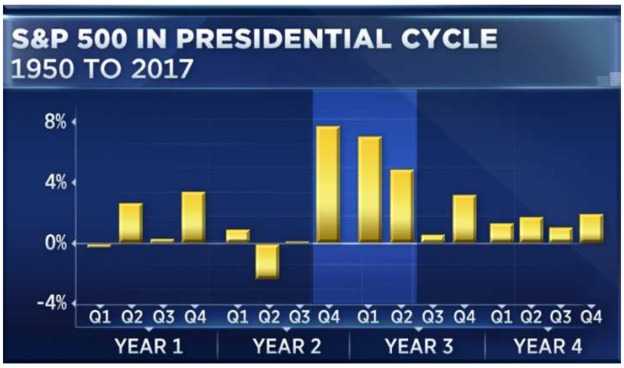
And the high yield market, a reflection of the most credit sensitive components of the markets, is confirming a lack of inflation fears as well. If the investors thought that inflation was an imminent threat, high yield bond spreads would be moving upward to compensate for the risk. In fact, the opposite has occurred as the previous chart highlights. With that said, there is no denying that the potential end of the 30 year Bull market in bonds may be closer to a becoming a reality than it has been in some time.

30 Year Bond Bull Market May be Nearing It's End

Source: Bloomberg; The Daily Shot

Yeas and years of low yields on bonds (heavily influenced by government buying via quantitative easing) has forced money into risk assets like equities at an almost constant pace since the Global Financial Crisis. A reversal of these dynamics has investors worried that these capital flows will flip, drawing money out of equites and back into safe haven bonds.

Entering Historically Constructive Period for Equities

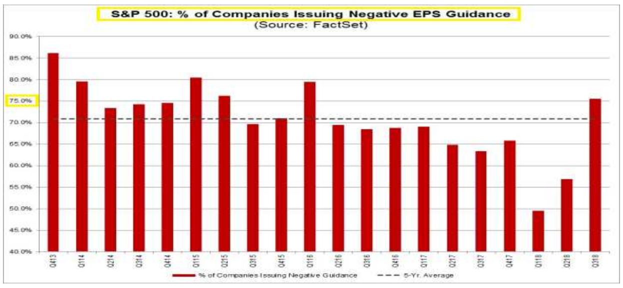


Source: LPL Financial

Fortunately, as the above chart demonstrates, we are entering the fourth quarter, traditionally a good time for stocks. More importantly, a Q4 in a presidential midterm is even more supportive with an average return of almost 8 percent followed by two additional strong quarterly periods as well.

The next potential market moving information will likely come in the form of Q3 earnings results which many are looking to as the beginning of a focus away from rate concerns and recent stock weakness.

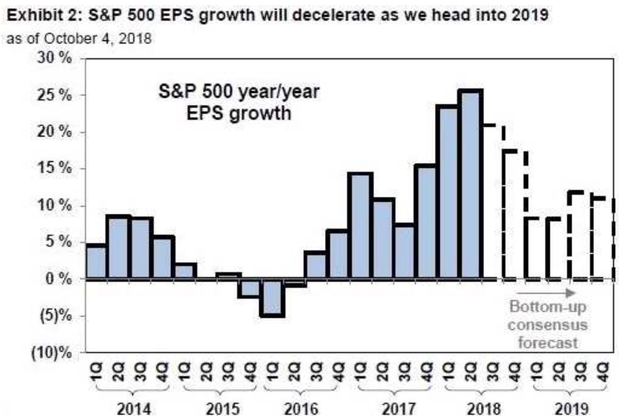
Negative Earnings Guidance is at 76% - Highest Since '16



Source: Factset

As the old adage goes, earnings drive prices, and fortunately the picture on that front is still very solid. Consensus estimates for S&P 500 earnings growth in Q3 are right around 20 percent. That is a tremendous rate of growth when considering that the current business cycle is in its ninth year of expansion.

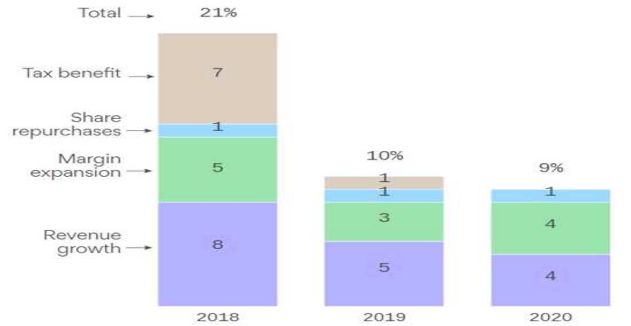
Earnings Set to Slow After Q2 2018 Peak of 25%



Source: Goldman Sachs Global Investment Research

A few things to keep in mind however. First, Q2 earnings results were likely peak levels that will not be revisited any time soon. As the above chart from Goldman Sachs highlights, market expectations are for growth to slow fairly rapidly by the beginning of 2019 to more historically sustainable levels of around 10 percent. Bear in mind that 10 percent growth is still quite good, however, when thinking about market trends, it is often the direction of change and the rate of change that takes precedence over the actual numbers themselves. In other words, it is more difficult to argue for prices moving meaningfully higher when business activity is slowing. One could certainly argue to the contrary, however, it would be harder to argue against the notion that the tax cuts of 2018 represented a "sugar high" for earnings - a quick one time boost. As the chart below shows, the tax benefit to earnings was significant throughout this year. However, Its impact will quickly fade while at the same time, revenue growth is set to slow measurably.

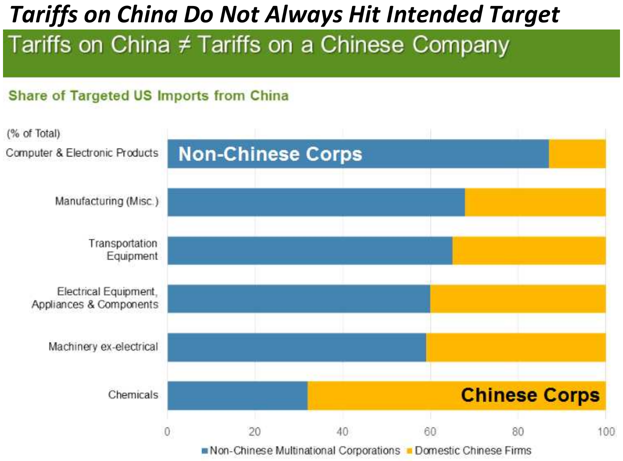
"Sugar High" of Tax Cut Effect on EPS Set to Quickly Fade



Source: Factset; Axios

Obviously, another key determinant for future growth will be the pace of global trade. As we have written about for much of this year, a policy which pursues an ever increasing amount of tariffs on goods will only serve to slow growth for all participants and not change behaviors. Tariffs are a very blunt tool and while particularly expensive for end consumers, they also present a challenge in terms of actually impacting the intended manufactures themselves as one can see below.

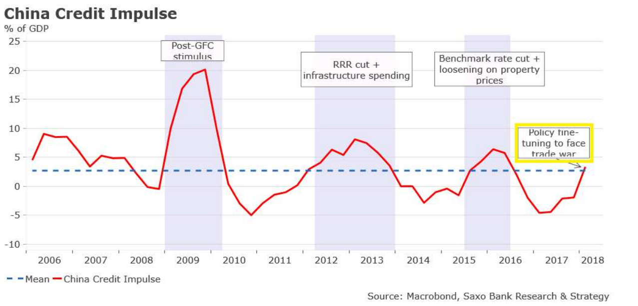
Tariffs on China Do Not Always Hit Intended Target



Source: Lazard Asset Management

As the previous chart highlights, many of the Chinese goods currently under tariff by the US are actually being produced in China by non-Chinese multinational corporations according to Lazard Asset Management.

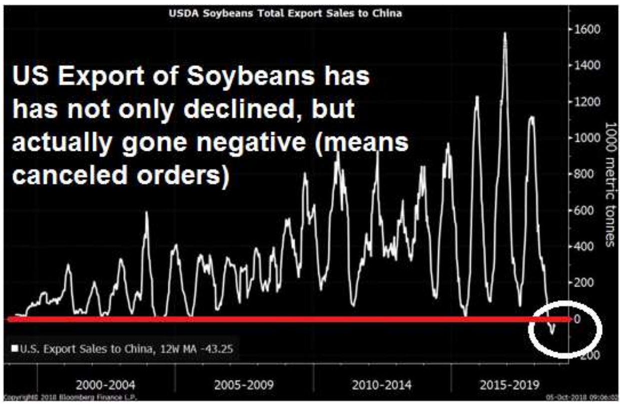
China Has Responded to Trade Tensions with Stimulus



Source: MacroBond; Saxo Bank Research & Strategy

Additionally, China unquestionably has several tools at their disposal to combat any slowdown in activity resulting from trade tensions. As the chart above from Saxo Bank points out, the Chinese credit impulse, or the amount of change in new credit issued has turned positive and is now at 3.3 percent of China's GDP. In other words, they are flooding their economic system with liquidity to help foster the continuation of growth. As Saxo Bank stated, when China has taken this action in the past (blue shaded regions), growth in the economy of both China and emerging markets improved notably.

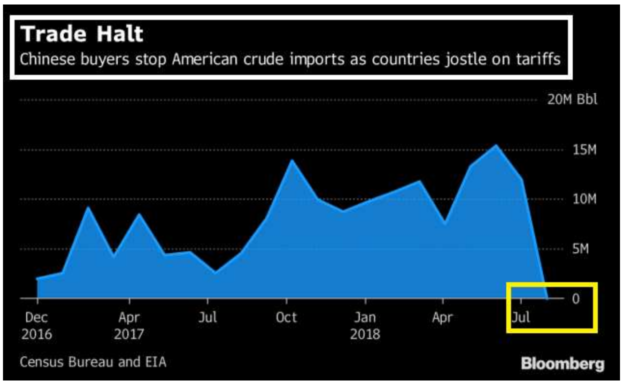
China Ceased Buying US Soybeans & Cancelled Orders



Source: Bloomberg

China also has a clear understanding of their leverage as the second largest economy in the world. As one can see above, China has not only stopped buying US soybeans entirely, they have also cancelled future orders, turning measures of economic flow negative. This is a calculated course of action. As we have discussed in past Insights, China is keenly aware of the geographic location of the Trump base and have therefore reacted to tariffs in ways that will have the greatest impact. According to the Purdue University/CME Group Ag Economic Barometer, the US agriculture economic activity is down -25 percent in 2018. Even non-tariffed areas are being affected. The chart below illustrates the fact that China, who has rivaled Canada for years as the largest importer of US oil, has now completely shut-off their purchases.

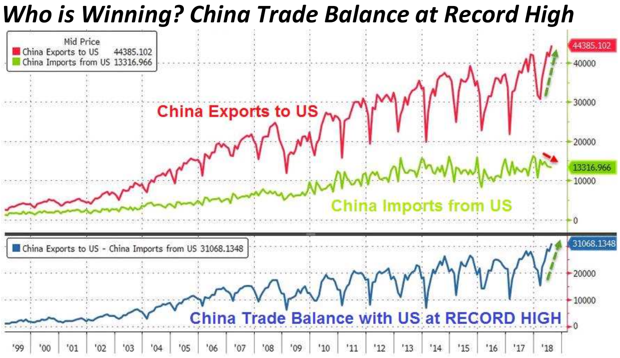
China Has Also Utilized Their Scale in Non-Tariffed Areas



Source: Census Bureau; EIA; Bloomberg

Admittedly, these actions are not enough to hold back the entire US economy, but to a large extent, US consumers are doing the work for China in the trade war. As of the end of September, US exports into China are in decline, while China exports are at their highest level *ever*. This means that China's trade balance with the US is at a record high. From China's perspective then, the trade war has worked out just fine thus far.

Who is Winning? China Trade Balance at Record High



Source: Zero Hedge

Going Forward

As we discussed, despite the recent sell-off, nothing has fundamentally changed and we are entering some of the most historically bullish periods for equities. We are therefore 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, rising input costs in the form of oil 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 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. We also see an opportunity in select healthcare companies. These names are less impacted by trade issues, and after trailing for much of the year, the healthcare sector is now outperforming the S&P 500 in 2018. With valuations still reasonable in many areas of the sector, we will be adding where appropriate. Additionally, given the expectation that the price of oil will rise meaningfully in 2019 based off of supply dynamics, we would be adding what we view as well positioned companies in the energy space.

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. We believe that this move is overdone and may likely reverse in the near-term.

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. 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 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.

The recent spike in 10 year treasury yield illustrates the concern in the bond market. With the Fed signaling its commitment to raising interest rates, 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. The spread was at 24 basis points in September. 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.