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Market Update
October 12, 2018

After five straight monthly gains, U.S. equity markets have experienced a moderate decline to start the month of October. Following a decline of 5.3% from October 9th through October 11th this week, the S & P 500 has now declined 7.2% from its all-time high (established on September 20, 2018). We know big market drops can cause uneasiness or concern, so we wanted to share a few thoughts on recent market weakness and our view of the economy. The good news is that as of this writing, all major U.S. markets remain higher on a year to date basis. On the other hand, after a positive performance last year, both foreign developed (based on the ETF VXUS) and emerging markets (based on the ETF VWO) continue to struggle and remain in negative territory so far in 2018 (down 10% and 16% respectively as of this writing).

The important question we are trying to answer is what has changed? Our list of concerns that we have been monitoring this year has not changed very much. The U.S. central bank continues to gradually raise short term rates, trade concerns with China remain an ongoing issue and the U.S. budget deficit is likely to continue growing larger. Trade negotiations between China and the U.S. are currently at an impasse. We will be keeping an eye out for the upcoming G20 meeting of world leaders (which takes place from November 30 – December 1, 2018) in Brazil for any signs that the U.S. and China may be able to find some common ground and end the current trade stand-off. Other concerns include economic uncertainty in a number of emerging markets (like Turkey, Argentina and Venezuela) and budget/political issues in Italy. However, these concerns are less important than the issues raised above.

More recently, 10 Year U.S. Treasury Bond yields have started to move higher. Just a couple of months ago yields were around 2.80% but today they stand at 3.16% (after rising as high as 3.26% earlier this week). Importantly, we believe that yields are rising because the economy is performing well. We believe the issue for the markets is not that interest rates are rising, but that if interest rates rise too far too fast, this may lead to increased negative market volatility. Lastly, a corporate profit warning earlier this week

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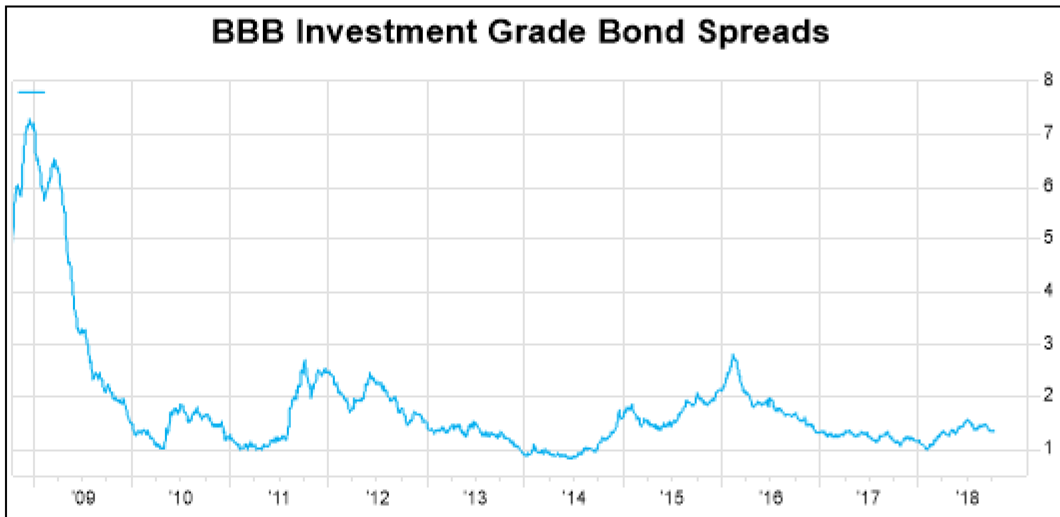
from a major paint supplier, PPG Industries (PPG), spooked some investors who are now questioning the outlook for the economy and corporate profits. For reference, chemical and basic material stocks are not an area we have been emphasizing in our portfolios.

We are now at the start of third quarter earnings season and as of the latest update, year over year earnings per share (EPS) for companies in the S & P 500 are currently forecast to increase 19.2% (source: Factset). We don't want to totally write off PPG's profit warning, but overall, we believe that when all is said and done, third quarter earnings season is likely to be fairly positive once again. What's more important is what corporate CEO's and CFO's have to say about the future.

As the economic expansion continues, it is only right to question how much more upside is left. Looking at a number of different economic indicators, we continue to believe that the U.S. economy remains on pretty solid footing. For reference, we monitor a number of leading economic indicators. Looking at several of our favorite indicators, weekly jobless claims (a gauge of the labor markets) remains near multi-decade lows, the Conference Board's Leading Economic Index (which has historically done a good job forecasting the direction of the economy looking out 2-3 quarters) remains in an uptrend, credit spreads (a measure of corporate balance sheets – see chart below, source: Factset) still look healthy, the real i.e. inflation adjusted Fed Funds rate (which measures how tight central bank policy is) is close to 0% despite seven rate hikes by the Federal Reserve bank since late 2015 and the Federal Reserve Bank's quarterly senior loan survey (which is a measure of lending conditions) remains supportive for economic growth.

The chart shows the yield spread for BBB rated investment grade corporate bonds. Currently that spread is 135 basis points or 1.35% above the yield of U.S. Treasury Bonds. This spread has been trending a bit lower in recent weeks but importantly, BBB



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rated bond spreads remain within the range seen over the past several years since 2010.

Looking at other key parts of the economy, consumer and business confidence surveys remain at historically high levels and indexes that track the manufacturing and services sides of the economy remain positive. One area that has weakened somewhat in recent months is housing. Despite positive job growth, with continued (moderate) wage growth and high consumer confidence levels, housing activity has slowed somewhat. We are not sure if the reason is because home prices have increased too high over the past few years, home inventories remain too low, millennials would simply rather rent versus buy or that higher mortgage rates have started to cut into home sales. Whatever the reason, this is something we will have to monitor.

In terms of corporate profits (which are an important driver of stock prices over time), the S & P 500 is currently forecast to generate 21.9% y/y earnings per share growth in 2018 followed by growth of just 10% in 2019. This year, seven of the 11 sectors in the S & P 500 are currently forecast to generate double digit growth while next year, five sectors are currently forecast to post double digit growth (source: CFRA, a division of S & P). In 2018, corporate profits have received a boost from last year's tax cuts along with a continued tailwind from U.S. stock buybacks. However, these tailwinds are likely to fade somewhat over the next several quarters. Looking ahead, corporate profits are more likely to track the performance of corporate revenues (which tend to track the direction of GDP). Therefore, continued healthy GDP growth will be a positive for sales and profits while a slowdown in GDP could start to put pressure on corporate profits down the road.

The Federal Reserve Bank is starting to get more attention as it continues to gradually raise short term rates. The central bank started raising rates in late 2015 and has increased short term rates eight times so far from around 0% to 2.25% as of the latest FOMC meeting. As rates continue to move higher, economists have started to debate 1) what the peak in rates will likely be over the next 12-24 months and 2) how high is too high. As for the first point, while the central bank has raised rates several times already this cycle, real i.e. inflation adjusted short term rates remain close to 0% (i.e. they remain accommodative). For example, the Fed Funds rate (which the central bank controls) is currently 2.25% while the core year over year inflation rate is now 2.2% (note: 2.25% minus 2.20% = 0.05%). In the last three Fed rate cycles, real short term rates peaked at 4.1%, 3.5% and 1.9% respectively (source: Strategas Research). Therefore, we believe there is still room for rates to move somewhat (but not substantially) higher over the next few quarters without hurting the economy and underlying profit growth.

Regarding the second question, how high is too high, when we start to see signs of stress build up in U.S. financial markets, that to us will be a sign the central bank needs to back off and

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move to the sidelines. A few indicators that would get our attention include rising credit spreads, a sustained rise in the dollar, a jump in the VIX volatility index (we have started to see this), a change in the central bank's Senior Quarterly Loan Survey, weakness in the jobs market or a widespread and persistent decline in stock prices. In addition, if surveys of corporate CEO's and CFO's start to weaken, that could be a sign that the outlook for the economy may be starting to weaken.

Turning to market internals (i.e. when you look beneath the hood of the market) we are starting to see some signs of near-term weakness. For example, recent weakness in a few sectors of the market like semiconductor stocks, autos, small capitalization names and housing related companies have gotten our attention. Looking back to late January when the S & P 500 last peaked, 83% of stocks in the index were trading above their 200-day moving average (i.e. were in an uptrend). That figure stood at around 70% when the market peaked in late September and today stands at a reading of below 40% (which is a potential yellow flag). We would like to see a rebound in this figure over the next several weeks.

The good news is that following this week's market sell-off, there are some signs that we may be closer to the end of recent market declines. Based on the fact that volume has been heavy on the downside, the ratio of declines to advances was fairly extreme, 76% of stocks in the S & P 500 made 20 day lows in price this week and the CBOE 5 day put to call ratio spiked higher, this kind of climatic looking data indicates to us that the market is starting to look oversold. Also, dating back to 1950, -3% daily market declines (which we saw on Wednesday) have historically been positive for equity markets looking out over the next 1,3 and 6 months since 1950 when the stock market is in an uptrend (source: Strategas Research). Therefore, while recent selling has been sharp and fairly widespread, we believe we may not be too far away from market levels where buyers start to come back into the market. Importantly, looking at long-term charts for the major U.S. indices (dating back to the start of the current bull market in 2009), the S & P 500, Dow Jones Industrial Average, Nasdaq Market and Russell 2000 Small Cap Index all currently remain above their long-term uptrend lines and remain on monthly MACD buy signals (note: MACD is a measure of long term momentum).

An interesting fact we wanted to share. Historically (since 1946), the S & P 500 has advanced 100% of the time in the 12 months following mid-term elections (source: Strategas Research). We find this encouraging, but understand that ultimately, it's economic fundamentals (such as sales, profits, inflation and interest rates) that help determine the direction of equity markets. We would not be surprised to see some additional weakness over the next few weeks heading into mid-term elections in early November. However, following mid-term elections, historical stock market patterns look like they could turn more favorable.

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In terms of portfolio allocation, we continue to favor the U.S. over foreign markets, large caps over small caps and growth versus value stocks. Due to stronger growth as a result of last year's tax cuts, U.S. equities have well outperformed foreign stocks so far this year. Earlier this year we capped our foreign holdings at about 15% (a little higher in our more aggressive portfolios). At least so far that has turned out to be an astute move. At some point, the tables will turn and foreign markets should perform better due to more attractive valuation levels, more accommodative monetary policy and the potential for corporate profits to rebound off very depressed levels. This is something we will be on the lookout for in quarters months ahead.

Given where we are in the economic cycle, we believe it makes sense to favor more stable large capitalization companies versus more speculative small cap companies. For reference, according to Strategas Research, just 13% of companies in the Russell 1000 Large Cap Index are currently losing money while 38% of companies in the Russell 2000 Small Cap Index are currently unprofitable. Turning to growth versus value, growth stocks (except for a few short periods) have outperformed value stocks over the past several years. For now, we continue to favor growth stocks versus value stocks because of their ability to generate consistent and attractive growth no matter how the economy is performing. However, due to rising interest rates, some signs of a pickup in inflationary pressures, along with the fact that valuation levels for growth stocks vs. value stocks are starting to get somewhat stretched on a multi-year basis, we are on the lookout for a potential shift from growth to value.

In summary, after five straight months of gains, the stock market has started the month of October with some profit taking. For reference, markets typically experience 3-4 pullbacks of around 5% and 1 to 2 corrections of 10-20% per year on average (since 1950, Source: JP Morgan Asset Management). Therefore, an occasional pullback or correction, while not pleasant, is something that is a normal part of the investing cycle. As we have highlighted over the past several quarters, there are a number of big picture issues on the minds of investors including the Federal Reserve Bank policy, the level and direction of interest rates, tariffs and trade wars with China and the outlook for the economy and corporate profits. These are issues that we are monitoring as we gauge their potential impact on the economy and financial markets.

We acknowledge that market internals have weakened a bit near term. However, again, from our vantage point, the U.S. economy still appears to be on pretty solid footing. Ultimately, stock prices tend to follow the direction of corporate profits over time. While the year over year growth rate of corporate profits will slow in 2019 (after strong year over year growth of 25% in each of the past two quarters), we believe that the most likely outcome remains a period of moderate growth in the economy and corporate profits

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over the next few quarters. We acknowledge that we may be in the latter stages of the current expansion. However, that does not mean a downturn or recession (which we don't currently forecast) is right around the corner.

As always, if you have any questions please do not hesitate to reach out and give us a call.

Respectfully,

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