CIO Newsletter

Q4 2018

Bear Wave Reaches U.S.

Current Environment

The fourth quarter of 2018 saw an abrupt reversal in sentiment, starting in October and deepening in December. In the third quarter, the U.S. stock market reached a new peak level as investors focused on the pattern of strong earnings growth, while overlooking the looming problems of monetary tightening and a trade war. But early in October that narrative and perspective appeared to flip: Reported growth year-over-year in Q3 S&P 500 earnings at 26.9% (see chart on the next page) was the highest in many years, but any companies who offered cautious guidance for 2019, especially linked to trade war concerns, saw their stock price decline. The underlying fundamentals did not change much in the U.S. economy: GDP growth was 3.4% for Q3 after 4.2% for Q2, unemployment remained very low, inflation remained muted and declined slightly, oil prices fell substantially, consumer sentiment and spending remained high, and corporate earnings looked healthy. But the focus had shifted to the future prospects for corporate earnings, with growing fear that monetary policy and trade policy would become a difficult headwind while the temporary tailwind of fiscal policy would soon falter. This is consistent with the late cycle or transition period that we have described before.

This reversal in sentiment felt very sharp absent any significant weakening in fundamentals. The U.S. stock market, represented by the

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S&P 500, at its lowest point in December had just about reached the technical definition of a bear market: a 20% decline from the recent peak. This brought to the U.S. an expanding bear wave in 2018 that had first hit emerging markets, then in developed foreign markets and in oil, then in U.S. small cap stocks and finally in U.S. large cap stocks. Tightening global liquidity and a stronger dollar had started the stress in emerging market currencies, which continued as growth slowed in China. Slowing growth in foreign developed economies – in fact, both Germany and Japan had economic contraction in Q3 – and political uncertainty like Brexit broadened the market stress outside the U.S.

Growing oil inventories and less-than-expected export declines from Iran next weighed on oil prices. But now the U.S. stock market has fallen sharply in anticipation of rather than in observation of weaker fundamentals. It remains to be seen just how corporate earnings and U.S. economic activity will fare in 2019, with a weaker ISM index and a stronger jobs report sending mixed signals at the end of December. Advance predictions of problems – to which this newsletter

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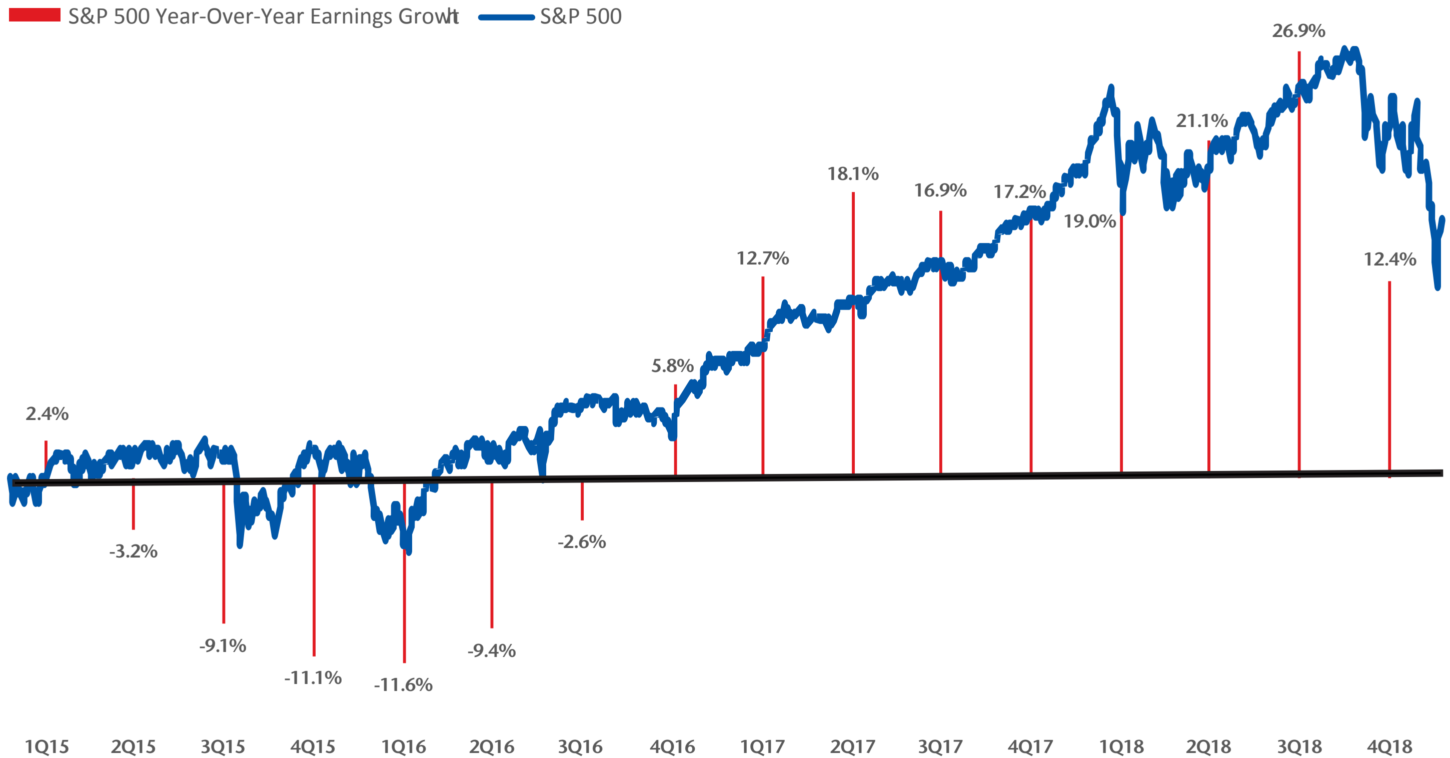
Current Environment (cont'd)

S&P 500 Year-Over-Year Earnings Growth



Source: FactSet. Note that 4Q18 growth in S&P 500 earnings is an estimate from Standard & Poor's.

admittedly contributed – may have created a self-fulfilling prophecy as investors were all too ready to reduce their risk exposure once sentiment turned.

There will be potential eventually for a rebound in stocks, but first the market must decide how far to fall – and technical indicators remain negative for now - and then investors will need the uncertainty of the trade war to be resolved and for monetary policy to realign with economic expectations. The forward price/earnings ratio on the S&P 500 was above 18.3 in January 2018 but finished the year at 14.4.

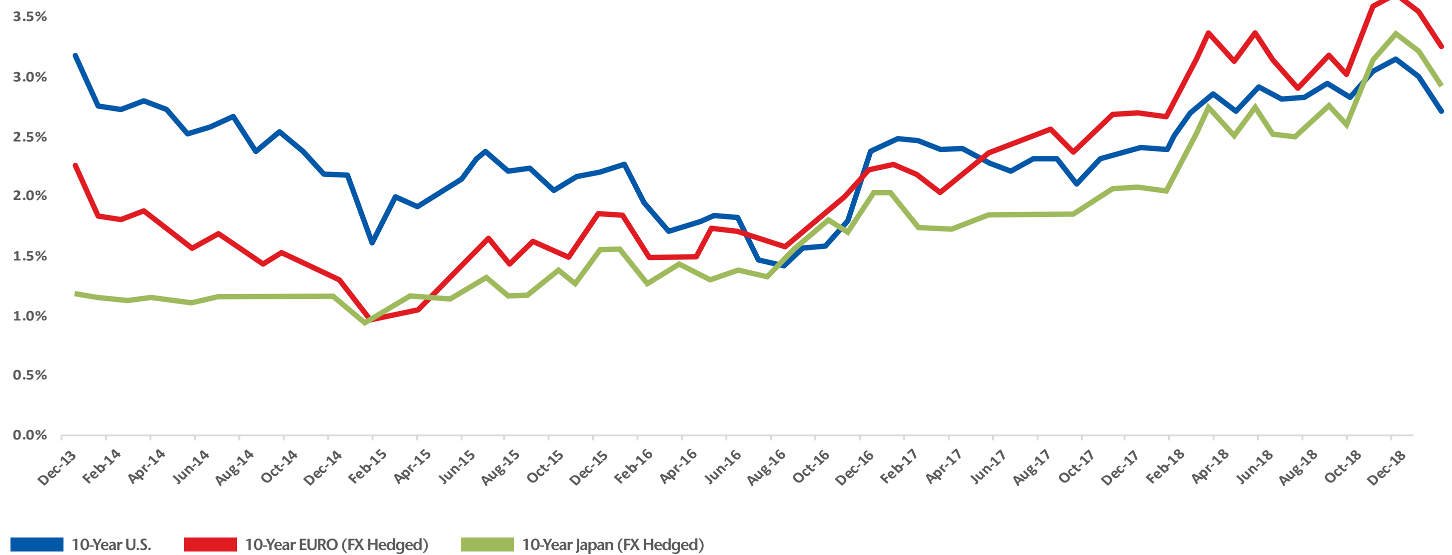
Monetary policy has been a prominent topic in this newsletter throughout 2018. The FOMC confirmed its expected Fed Funds rate increase in December, which is the ninth in the current tightening phase.

> " The FOMC dot plot continues to project further rate increases in 2019, but the market for Fed Funds futures predicts none or just one in 2019, followed by cuts in 2020 – anticipating a recession."

The FOMC dot plot continues to project further rate increases in 2019, but the market for Fed Funds futures predicts none or just one in 2019, followed by cuts in 2020 – anticipating a recession. Movements in the yield curve have been an important barometer throughout 2018. For most of 2018, short dated yields rose in line with Fed tightening, but the yield curve flattened as investors feared that tightening would overshoot and slow the economy, and implied inflation expectations remained subdued. In late September, the longer dated yields rose in sympathy with European and Japanese yields as tighter liquidity increased the cost of currency hedging and pushed the hedged yield on European and Japanese bonds above U.S. bonds (see chart on the next page) – even though the U.S. bonds have much higher absolute yields – effectively pulling foreign capital out of the U.S. bond market (anticipated in the Q2 2018 newsletter). This spike in long yields in late September was probably part of the catalyst for the stock market sell-off in October, especially in growth stocks. Then in Q4 we saw U.S. yields decline and flatten as bonds became a safe alternative to falling stocks. The U.S. 10 year yield declined by more than 0.60% from its recent peak.

Current Environment (cont'd)

Global 10 Year Government Rates with Currency Hedging



Source: FactSet. The yield for the zero-coupon 10yr bonds is used, with the Japanese and European bond yields then adjusted for the annualized forward/spot carry to hedge to U.S. dollar.

Long-Term Outlook

Although political uncertainty, especially in the form of Brexit, a trade war and a U.S. government shutdown, represents an immediate source of concern for investors, it is also worth considering some longer term political trends that will affect the investment landscape. Recent years have brought a swing toward populist nationalism even as we have watched the economic destruction wrought by populist regimes in Venezuela and Zimbabwe, plus the growing economic damage from populist regimes in Argentina, Brazil, South Africa, Turkey and many more. From an investor's point of view, populism generally involves fiscal expansion that delivers a short-term boost in growth followed by inflation, lower productivity from misinvestment, and excessive debt burden that all lead to recession. Populism also generally involves crony corruption and uncertain operating environments for business. Most of the economic history of the effect of populism comes from developing economies where brain drain and capital flight can sharply amplify the negative outcomes, but it is not certain that populism in large developed economies can or will suffer as harshly due to a lack of alternative destinations for people and capital.

> "fiscal expansion generally could occur over the next several years, offering some short-term growth but creating a longer term drag as debt servicing consumes a larger share of fiscal budgets."

However, it does seem likely that fiscal expansion generally could occur over the next several years, offering some short-term growth but raising interest rates and creating a longer term drag on economic growth as debt servicing consumes a larger share of fiscal budgets.

Developed economies have managed to outgrow heavy debt burdens in the past, but generally this required demographic growth. For example, the debt for the U.S. fiscal expansion in World War II, which also finally ended the Great Depression, was offset by a post-war demographic expansion from the baby boom. The debt accumulated globally from undisciplined Keynesian policies in the 1960s-1970s was offset by the expansion of the labor force as many more women entered paid employment in the 1980s. However, there may not be another demographic boost easily available to developed economies, unless they wish to open to significant levels of immigration.

Current Positioning

The sell-off in stocks in October, initially appearing to be a technical event but then lacking any meaningful recovery in November, prompted us to take a more bearish outlook on stocks. We decided in mid-November to use any rally as an opportunity to sell to an underweight position, and thankfully that opportunity arrived in the last week of November prior to the steeper sell-off in December. So in the last week of November we moved to a deliberate underweight to stocks, and the market decline in December has increased that underweight further, for which we had no appetite to rebalance. Now as January begins we are willing to rebalance toward our original target level of underweight, but otherwise waiting for more information on economic and corporate fundamentals. As described in previous newsletters, we had already reduced our exposure to corporate credit spread prior to the spread widening that started in September and deepened in Q4.

> "The sell-off in stocks in October, initially appearing to be a technical event but then lacking any meaningful recovery in November"

Strategic allocations to diversifying asset classes generally fared better than stocks in Q4. Real estate, fixed income and absolute return (also known as hedge funds) offered some relief from equity declines, but unfortunately insurance-linked securities, after performing very well through September, suffered a sharp reversal too in Q4 as Hurricane Michael and especially the California wildfires incurred greater losses than expected.

Most of our client pension plans saw their target hedge ratio and associated target duration increase during Q3 as yields rose, and so they had some greater benefit from the subsequent decline in yields in Q4. From a tactical perspective, we had (unfortunately) remained slightly underweight the new higher duration targets, typically by 0.5% of target hedge ratio, e.g. 49.5% instead of 50% hedge ratio. With yields having now fallen so much, some pension plans will re-risk (lower) their duration and hedge ratio according to their policy. From a tactical perspective, we are keeping for now the slight underweight to target duration, but we will continue to reassess.

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We did raise our outlook for emerging markets assets during Q4. Although cautious about further volatility, the deep sell-off in emerging market currency earlier in 2018 made the valuation attractive enough to erase our underweight and return to a neutral allocation. If we are approaching the end of the FOMC's monetary tightening cycle, then we may also be close to a medium-term peak valuation for the dollar. Valuations in stocks and credit (investment grade and below) have become more attractive over the past three months, but we are first waiting to see how much fundamentals will weaken before renewing our appetite for these assets.

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