THE VIEW FROM HERE

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STEPPING BACK FROM THE CLIFF'S EDGE

After nearly 10 years of economic expansion and a bull market, the sheer length of this latest cycle was always going to be a concern. We all knew this couldn't continue forever, so the question became, "How will it end?" With investors across the globe attempting to divine the tipping point, market sentiment became increasingly important to market performance, with each new headline being digested as the tell-tale sign of what's to come. In this environment over the past few years, we likened market sentiment to investors gripping to the top of the towering cliff that they had climbed over the past decade, waiting for the slightest breeze to push them over the edge into the abyss. At the same time, however, no one wanted to miss out should the climb continue to even greater heights…

It was for this reason that, back in the inaugural September 2018 paper of this series "The Good, The Bad, and The Ugly" as well as a follow-up note in October, we advocated for deleveraging client balance sheets and de-risking portfolios that had inadvertently or intentionally become overweight risk. In our opinion, continuing to overweight portions of the market that are driven by momentum or those which carry greater sensitivity to investor sentiment was akin to stepping in front of a bulldozer to pick up a few extra nickels. Our view, at the time, was concerned primarily with the potential of far greater downside risk then upside opportunity.

We do not like market disruptions, volatility spikes, or bear markets any more than anyone else but, in our opinion, what we have witnessed over the past 2-3 months is a return to a more normal market environment – high volatility, a welcomed return of focus on fundamentals, and more reasonable valuations. History suggests that the current market downturn may continue for a while, but we view this as an opportunity to reallocate client portfolios at more realistic valuation levels. An additional benefit of reallocating portfolios during such a period is that it allows for the prudent harvesting of tax losses. As such, we have sought to capitalize on this benefit in order to potentially reduce the unrealized tax burden that accumulates during a long bull market. While we are still cognizant of many of the risks which we discussed in September and see now, in some cases we believe the recent sell-off has provided attractive entry points for a disciplined and pragmatic investor.

MARKET SENTIMENT CAPITUALTES TO NEGATIVE HEADLINES

With market sentiment appearing to be a predominant driver of performance over the past few years, it was only a matter of time before the euphoria and "over-buying" any good news gave way to doom-and-gloom. We now believe that investors are "over-selling" any bad news (even if it is only potential bad news). The Q4 sell-off has been so significant that most major global asset classes ended 2018 in negative or only modestly positive territory, despite a strong start to the year and positive economic data.

There most certainly are risks to be concerned about, but investor sentiment seems to have fallen off a cliff, far below what is warranted given the actual state of affairs.

First, let's summarize the potential negatives:

• The partial U.S. government shutdown and budget squabbles over funding for a border wall. This makes for breathless headlines and political brinksmanship, but, historically, the markets have shrugged off temporary shutdowns. In addition, with only non-essential government services on furlough (approximately 25% of the government), the economic risk is negligible.

• Massive and rapidly growing government debt and deficits. This is a real problem and will almost certainly get worse with a split government. So far, the markets seem to be ignoring this issue, but it may become more "real" and tangible when arguments over raising the debt ceiling heat up in earnest next March.

• Continuing trade tensions between the U.S. and China. The markets rallied briefly when, during the G20 meeting in South America, President Trump announced there had been "significant progress" in discussions with China. Perhaps, but the devil is in the details, and when it became clear that details were hard to come by, the markets sold off hard. Slow progress appears to be the current path, which the markets generally will view as positive.

• Central Bank Policy. There is a distinct "desynchronization" of global central bank policy, with the U.S. and the ECB tightening (or, at least, reducing the level of easing), while China, Japan, and the U.K. remain largely accommodative. This has been one driver of current market volatility.

• The U.S. Federal Reserve Bank wants to continue a disciplined rate "normalization" policy, and, as expected, raised rates an additional 25 bps in December. But recent signals from the Fed suggest it may back-off of its planned 3-4 rate hikes next year, as the economy slows and the markets have free fallen over the past quarter. The consensus opinion now is that the Fed may raise rates 1-2 times next year but will be increasingly sensitive to economic and market indicators going forward. In fact, Fed Chairman Powell has publicly affirmed this policy approach in January to assuage market concerns from his December comments that the Fed was on a firm rate-hike path.

• The recent release of December employment data showed that U.S. Nonfarm Payrolls surged 312,000, the Unemployment Rate actually ticked up to 3.9%, and Wage Growth jumped 3.2% from the year prior. This data significantly defied market expectations of a 176,000 increase in payrolls, the Unemployment Rate falling to 3.6%, and Wage Growth hovering around 3% on the year after a 0.3% increase in November. The Unemployment Rate unexpectedly rose as 419,000 new workers entered the labor market and the Labor Force Participation Rate increased to 63.1% (source YCharts). To us, this confirmed our September belief that the economy was not yet at full employment (despite the historically low rate) as sufficient slack remained to encourage long-frustrated workers to reenter the booming job market.

• While this new information was received positively as a welcomed reprieve from the negative sentiment pulling markets downward, employment data can be a double-edged sword. On the one hand, it demonstrated that the economy is not yet at full capacity or overheating and may yet have room to continue steadily expanding. Coupled with this, a spike in wage growth should not be viewed as an inflationary concern so long as productivity is increasing as well (which has been the case). On the other hand, such strong data could reignite the argument for more quickly tightening monetary policy – i.e. raising rates – to head off potential inflation. In addition, employment data is sometimes viewed as a lagging indicator which may imply the best days are now behind us. In our view, however, the latter is not the case. We continue to believe adequate capacity remains as the economy breaks out of the lackluster recovery experienced in the years after the Great Recession.

• We believe that some of the current market anxiety is natural. We were told for almost a decade that "Quantitative Easing" – flooding the global markets with liquidity – was positive and supportive for the value of risk assets – and it was. So now that the Fed (and, to a lesser degree, the ECB) is pulling liquidity out of the markets, we somehow are supposed to believe that it will not be bad for the value of risk assets? We don't think it works that way. The Fed will have to delicately balance its policies of rate increases, bank reserve interest rates, reducing its balance sheet, and market liquidity in order to navigate away from risks like inflation or spurring a recession.

• We are increasingly concerned about the state of the public interest rate & credit markets. The credit quality of the US Investment Grade bond market is deteriorating, with the majority of issuance now rated BBB – the lowest investment grade level. When the next recession eventually comes, if more than even a few of these issuers fall into non-investment grade status, we don't believe the High Yield market has sufficient liquidity to absorb the volume without significant price disruption. We've spoken with multiple fixed income managers over the past few weeks, all of whom are increasing their cash positions in anticipation of this disruption eventually occurring (and positioning themselves accordingly to buy assets at significant discounts).

• There are certain geopolitical events that have, to one degree or another, generated anxiety in the markets. Specifically, the ongoing fiscal and budgetary disagreement with Italy (the Eurozone's third largest economy), the ongoing uncertainty over "Brexit" (and accompanying political turmoil for UK Prime Minister Theresa May), the fall from power of German Chancellor Angela Merkel, the riots in France over a proposed fuel tax, and the ongoing tension in the Middle East over the assassination of journalist Jamal Khashoggi. None of these issues individually seems concerning enough to overturn a generally positive global economic environment, but collectively they appear to be contributing to heightened investor apprehension.

In the context of all this potential bad news, along with other real risks, it is understandable that investor sentiment has fallen and anxiety increased.

But now let's examine the other side of the coin – the positive news:

• The U.S. economy is going strong and is expected to remain so through most of 2019 and potentially into 2020. It probably will not maintain its torrid pace of the past 2-3 quarters, but even though this most recent economic recovery has been historically long (though low and slow), it still seems to have some legs left.

• Inflation remains under control – wage inflation in the U.S. is increasing only slowly, and commodity prices remain repressed by slowing demand and a strong dollar. U.S. inflation remains well within Fed targets and, outside the US, inflation simply is not an issue.

• Interest rates remain low, historically speaking, and also under control. Rates had begun to grind higher earlier in the year as the Fed tightened fairly aggressively and the economy expanded. But with inflation under control and the recent "flight to quality" rally in prices (reducing yields), the 10-year Treasury once again is trading below the psychological barrier of 3%. This helps equity valuations as well as corporate (and government) debt servicing.

• From a portfolio management perspective, a steady increase in rates creates an environment in which we can more efficiently solve for client's income needs while controlling for the overall risk profiles of portfolios.

• The non-U.S. global economy remains expansionary, though slowing. Many central banks remain accommodative or plan to become more accommodative during 2019 as their local economies decelerate and inflation remains muted.

• U.S. earnings remain strong, though they, too, are expected to decelerate over the course of 2019 as the impacts of tax reform (e.g., repatriation of offshore profits and heavy stock buyback programs) begin to taper off. But, even after stripping out these transitory events, corporate revenues and earnings should show reasonable positive growth.

• Valuations have returned to earth. It can be argued that the market got ahead of itself through the first three quarters of 2018, raising equity valuations to levels well above historical averages. But the combination of strong earnings, low interest rates, and falling prices have brought down equity P/E ratios to much more "normal" levels, especially outside of the U.S. At some point, should valuations continue to fall, investor bullishness will return, given the underlying strength of earnings and the economy.

As we stated in the introduction, we do not relish periods of market disruption, spikes in volatility, or large sell-offs. But it is imperative for one to keep in mind that the experience of Q4 2018 represents a return to normalcy. We welcome the return of a market that focuses on fundamentals and values investments based on such. In addition, we view this environment as an opportunistic one. With a dedicated eye on underlying realities instead of broad (often irrational, in our opinion) sentiment, we believe the current environment may provide some attractive long-term entry points for several asset classes.

With the above as a backdrop, surveying the current economic and investment landscapes, we now turn to what we see moving forward.

TAKING A STEP BACK TO MOVE FORWARD ONCE AGAIN: ECONOMIC & MARKET OUTLOOK

The global economy continues to (slowly) expand, though there is a distinct deceleration and "desynchronization" of growth. The U.S. economy shows continued growth, though forecasted to slow in 2019. At the same time, the rest of the world appears to be decidedly decelerating – still expansionary, but slowing down – especially in Europe, Japan, and China.

U.S. Inflation remains stable and in line with Fed targets, and we maintain our belief that it does not represent a threat to continued economic expansion. Wages in the U.S. are increasing only slowly (though showing signs of acceleration), oil prices have fallen significantly over the past three months, and overall commodity prices remain repressed by slowing demand and the strong dollar. Outside the U.S., inflation simply is not a problem, and, in fact, Europe may soon have to worry once again about entering a deflationary regime.

The positive impacts of fiscal stimulus, tax reform, and regulatory relief remain in place, but should begin to taper as we head into 2019. The Fed previously had laid out a fairly aggressive tightening program over the next 12-15 months, but there is now some belief it may "back-off" of that plan in the face of the recent market correction and expectations for a slowing economy in the latter half of 2019.

Solid U.S. GDP growth, as well as respectable earnings and revenue growth, make for a generally positive market environment and, despite the recent sell-off, we maintain a generally optimistic outlook for U.S. stocks over medium- and longer-term time horizons (though the current correction and disruption may continue over the short-term).

Ongoing trade tensions between the U.S. and China, European tensions over Italy's fiscal state and the U.K.'s struggles with "Brexit", and decelerating non-U.S. economic growth seem to be the largest potential threats to the current economic and market regimes.

Emerging Market and EAFE (Developed International) markets continue to be hurt by a generally strong U.S. dollar, slowing economies, trade tensions, and a corresponding "risk-off" mentality driving investment outflows. That said, due to relatively attractive valuations following the steep price declines earlier in the year, investors are beginning to reconsider these markets from a longer-term perspective. These markets posted strongly negative performances in 2018, in both local and U.S. terms, and will continue to exhibit higher volatility, but we still like them as longer-term positions and opportunistic entry points, from both a valuation and economic growth perspective. In addition, we believe the U.S. dollar strengthening cycle which has plagued these markets recently will begin to wane in severity.

At current interest rates and credit spreads, the public credit markets continue to look very expensive to us, and our return expectations are muted accordingly. We are nearing the end of the current credit cycle and risks are increasing, especially in the high yield space, which is often a harbinger of an impending market correction.

The leveraged loan market (i.e., floating rate bank loans) has seen a decided deterioration in both the credit quality of borrowers and in loan covenant structures – both distinct warning signals.

Likewise, the traditional investment grade bond market has seen a downturn in the average credit rating of borrowers. This could have dramatic implications if / when the next recession hits and corporate revenues decline. Many investors are turning to shorter-duration bond strategies and even cash solutions, which finally have a positive real yield again due to the Fed rate hikes. The yield curve is so flat that investors simply are not being sufficiently compensated to take on term or duration risk, despite the recent "flight to quality" rally. For investors who can access the private markets and handle some degree of illiquidity, we believe there are better opportunities in the private versus public credit markets.

Given the current uncertain state of the public equity and credit markets, many investors are revisiting the use of alternative investments within their portfolios, both for diversification purposes and as a means of accessing lower-correlated sources of potential return. We continue to believe that certain alternative investments may deliver superior performance than their liquid alternative brethren, because of less liquidity and leverage constraints.

We previously muted our short-term expectations for real assets and the overall commodity complex, due to lower than expected global inflation, slowing demand, falling oil prices, and the strong U.S. dollar. However, we are beginning to believe that these markets have been over-sold and may be poised for a comeback as we head into 2019.

While we generally are constructive on the global economy and overall market performance, the public markets are "rationalizing", and the market volatility we long expected has materialized. We still believe that the market can move higher over the next 6-12 months, but we do not expect it will be the smooth ride that investors have become accustomed to over the past 10 years.

CONCLUSION

In summary, we believe the tide of market sentiment has turned, but irrationally so. That investors "over-bought" good news in the first three quarters of 2018 and very quickly shifted to "over-selling" bad news at the end of the year, signals to us that market sentiment had become an overwhelming and irrational driver of returns. In our opinion, this overreaction will correct itself, and from the trough of this sell-off, a renewed focus on fundamental determinants of investment valuation can send markets higher again. Along the way, we will look for those opportunities that provide attractive entry points for client portfolios, while remaining cognizant of risks on the horizon.

To be sure, there are risks across the globe, be they economic, market, or geopolitical risks. But the U.S. economy is strong, the global economy is slowing but still expansionary, interest rates are low by historical standards, inflation is muted, and corporate earnings continue to stand on solid footing. We do not expect that the market leading performers of the past decade will be the same leaders moving forward, and, in fact, an increase in volatility and dispersion may change the market landscape significantly. For this reason, we continue to favor positioning portfolios in a more defensive stance, with the goal of potentially limiting our downside risk exposure. From this stance, we can wait patiently – with some dry powder on hand – for attractive opportunities as they arise.

While the increased market volatility can be difficult to endure for some, we believe focusing on a disciplined and pragmatic investment process and continued alignment with long-term financial objectives remains the appropriate course of action.

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