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The Digest For A Turnaround

How do we know when the washout is over? What do we analyze to help determine when and if stocks can begin to turn around and restart their uptrend? What should investors do during times of excessive volatility and a high level of uncertainty?

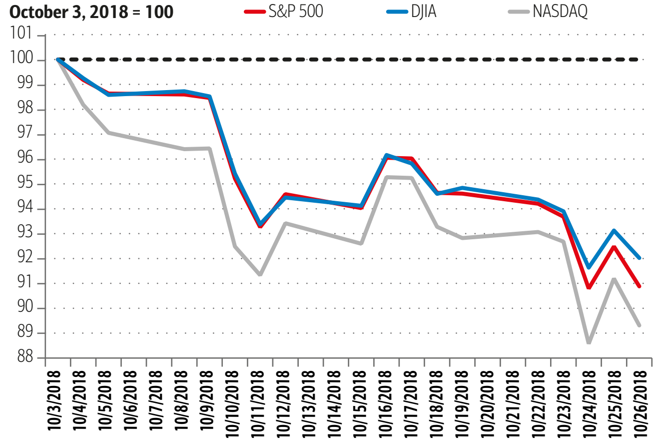
In the following report, the Chief Investment Office attempts to answer these important questions in order to help reposition portfolios for the balance of this cycle.

WHAT CAUSED THIS LATEST MARKET CORRECTION?

The downdraft began in earnest shortly after two speeches. On October 3, Federal Reserve Chairman Jerome Powell said that short-term interest rates were a "long way from neutral at this point, probably." This implied that rates were going higher for longer, and the word "probably" added more uncertainty, which surprised the market. Secondly, one day later, on October 4, Vice-President Mike Pence delivered a speech to the Hudson Institute in Washington regarding the U.S. and China's relationship. The main message from the speech suggested that China is waging a "campaign to erode American industrial advantages." This spooked the markets further. The negative activity across equities gathered steam for the next two weeks, before stocks ultimately fell into correction territory (which is defined as a decline of 10 percent or more from the 52-week highs) last week, as a series of events all culminated together, igniting growth fears in the minds of investors (Exhibit 1). In terms of sector activity, 7 out of the 11 sectors are in correction territory while around three-quarters of the stocks in the S&P 500 have corrected at least 10 percent.

Concerns have developed throughout October regarding the overall level of growth in the world for next year. Worries over a multitude of issues—the strength of the dollar impacting the overseas businesses of multinationals, the budget battle between Italy and the European Commission, Brexit, heightened geopolitical fears emanating from the Middle East,

Exhibit 1: U.S. Equity Market Performance Since October 3, 2018



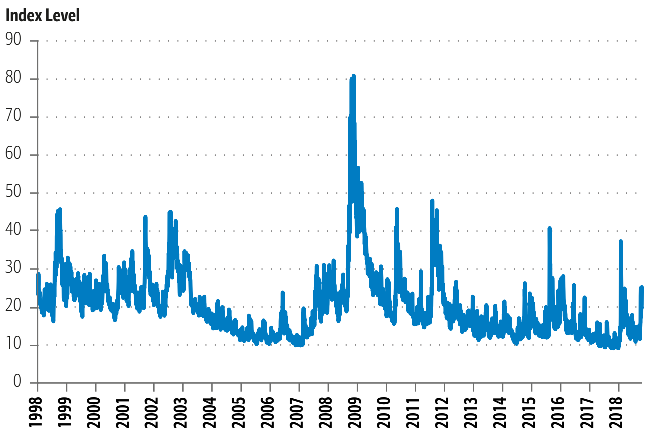
Source: Bloomberg. Data as of October 26, 2018. **Past performance is no guarantee of future results.** Performance would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend.

the sharp fall in oil prices, the ongoing tariff and trade "war" with China, and higher rates as the Fed maintains their well-telegraphed march toward their "neutral fed funds rate"—have all contributed to the continued sharp pressure on equities. This has increased volatility and sparked a significant portfolio re-positioning wave across various asset classes and a major re-pricing of risk within equities.

Given the length of this current economic cycle, which could be the longest on record without a recession, post the midway point of 2019, and the fact that we haven't had a bear market decline, as defined by a 20 percent or more drop from 12 month highs, since the depths of the Great Recession in 2008-early 2009 (the S&P 500 came close—down 19.7 percent—during the fiscal cliff worries and U.S. debt downgrade in 2011), investors are on edge and reacting to any signs that a growth slump could be on the horizon. Is it time to panic and completely exit the markets? No. We view this latest sharp decline in stocks as a correction phase, one driven mainly by psychological fears that the cycle is over, plus heightened geopolitical uncertainty, rather than a warning shot that a recession or hard economic landing is in the near future.

Moreover, the sharpness of this correction has been accelerated by technically-driven selling as key index levels have been breached throughout the month of October. With the increased inter-connectedness of global markets and trading programs—not to mention the wide reach of the machine-based quantitative investment funds—a downdraft in equity markets can happen quickly and catch many by surprise. We call this "episodic volatility." In addition to these quick moves, as the Fed continues to broadly tighten policy, we are transitioning to a regime of average levels of volatility. For the Chicago Board Options Exchange (CBOE) Volatility Index, ticker symbol VIX, that average level is around 20, which seems unnerving for most investors coming out of the lower than normal 11 level in 2017 (Exhibit 2).

Exhibit 2: CBOE VIX Index since 1998



Source: Bloomberg. Data as of October 26, 2018.
Past performance is no guarantee of future results.

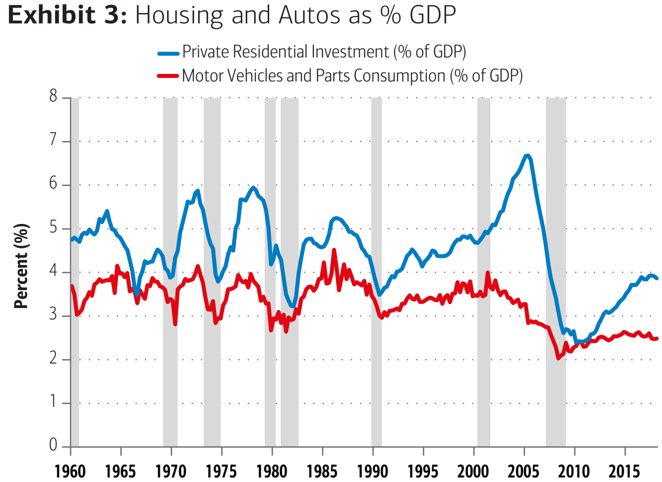
We believe this washout needs a little more time before it begins settling down, primarily due to more technical factors and key index levels that we have yet to reach this time around, relative to the lows in February. The lowest level for the S&P 500 in February was approximately 2532 (it closed at 2658 on October 26), as fears grew that the Fed was going to hike rates too much, potentially causing an inverted yield curve if long-term yields fell below short-term rates, and eventually pushing the U.S. economy to roll over into a recession. Markets consolidated in the spring and eventually recovered to new all-time highs by the end of September, as the prospects for corporate earnings were revised upward and the U.S. economy broke away from the rest of the world.

In addition, since World War II, according to Bloomberg, the average correction in the stock market is about 13 percent and lasts around 4 months, which would place the S&P 500 at around 2558. This is important because as growth fears develop, a re-pricing of risk gathers momentum, which induces a valuation re-set (the valuation premium is wiped away). This causes markets to settle down to lower levels that are more "appropriate" given the expectations for higher rates and slightly lower growth in the next 12 months. We view a valuation re-set as a normal market development, particularly this late in the cycle, and especially as the largest central bank in the world, the Fed, is normalizing monetary policy.

WHY ARE WE STILL CONSTRUCTIVE ON THE U.S. ECONOMY AND REMAIN FAVORABLE ON EQUITIES?

In our view, the equity-market weakness is not due to the economy, as many fear, but rather to a confluence of policy risks, as described above. Although some may point to the weakness in housing and auto sectors as warning signs that the U.S. economy is getting tired and is about to roll over, we don't share that view. In fact, according to our BofA Merrill Lynch Global Research economics team, home construction and auto sales as a share of gross domestic product (GDP) (Exhibit 3) tend to peak in the second-half of business expansions—but that does not tell you whether the economy is in the fifth inning or ninth inning of the expansion. In addition, we view the recent housing slump as a "growth pause" due to higher rates; but favorable patterns, driven by the millennial demographic, should keep the long term trend attractive for years to come. We do believe U.S. economic growth is set to slow next year, from 4.2 percent in Q2 and 3.5 percent in Q3 this year, but it should still remain above trend, at a healthy rate, around 2.6 percent or better for the full year 2019.

Exhibit 3: Housing and Autos as % GDP



Source: U.S. Bureau of Economic Analysis. Data as of Q3 2018.

WHAT SHOULD STILL POWER THE U.S. ECONOMY NEXT YEAR?

Consumer spending is running strong, as borrowing rates still remain low and the debt-service-to-income ratios are around record lows. This is primarily due to the deleveraging that took place after the credit crisis and the rise in income levels in the last few years, as the job market grew handsomely. Consumer confidence remains high and, given that there are still more job openings than available workers to fill them, we expect optimism to remain and full employment at much lower levels than normal. Business confidence is also strong, particularly at the small business level, which tends to be the main engine of job growth and the economy overall. We expect an increase in productivity in 2019, as business investment picks back up and output per worker rises. Although overseas growth has slowed in Europe and China, Japan is powering ahead with their own positive economic initiatives; and we expect China to ultimately put in place a sizable fiscal stimulus to help balance out the tariff and trade impact that has put downward pressure on their economy. Finally, we also believe corporate guidance for the fourth quarter and next year will need to stay positive, or at least in line, in order to wipe away the skepticism that rising material prices are weighing on profits.

We expect profit growth in corporate America to increase again next year. For 2019, we currently expect S&P 500 earnings to rise about 6-7 percent from the closing base in 2018, which is below consensus but still healthy. And, yes, we believe we are at peak earnings growth, given the significant strength we are seeing this year, at over 20 percent. But we do not subscribe to the view that the level of earnings overall has peaked. In other words, we see earnings growth slowing next year and beginning to track closer to nominal GDP, rather than 3-4 times that level. Since equities are a discounting mechanism of future expectations, the relative change in growth does matter. This is usually why valuation premiums get re-set when slower growth is forecasted. Sometimes these re-pricings of risk go too far, as emotion takes over and the worst-case scenarios (i.e. hard landing, recession, systemic crisis) are discounted. When this occurs, the market can often overshoot to the downside.

Throughout this year we have been saying that earnings are going to have to do the heavy lifting in order for new highs in the broader market to materialize. We witnessed this in late September (S&P 500 hit an all-time high of 2941, or less than 2 percent below our top end target of 3000), as the profit engine in the U.S. strengthened considerably from the beginning of the year. This was mostly due to organic growth, with some benefit from the fiscal tax reform. Capital spending and a healthy consumer were the main catalysts. We expect this to continue into next year, even if the growth level in the economy settles down closer to the mid 2 percent mark, from over 3.5 percent in the most recent quarter. This is important because we are now heading into the time of year that has traditionally produced the largest gains in the overall market. The strongest six-month period of the year, since 1928, according to Bloomberg and BofA Merrill Lynch Global Research, has been between November and April, which has produced average returns of around 5 percent (up 71 percent of the time).

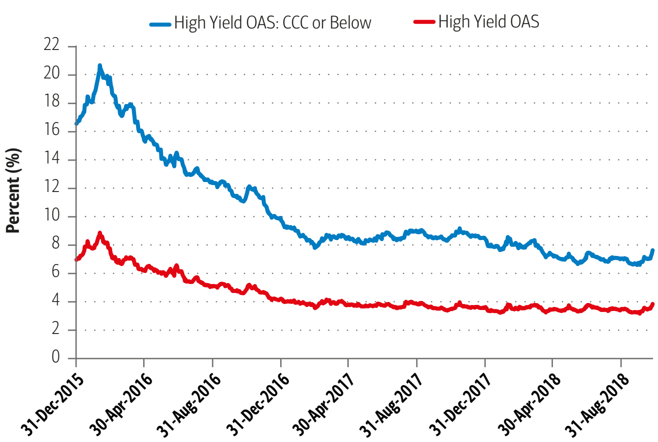
Lastly, given our belief that the current episode is a regime shift—a period that begins to price in a different economic backdrop and new policy responses—we would be ready to use liquidity (excess cash) to average into equities over time. This time around the cycle is shifting from secular stagnation (a majority of years post the financial crisis), characterized by below-trend economic growth, record low rates, constant deflation concerns, and low volatility, to a reflationary type of cycle that exhibits higher economic growth, higher rates, a pick-up in inflation, and higher volatility. This shift requires portfolio repositioning. The leaders of the last cycle won't necessarily lead, in such magnitude, in the new part of the cycle.

This regime shift is most evident in the rise in yields, which is forcing a change to exposures across asset classes. Equity valuation has been re-priced downward by over 20 percent, from around 19 times forward 12-month earnings on the S&P 500, to below 15 times currently. Increasingly, as the Fed tightens and interest rates rise, it will be hard for valuations to retrace higher. And short-term yields (2-Year Treasury yields are over 2.80 percent) are now considerably above the dividend yield of the market (S&P 500 dividend yield is about 2 percent). This creates competition between allocations to core equities and some areas of shorter duration fixed income. It wasn't too long ago that cash yields were close to zero percent. At this stage, an increase in diversification across and within asset classes becomes more important. We view equities as back to fair value at current prices, based on more conservative growth expectations, and the fact that we still forecast yields to grind higher, not shoot higher. Therefore, with our view of good growth mixed with a balanced Fed policy, we are still constructive on equities on an absolute and relative-to-fixed-income basis.

WHAT ABOUT FINANCIAL STRESS? HAVE YOU SEEN ANY SPECIFIC WARNING SIGNS?

We have not seen specific warning signs of financial stress at this juncture in the U.S. We typically analyze the credit markets first and, more specifically, credit spreads in the U.S. and overseas (including bank debt). We then assess a broad set of leading economic indicators, the health of corporate and household balance sheets, the slope of specific parts of the yield curve, employment statistics, and the relative performance of various sectors of the economy. We have not witnessed a breakdown in lower-quality credit (high yield), which would typically experience a significant widening out in spreads (Exhibit 4). In addition funding stress would be picked up in bank debt spreads, which has not occurred; and although the yield curve has flattened slightly in the past week as longer term yields have come in, the 10-year to 30-year yield and overnight rate to 10-year yield differential are still suggesting a mid-cycle, not the end of the cycle, phase (Exhibit 5).

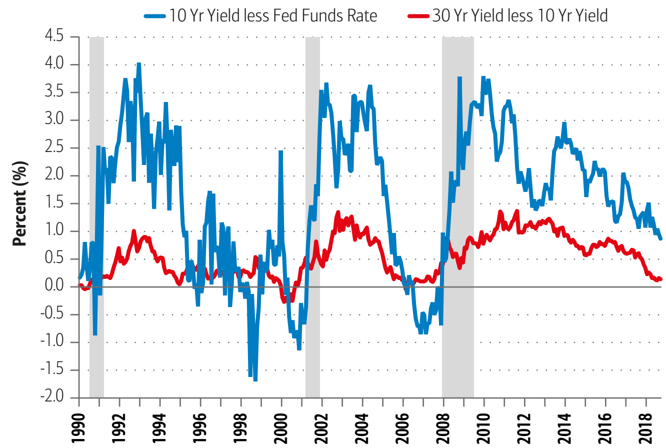
Exhibit 4: High Yield Spreads Have Remained Tight



Sources: ICE BofAML; Federal Reserve Bank of St. Louis. Data as of October 26, 2018. Time period chosen is chosen to illustrate more recent trends.

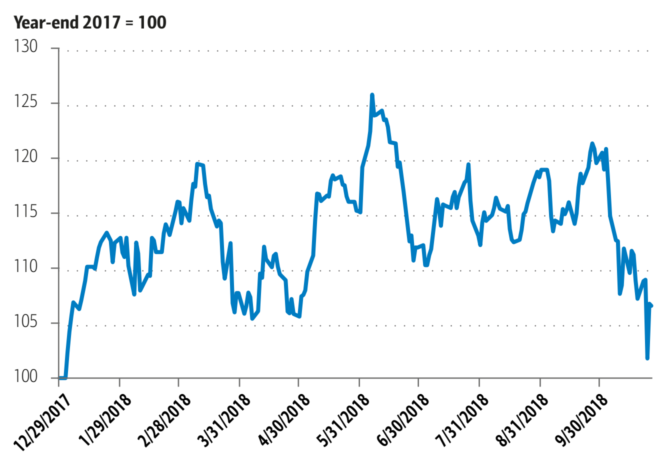
The areas that some market watchers have been pointing to as more than a growth scare include the rise in Italian 10-Year government bond spreads relative to German bunds, the relative performance of Utilities to Technology stocks (Exhibit 6), the fall in Financial stocks (Exhibit 7), the significant underperformance of housing and auto stocks (Exhibit 8), the recent rise in gold prices and the large fall in oil prices (Exhibit 9). We characterize these adjustments in a few ways. The excessive outperformance of growth or momentum stocks, led by the Technology sector, became way too extended and needed to remove some of the premium, as the growth outlook overall was revised slightly lower. This is also the case when you examine value versus growth as style factors and, geographically, with the U.S. versus the rest of the world. Furthermore, a normal re-set to lower economic growth projections in more economically sensitive sectors, plus a move to hedge geopolitical risk with gold exposure, has occurred. As far as the 12 percent fall in oil prices in the past month is concerned, we believe this is due to a small decline in emerging market (EM) demand; but mainly due to the recent move to raise the level of supplies. Finally, the Italian budget situation remains a real concern, and we will be watching this closely for any signs of contagion spreading to other parts of Europe. In general, measures of financial stress in emerging markets (EMs) are currently higher relative to the U.S., as indicated by the deeper correction in EM and Chinese equities, a decline in the Chinese Yuan, and fiscal stress in Argentina and Turkey.

Exhibit 5: Yield Curve Measures Suggesting the Economy is in Mid-Cycle



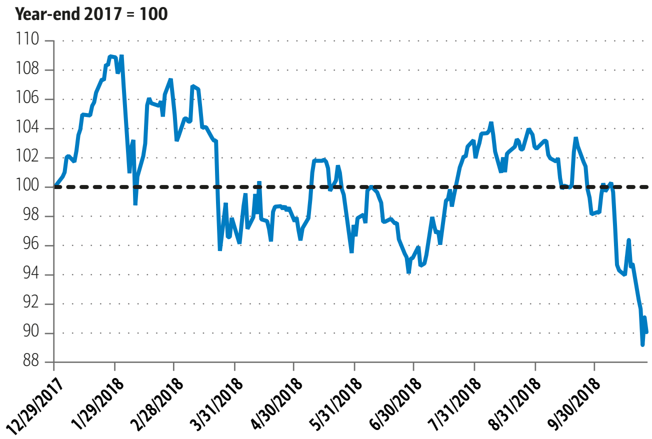
Figures represent monthly, end of period values.
Sources: Federal Reserve Board; Haver Analytics. Data as of September 2018.

Exhibit 6: Relative Performance of Technology vs. Utilities Since December 29, 2017



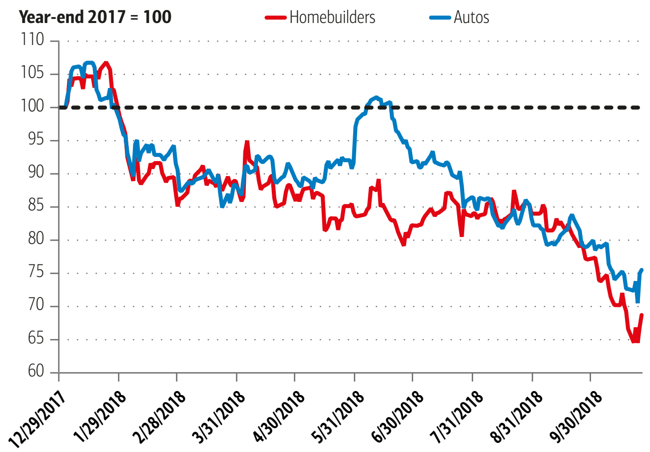
Source: Bloomberg. Data as of October 26, 2018. **Past performance is no guarantee of future results.** Performance would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend.

Exhibit 7: Bank Stock Performance Since December 29, 2017



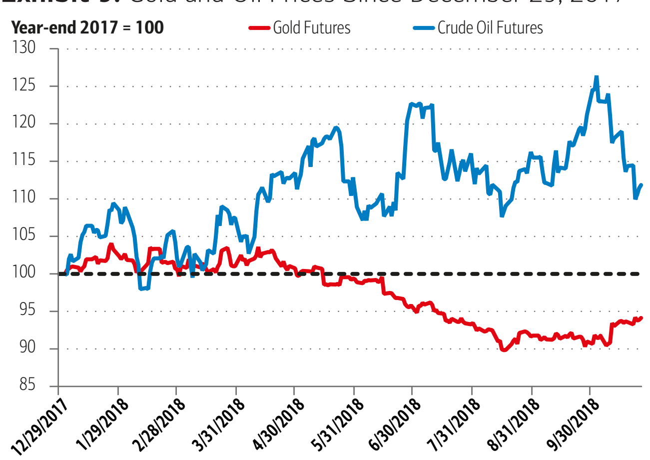
Data represent the S&P 500 Banks Index. Source: Bloomberg. Data as of October 26, 2018. **Past performance is no guarantee of future results.** Performance would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend.

Exhibit 8: Homebuilders and Auto Stock Performance Since December 29, 2017



Source: Bloomberg. Data as of October 26, 2018. **Past performance is no guarantee of future results.** Performance would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend.

Exhibit 9: Gold and Oil Prices Since December 29, 2017



Source: Bloomberg. Data as of October 26, 2018. **Past performance is no guarantee of future results.** Short term pricing analysis shows recent trend and may differ from other time periods.

WHAT ARE THE MAIN RISKS?

As with most market environments there are still some risks out there that are high on the wall of worry. These include the heightened level of geopolitical risk, given the recent developments in Saudi Arabia, the uncertainty over our own mid-term elections, the rising potential for a power shift in Germany's regional elections and the beginning of the post-Merkel era, Italy's budget battle with the European Commission and the potential for wider spreads on Italian debt, a Fed bent on pushing rates more than the market expects in 2019 (3 hikes versus 2 expected), and the growing concern that a trade "war" with China lasts a lot longer than expected and disrupts the global supply chain, which would raise costs for multinationals. These concerns will need to be constantly assessed in the coming weeks and months. We do not expect them to alter the growth outlook in a way that rolls the economy over into a hard landing.

WHAT NEEDS TO DEVELOP TO STABILIZE, AND EVENTUALLY RESTART, THE UPTREND IN THE MARKET?

We believe it's important to not overly complicate this latest downdraft. Market cycles can take on a number of different paths as the cycle is maturing, and there are usually core elements that determine the difference between the cycle ending in a recession, or more of a soft landing, in which equities correct sharply but do not fall into bear territory. This time around is similar to the February 2018 drawdown, as well as the late 2015 – early 2016 slump, in our view. Both market episodes occurred mainly due to growth scares and also included a strong dollar, a yield curve that flattened, a Technology sector that became over extended, Fed hike worries, Chinese Yuan weakness, and elevated geopolitical risk. Growth slumps can cause portfolio repositioning such as we are witnessing now. Sometimes it can be sharp depending on how much the leaders outperformed the rest of the broader market and depending on the time traveled from the last bear market decline.

We believe we will need to maintain above trend growth (above 2 percent real GDP) in the U.S. for 2019, global GDP growth at or above trend (real GDP around 3 percent), corporate earnings growth close to nominal GDP growth or higher (above 5 percent), a budget agreement between Italy and the European Commission, an increase in the possibility for a Fed pause, if needed, stable inflation, and not necessarily an end to the trade "war" with China, but rather evidence that input costs are not rising above the level of revenue growth, particularly in the industrial sector. In this regard, nominal GDP growth above 5 percent should help spur top line growth that's high enough to support corporate margins, as some input costs are rising. China's recent fiscal stimulus is being closely watched for its stabilizing effect on economic growth into 2109, and ultimately recovery of asset prices broadly within the EM universe.

If these developments materialize, we would expect investors to begin to raise their risk exposure over time. This would create a "climb the wall of worry" environment again, with each earnings season remaining the core catalyst. Strong economies often do not produce above-average capital market returns, because risk assets typically already discount the good news. We experienced this enthusiasm in 2017 and again in January of this year. As the cycle matures and growth slows down from above trend levels, investors begin to focus on the rate of change versus the absolute level of growth. Therefore, since we are later in the market cycle, we expect equity returns, on average, to begin to settle down closer to the level of nominal GDP growth (5-6 percent or slightly higher) versus above 14 percent, on average, which investors have had the opportunity to experience since the lows of the global financial crisis in March 2009.

WHAT SHOULD INVESTORS DO?

We believe investors should raise the level of diversification in portfolios, particularly in equities, and use shorter duration fixed income as a way to add some income and help protect against higher equity volatility. Diversification works when you need it the most! Our portfolio models are designed to diversify risk. We also expect a wider opportunity set in active management relative to passive, given the increase in volatility, our forecasts for lower index returns, and an increase in dispersion amongst industry groups and stocks in general.

We continue to maintain our favorable view on equities, as long as economic growth remains good, and would continue to have a higher allocation in shorter dated fixed income (inclusive of cash) relative to longer duration. Within equities, we maintain our higher quality bias with a preference for the U.S., relative to our strategic benchmarks. We are still neutral on commodities and non-U.S. developed markets, given Europe's political and economic headwinds. We would raise our weighting in commodities if inflation was expected to trend much higher and/or a long cycle of dollar weakness was beginning to develop.

During this market weakness we would have an allocation plan ready, as the dust settles, to add to specific exposures. We would use emerging market exposure for long-term growth; and the same view applies to the Technology and Healthcare sectors, specifically in the U.S. We believe the Financials sector has corrected too far and has become more attractive. The Industrial sector should continue to have some "tariff and trade" headwinds against it, so we expect more attractive prices in the coming months. We believe that value has begun an overdue catch-up phase versus growth, but we caution on switching completely from one style to the next. We prefer a diversified mix between both, with a slight preference toward value.

In terms of core company characteristics, we prefer strong balance sheets overall, companies that are not in need of financing, have solid dividends and are growing them, firms with strong free cash flow, (increasingly important as interest rates are rising) and their shares are not trading at sizable premiums. In growth companies we prefer those that are growing handsomely above the market rate, have good balance sheets, and can evolve their strategic business plans alongside key themes that are catalysts of future growth. We would focus on managers that have a tendency to increase exposure to the company characteristics mentioned above.

As we discussed at the beginning of this report, it is important not to panic during times of significant market stress, especially as the prospects for the economy remain constructive. Predicting market bottoms is very difficult and not a consistently successful strategy, in our opinion. In contrast, understanding the fundamental catalysts needed to establish stability and eventually turn back up, can help investors take advantage of large downdrafts that do not include hard landings in the economy. Have a plan ready and reposition or rebalance over time as markets begin to stabilize. Let the volatility settle down while the technical factors work themselves out and shorter term speculators exit. We are staying the course.

IMPORTANT DISCLOSURES

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It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax (AMT).

The investments discussed have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT).

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