Stegent Equity Advisors Investment Letter

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The beginning of the first quarter was serene and pleasurable, as equity markets levitated on the back of increasing earnings expectations and solid world economic underpinnings. But the market euphoria didn't last long. February saw volatility awaken from its slumber with a jolt, kicking off a long-anticipated correction that reminded investors there is never a free lunch in the world of investing. As the quarter progressed and the correction intensified, investors were forced to endure an emotional roller coaster as markets swung wildly. By the end of the quarter, most developed markets had chewed through early year gains and returns fell mildly into the red. As we start the second quarter, investors are left to wonder if the market is turning from bull to bear, or just correcting from an overbought and highly complacent condition.

Catalyst 1: Inflationary Transition

The start of the volatility spike was largely predicated on an inflation scare resulting from details within the January employment report indicating that long stagnant wages were finally beginning to rise. This catalyst appeared to align with the idea that the economy is transitioning towards the late phase of the cycle, causing markets to begin to discount the possibility that the disinflationary backdrop that has characterized the environment ever since the financial crisis is gradually turning more inflationary.

While inflation has been dormant for many years, there are several reasons to believe that inflationary green shoots are beginning to develop in the U.S. economy. From a cyclical perspective, actual GDP growth rates are starting to outstrip potential growth, meaning that aggregate demand has reached the point where it is starting to outstrip supply which typically causes prices to rise. One part of the economy where this seems evident is in the labor market, where the unemployment rate has already fallen below the equilibrium level that usually signals a pickup in wage levels. Other cyclical inflationary catalysts include a weak dollar and commodity prices that are steadily rising.

To compound the cyclical backdrop, the current administration's stance on trade and immigration also suggests a more structural foundation for inflation is building as the pendulum appears to be swinging from peak globalization towards protectionism. As this gradual transition from disinflation to inflation takes place, it's perfectly normal for markets to undergo a volatile adjustment phase, but it's also premature for a slow normalization of inflation and interest rates to end the economic cycle just yet.

Catalyst 2: Tariffs & Trade Wars

In 2017, a major theme of investment pundits was that a post-election "roadmap" was developing that would shape investment markets over coming years. The roadmap had three components. The first was that fiscal policy was set to pick up, and it has through the recent tax reform that was enacted. The second component was that the administration would focus on deregulation, and they have been addressing that as well. In 2018, these market friendly forces are still with us, but they have now been joined by the third element of the roadmap, which is a turn towards protectionist trade policy.

Unlike the first two components, which tend to be supportive of growth, earnings and markets, this last component is not generally considered a positive for the stock market. The administration's protectionist policies started modestly, but they have been escalating steadily this year, with the most recent policy measures threatening to apply tariffs on a wide range of Chinese-made goods. The market is understandably jittery about the prospects for an all-out trade war, as history has shown that although tariffs may help support certain industries, they also usually end up creating significant headwinds for the economy as a whole. While the risk of a trade war is higher than it was coming into the year, there are still reasons to believe that the threat of tariffs is being used as a high pressure negotiating tactic, and that both sides should ultimately realize that it is in their best interests to come to an agreement rather than risking a full-blown trade war that would likely damage the global economic backdrop.

Catalyst 3: Bitten by the FAANG

The latest bull market has been particularly kind to a subset of stocks that has come to be known as the FAANGs. FAANG is an acronym that stands for Facebook, Amazon, Apple, Netflix and Google, which have been some of the market darlings during the current bull market run. Believe it or not, these names have been responsible for approximately 25% of the entire market's gains since the 2016 market bottom. Recently, some of these leaders have come under fire for a variety of reasons. Facebook finds itself in the middle of a crisis of confidence, Amazon is being attacked by the White House, and the entire technology sector appears vulnerable to rising trade tensions between the U.S. and China.

Some analysts are concerned that the recent underperformance of these stocks is signaling that the broader market may be losing a major area of market leadership, and one that exerts a hefty influence on the behavior of the major indices due to the lofty weightings of some of the stocks included in the cohort. The good news for technology is that it should be the beneficiary of an increase in business spending this year, and setting aside some of the bigger companies, the sector still sports a very reasonable valuation in a market that is getting overvalued. Also, despite the latest news headlines surrounding some of these companies, the relative performance of the sector is holding up very well even in the face of trade spats and some idiosyncratic problems in select names. So, it may be too early to give up on technology at this juncture.

Base Case: Still A Correction, Not A Bear

The market has clearly been on a roller coaster ride and the correction appears to be wearing on investors' nerves as markets swing wildly from headline to headline. The exaggerated nature and speed of the moves only adds to the confusion and serves to create a feeling that something major has changed in markets. We do think the market has entered the late cycle, which is inherently more inflationary and tends to carry a higher level of volatility, but that hasn't yet altered our current base case that the market is simply undergoing a much-needed correction rather than turning towards a cyclical bear market. Some of the recent market moves have certainly been unnerving, but the weight of the evidence continues to point towards positive developments happening beneath the surface of increasingly noisy headlines.

Despite a policy backdrop that has created some new risks, it's important to remember that tax and deregulation policies already enacted are starting to flow through economic data and along with record amounts of share buybacks, should help to put a floor under markets for the remainder of the cycle. It helps that the fundamentals of the global economy are still healthy as well.
The U.S. economy still appears to be growing at a firm level, and so far, there has been no deceleration in leading indicators that would warn that this expansion is coming to an end. Consumers may be held

back somewhat due to a low savings rate, but business spending seems ripe to rise at a brisk pace given the combination of elevated confidence, tax cuts, and the front loading of business expenditures that was part of the 2017 tax legislation.

Outside of the U.S., there has been a leveling off in economic activity in various economies around the world, but for now this appears be just a deceleration in forward momentum following last year's robust synchronized upswing and not another downturn. On balance the global economy remains healthy, which should continue to support risk assets whenever this volatile digestion phase settles down.

Primary Trends Supportive, Sentiment Starting to Clear, Bottoming in Play

Despite some short-term technical damage, longer term trends in markets are still supportive of a bull market, and sentiment that was overly complacent just a few months ago is returning to a healthier level of skepticism. While recent price activity is testing investors' nerves, the good news is that the declines toward the February lows are showing characteristics of a market that is entering the later stages of a bottoming process. It would be encouraging to see a good dose of buying enthusiasm that would help to confirm that the corrective process is ending and the bull market is resuming. Of course, there's no guarantee that this will occur, especially as we are entering the seasonally weak summer months, so it will be critical to pay close attention for signs of any negative divergences during rallies. For instance, a rally back to the recent high with waning participation might be a warning sign that the foundation of the market is weakening. For the moment, the message from the indicators is that a bottom is close at hand, but it will be important to remain vigilant as this process continues to play out.

Hedging Our Bets

Despite our current assessment that fundamentals are still healthy, and that this correction is not likely to turn into a bear market, it's also apparent that risks continue to build, which makes it prudent to begin increasing some portfolio hedges to defend against a variety of risks that could prematurely end the business cycle and bring on a bear market in risk assets. The list of risks has grown recently, but perhaps the most significant for equities is a policy mistake out of Washington. If the administration accidentally miscalculates and pushes trade negotiations too far resulting in a full-blown trade war, it would very likely be a game changer for any economic or market outlook. Indeed, in the event of a trade war, economic growth globally would suffer—possibly leading to a premature recession—and it would surely rattle financial markets.

While the risk of that actually happening still appears to be low, there is no doubt that it has been steadily rising this year. Currently, we hold an optimistic view that cooler heads will ultimately prevail since it's in both the U.S. and China's best interest to dial things back, but the administration has frequently taken an unorthodox approach to addressing issues like trade and is creating uncertainties that are hard to quantify for markets. In this type of environment, it seems sensible to hold a variety of hedges in case something causes volatility to erupt again on short notice.

Diversifying Hedges More Important

Determining what hedges to use in portfolios is more complicated than it used to be. For decades, U.S. government bonds were the go-to safety trade in times of turmoil for investors. But recent dynamics are in flux for the bond market, and it's harder to trust that asset class these days. Bonds risks are heightened due to the transition to a more inflationary world, an increasing supply of government debt from Federal Reserve balance sheet reduction, and Chinese policymakers that are threatening to use treasuries as a weapon if trade tensions escalate. In today's environment, investors can't be as sure that treasury bonds can be relied upon to dampen portfolio volatility like they used to.

For the time being, we believe the best strategy is to carry a variety of hedges that may work if the worst comes to fruition. One of the most attractive hedges in a policy mistake scenario is gold, so we will begin modestly increasing positions back in the shiny metal to defend against the increasing risk of that occurring. But gold is volatile and has its own risks, so it also makes sense to carry other hedges like real estate and other real assets (farm land, crops, timber, toll roads, airports, etc.), as well as a small percentage of long term treasury bonds in case growth is cut off prematurely. In short, we are currently navigating a very tricky environment that demands some diversification within the portfolio hedges that are being used.

Conclusion

The first quarter of 2018 produced an awakening in market volatility that was overdue after the serene run in markets over the previous four quarters. This market correction has clearly been a violent and gut-wrenching affair, with numerous reasons to give the bears hope that the market cycle is finally turning south. However, looking beyond the headlines and hysteria, we still think there are solid reasons to believe that this bull cycle is not finished yet. World fundamentals still look solid and should remain supportive, and investors are arguably beginning to focus more on what could go wrong than what might go right. Our base case is still constructive, and we believe that stocks are getting closer to the end of a bottoming process that should setup markets for a more positive bias over coming quarters. But we also acknowledge that there are some risks building that must be hedged and monitored closely. The tail end of a bull market can often be the most volatile, but there is usually enough upside remaining to be worth the risks.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor. Please reach out with any questions or concerns.

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