Stegent Equity Advisors Investment Letter

Market Review
October 2018

The third quarter saw mixed performances across the major asset classes. Large cap U.S. stocks surged, developed international equities and U.S. bonds were flat, while emerging market equities experienced major losses. The clear winner for the quarter and year to date has been the U.S., as domestic investors have been rewarded with sizable gains at a time when international markets have suffered losses. The current temptation for investors is to keep piling into the U.S. since it's worked the best, but astute observers realize that past performance is not indicative of future returns. Looking into the fourth quarter, investors are left to contemplate the inconsistency that has formed between performance in the U.S. and the rest of the world, and decide whether they should position for a continuation of the current trend or play for a change that begins to close the performance gap.

Explaining the U.S. Story

The current narrative for relative strength in domestic markets isn't very complicated. It starts with solid fundamentals that have received a boost from late cycle tax cuts and an unprecedented shift towards deregulation. Supportive U.S. policy has led to recent strength in the economy, earnings, and stock prices. Second quarter GDP growth picked up appreciably to a healthy 4% pace, and earnings growth of over 20% this year has been very impressive. Clearly tax reductions and less regulation has worked to unlock short-term animal spirits, which has translated into an acceleration in economic activity and risk-taking by market participants. As the current economic expansion edges closer to being the longest of all time, an important question is how sustainable will the recent uptick in fundamentals prove to be? In order to answer that, investors need to assess a related issue regarding whether or not the business cycle has reached a tipping point where a further acceleration in the economy will start to become counterproductive for markets by causing things to overheat.

The Case for Sustainability

The case for continuing U.S. strength rests with the idea that a virtuous cycle may be starting to take hold in the economy. Bullish analysts point to the massive wave of tax cuts and deregulation that has unleashed an optimum backdrop for corporate profitability. Profitable companies are usually willing to make investments in future growth, and right now analysts contend there are compelling reasons for businesses to invest, given an aging capital stock and tax policy that is incentivizing companies to commit capital. The economic bulls also believe consumers are quite healthy and could be ready to convert some savings into spending. If they do, that could fuel another leg higher for profits. Company cash levels are high, and that could help sustain the recent wave of corporate share buybacks, which helps lift stock prices by increasing earnings per share and reducing the supply of outstanding stock in the marketplace.

One of the more exciting theories supporting economic sustainability is that productivity is beginning to pick up after a long slumber. Rising productivity would be meaningful as it would allow for a higher

potential level of economic growth while keeping a major inflation outbreak from developing. A moderate level of inflation would allow the central bank to achieve its mandate of price stability without having to turn overly aggressive in their rate raising campaign. With higher productivity and no major imbalances, the economic expansion would theoretically still have a long runway before it is ready for a downturn.

Missing Expectations or Twilight Zone Redux?

Our base case scenario does not call for a recession to materialize over the next few quarters, but we also realize that the current expansion is closing in on becoming the longest ever. Therefore, it's imperative to be on high alert for warning signs that the business cycle may be starting to turn. While the full weight of the evidence is still no worse than neutral, there are some potential cracks in the outlook that we are closely monitoring. Some of the areas of concern include falling monetary metrics, peak confidence levels, housing and auto sectors that are struggling, deterioration in the breadth of various leading indicators, and a downturn in some measures of global trade. As a base case, a down turn in the business cycle appears to carry a low probability over coming quarters, but these data points suggest that the accumulation of interest rate hikes, yield pressures, and a shift in trade policy may be starting to take a toll on an otherwise healthy economy. In short, a recession does not appear to be likely in the near future, but it also may not take much for some economic disappointment to set in if the economy has peaked for the cycle and begins to oscillate back towards the lower end of its recent range.

Another issue worth pondering is whether good economic news will continue to be perceived as bullish for the stock market. The concept that the economy could do well while the stock market does not may seem counterintuitive, but there are many historical episodes when this has occurred. For instance, back in the spring of 2013, our financial markets were in somewhat of a "Twilight Zone" when the economy and markets were temporarily disconnected. This disconnect between poor growth dynamics and red-hot equity markets at first blush seemed odd, but things began to make sense when we considered the fact that central bankers and unprecedented liquidity were currently in charge of financial markets. When viewing the behavior of markets through this lens, anything that encourages central bankers to keep priming the liquidity pump is likely to be temporarily good for markets. Such a counterintuitive backdrop is challenging to understand, as investors must be willing to take intuitive logic and turn it on its head to understand some of today's market moves.

Some analysts are beginning to wonder whether today's environment is starting to look like the mirror image of 2013, where good economic news could start to be viewed as bad news for markets. If this interpretation is correct, then investors must again reverse their intuitive logic to understand what is beginning to unfold. One thesis for a good economy but poor markets is that the economy may be starting to overheat due to late cycle fiscal stimulus applied to an already mature business cycle. Analysts concerned about an economic overheating point to actual economic growth rates that have begun to outstrip the economy's potential, which should naturally put pressure on prices that reverberate throughout the economy.

The potential for overheating is most apparent in the labor markets, where the unemployment rate has fallen to a 50-year low and is contributing to growing evidence that demand for labor is outstripping the available supply. Given today's labor market dynamics, it comes as no surprise that companies like Amazon recently announced significant pay increases for their workforce, since it is getting tougher to hire and retain workers. Up to this point, wages have been rising at a tepid pace, but if pricing pressures begin to shift into a higher gear, it could start to create downward pressure on corporate profit margins.

While a positive development for workers, if wage growth starts to accelerate, it could have important implications for generalized inflation, profits, the pace of short-term interest rate increases by the Federal Reserve, and a rise in longer-term yields. The Fed has been taking a very cautious approach in normalizing interest policy thus far, but monetary officials are keenly aware that slack in the labor market is dwindling and creating some risk of an inflationary impulse. Short-term interest rates have already been increased eight times from the cycle low, and if projections for continued economic momentum and rising inflation materialize, the central bank has little reason to halt the normalization process over the coming year.

Higher long-term yields take their cue from short-term rates, but they are also driven by other factors that affect supply and demand. Important forces that will likely increase future supply are the slow runoff in the Fed's balance sheet as they increase the amount of monthly bond sales and rapidly expanding deficits from higher government spending. As rates rise across the maturity spectrum, it can create several challenges for markets. Higher rates mean higher costs for borrowing, and a higher discount rate makes the present value of future cash flows intrinsically lower for stocks. Higher yields on perceived safe assets can also create competition for risk assets. For example, today a Treasury bill earning 3% is currently outstripping a conservative valuation model's implied long-term annualized return on the S&P 500, and with virtually no risk of loss.

Divergence Convergence & Two-Sided Directional Risk

As we've previously noted, a lingering risk that's been developing all year has been the striking difference in return profiles between the U.S. and virtually every other global market. As an example, as of the end of September the S&P 500 Index is up 10% with dividends reinvested. Meanwhile the MSCI All-Country World Ex-U.S. Index, which is a proxy for global markets that removes U.S. exposure, is down more than 5% for the year. A typical basket of emerging markets stocks is down over 10%.

From a fundamental perspective, international markets have been struggling to deal with a combination of a slowing Chinese economy and a cooling off from last year's coordinated upturn in world markets. Global markets are also likely feeling the pinch of a stronger dollar and higher U.S. interest rates, which may be starting to expose the weak links in the global economy, most of which are found in the emerging markets realm. How the outlook in China unfolds may hold the key to whether global markets will continue to fizzle or stabilize and start to rise again over coming quarters.

China is caught in the middle of a cyclical economic slowdown and is also at the epicenter of trade dispute with United States. Chinese stocks have quietly lost over 20% this year and the tariff wars in progress with

the U.S. are likely only exacerbating an already soft economy and putting pressure on important supply chains that are integral to world growth dynamics.

If Chinese data and markets continue to deteriorate, it may be signaling that the global economy is weaker than widely believed, which could eventually infect U.S. growth and asset prices. In this scenario, there is risk that U.S. markets might close the recent performance gap by a sudden drop in price.

There is also a brighter scenario that could unfold and recouple markets that would be much more supportive of price appreciation. One potential positive side effect from China's current weakness is that their policymakers have begun stimulating the economy more aggressively to combat weak growth and to stay ahead of ongoing trade frictions. Not only has China already used their currency as a policy tool to defend trade, but they have also lowered rates materially and begun to increase lending. If Chinese leaders undertake additional stimulus measures, perhaps an upside positive risk is that the global economy gets a fresh economic impulse that leads to a closing of the gap between the U.S. and global markets. If global growth can stabilize and start to resynchronize, there might even be a chance of a melt up in stocks led by China and other global markets that have already suffered sharp losses on the year.

Current Positioning

Last quarter we wrote that we would modestly reduce risk into market strength given that trade pressures were rising, and the overall risk reward setup seemed to be deteriorating. As the quarter progressed, we did incrementally reduce risk through a variety of positioning tactics. Our allocation to international equities has been reduced and repositioned into more defensive U.S. sector holdings, such as healthcare, staples, and insurance companies. Bond portfolios continue to be positioned with below average interest rate sensitivity and contain a barbell of floating rate and credit like holdings, combined with some longer duration quality bonds to defend against a possible hiccup in world growth.

Given the multitude of risks in play, we have also built a stable of liquid portfolio hedges including cash and gold. We acknowledge that these hedges won't necessarily work at the same time—nor should they—but managing risk in this unusual environment demands a variety of protections that work in different scenarios.

October Market Volatility

The last few weeks have seen a strong uptick in market volatility, and some of you may be wondering what we are thinking regarding our portfolios. Given that we are positioned somewhat defensively at the moment, we don't believe we need to rush to any judgements during days of hyper volatility.

There is a saying on Wall Street that the market goes up on an escalator and down on an elevator. Given the speed and apparent intensity of the market decline over the past month, emotions tend to get the best of us as we wonder if the current decline could mark the start of a bear market. In the history of major market tops going back to 1929, in no case did a bull market end under conditions that existed at the time of the most recent high in the S&P 500, just one month ago on Sept 20th. Simply put, at the time

of the Sept 20th high there was little evidence of the deteriorating breadth and rising supply of stocks for sale that has marked every major market top over the past 93 years.

Conclusion

It was a strong quarter for U.S. markets, as positive fiscal forces continued to course through the economy and propel domestic markets to better returns than the rest of the globe. There are still many positive forces supporting the U.S. economy that could allow it to continue to shine, as chances for a recession appear low over coming quarters, and the fiscal thrust seems likely to carry into 2019. Still, risks abound, and the cycle may be approaching a point where economic and earnings expectations are running too hot, and where markets may be entering an unusual phase where good news could potentially start to be bad. With fairly valued markets and an aging economic cycle, we believe it is prudent to lean towards defending more against the potential for risk of loss rather than risk of opportunity for now.

We'll continue to be alert for new evidence and catalysts that may move markets in a negative or positive direction, and as always, we will continue to adjust our portfolios based on the weight of the evidence.

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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