Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

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Rebound to Confound

The "December to Remember" that put an exclamation point on 2018 was quickly followed by the best quarterly return in nearly a decade.

Age Is Just a Number

The ten-year anniversary of the Great Financial Crisis renewed the debate as to whether bull markets die of old age or are intentionally halted by central banks. Now that the Fed has signaled it is done raising interest rates, attention needs to shift to economic signals and indicators of market confidence to determine if the current bull market has finally exhausted itself. In the following pages, we examine a yield curve that is beginning to whisper recession, various measures of confidence, and earnings, the ultimate driver of stock returns, to conclude that there are still plenty of opportunities to find companies likely to grow earnings faster than expectations.

(Continued on page 2)

Total Return	1Q19	1 Year
Russell 1000	14.0%	9.3%
Russell 1000 Growth	16.1%	12.8%
Russell 1000 Value	11.9%	5.7%
Russell 1000 Comm. Services	13.8%	5.2%
Russell 1000 Cons Disc	14.8%	11.1%
Russell 1000 Cons Staples	11.8%	10.2%
Russell 1000 Energy	16.4%	0.8%
Russell 1000 Financial	8.9%	-4.7%
Russell 1000 Health Care	7.5%	15.2%
Russell 1000 Industrial	17.2%	3.0%
Russell 1000 Info Technology	20.7%	16.6%
Russell 1000 Materials	11.1%	-1.8%
Russell 1000 Utilities	11.5%	20.3%

Total Return	1Q19	1 Year
Russell 2000	14.6%	2.1%
Russell 2000 Growth	17.1%	3.9%
Russell 2000 Value	11.9%	0.2%
Russell 2000 Comm. Services	15.1%	26.9%
Russell 2000 Cons Disc	13.2%	2.9%
Russell 2000 Cons Staples	7.5%	2.4%
Russell 2000 Energy	19.8%	-17.7%
Russell 2000 Financial	8.6%	-4.5%
Russell 2000 Health Care	16.8%	2.9%
Russell 2000 Industrial	12.2%	-5.0%
Russell 2000 Info Technology	22.6%	16.4%
Russell 2000 Materials	17.0%	-9.8%
Russell 2000 Utilities	10.5%	21.3%

Total Return	1Q19	1 Year
S&P 500	13.7%	9.5%
MSCI AC World*	12.3%	5.6%
MSCI AC World Ex U.S.*	10.5%	1.9%
MSCI World (Developed)*	12.6%	6.7%
MSCI Emerging*	9.8%	-1.9%
MSCI Dev. Europe*	11.6%	4.3%
MSCI Pacific Ex Japan*	11.7%	9.7%
MSCI Japan*	7.6%	-4.1%
MSCI China*	17.9%	-6.2%
USD/EURO	-1.8%	-8.7%
USD/Chinese Yuan	2.5%	-6.5%
USD/MSCI EM FX	0.1%	-5.5%

* in local currency, net of tax withholding

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(WWW.SMITHASSET.COM)

S&P Earnings Report Update (1Q 2019) by Chris Zogg, CFA
Market Perspectives (December 2018) by Rick Villars, CFA

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Trouble with the Curve

As the quarter closed, discussion turned to indicators that may be signaling an impending recession. One cautionary signal was the narrowing of the difference between short and long-term interest rates. Usually, long rates are higher than short-term rates as investors demand additional compensation for locking up their savings for an extended period of time. Towards the end of the first quarter, however, the difference between short-term and long-term interest rates inverted with 3-month bills paying *more* than 10-year notes (red line in Exhibit #1). The brief inversion of the yield curve rattled investors as similar inversions have preceded the past seven recessions. Fortunately, **a recession has not followed all inversions**. For a recession to be truly imminent, we believe both 3-month and 2-year rates would need to be above the 10-year rate for an extended period of time which is unlikely given the steeping in both the 2-year / 30-year and the 10-year / 30-year curves (green line and dashed blue line in Exhibit #1).

So, what does the 3-month / 10-year inversion portend? Some pundits have suggested the Fed has moved too far, too fast and that the economy has reached stall speed. If correct, bond investors expect weak economic activity to force the Fed to reduce rates in the not too distant future.

Historically, the turn in economic activity predicted by a yield curve inversion is the result of an over aggressive Fed. Exhibit #2 shows how the Fed funds rate generally exceeds inflation by a wide margin before an economic slowdown. With the Fed clearly on hold, it is difficult to see this measure moving into the danger zone anytime soon. In fact, it may turn out that the Fed paused at exactly the right time which has not always been the case. Exhibit #2 suggests the Fed usually continues to tighten well past the point of fighting inflation with the result being an economic recession. This time appears to be different.

Given the extended period of extraordinary monetary ease following the financial crisis and the use of previously untested tools by central banks around the world, we thought exiting to a more normal policy environment might prove difficult and could produce some unexpected outcomes. For example, since the end of the financial crisis, U.S. interest rates appear to have become more sensitive to the global economic outlook as evidenced by a weak purchasing manager survey in Europe coinciding with the 10-year U.S. Treasury rate dropping below the 3-month U.S. rate. Exhibit #3 highlights the precipitous drop in both U.S. and German rates in the gray shaded area. Interest rates on the German Bund dropped into negative territory on the report and U.S. rates weakened in sympathy. Europe is an important component of global growth and U.S. investors have become increasingly sensitive to its outlook. Additionally, bond markets have become increasingly global so when one component of that broader market has a move the whole fixed income market adjusts. Correlations between sovereign markets are rising and changes in liquidity in one market seep into others. When the outlook of the ECB changes it has an impact on U.S. markets.

Exhibit #1: U.S. Treasury Yield Curve Slopes
Long Maturity minus Short Maturity

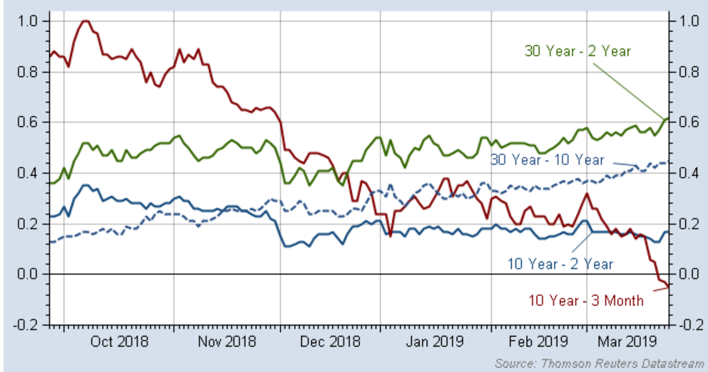


Exhibit #2: Real Fed Funds Target Rate
Fed Funds Target Rate minus Inflation

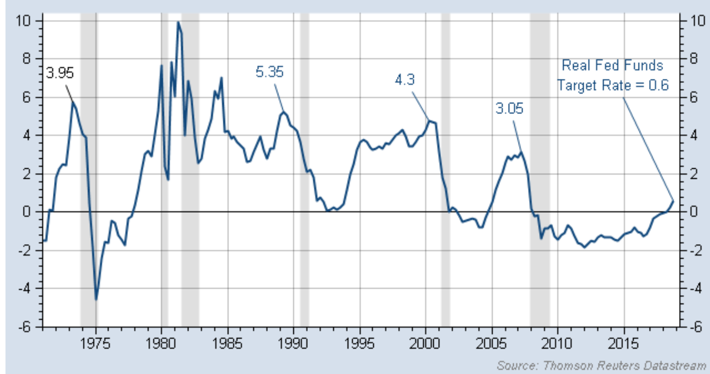
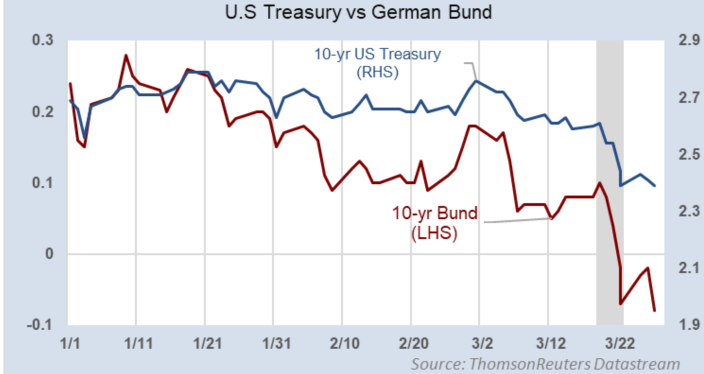


Exhibit #3: 10 Year Interest Rate Comparison
U.S Treasury vs German Bund



On the Other Hand

Looking beyond the yield curve inversion, there is a mixture of conflicting data. Weakness in U.S. purchasing manager surveys, soft vehicle sales, and the fact that economic releases have recently been disappointing relative to expectations would support the need for caution. But opposing

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those would be the fact that credit spreads between low quality bonds and U.S. Treasuries are steady and even a little better than the average of the last four years. Normally when interest rates start to reflect economic trouble, bond investors sell low grade bonds and shift into "risk-free" Treasuries which is not currently happening as illustrated in Exhibit #4. Other indicators that have not confirmed an imminent economic downturn include solid employment numbers and a rally in copper prices. Copper is often called "Doctor Copper" because it quickly reflects demand from economic activity. Housing activity has sent mixed signals, but prices are still climbing. Generally, copper and house prices rollover in the lead up to a recession and this has not happened.

Although considered to be a coincident indicator, the St Louis Fed Recession Probabilities model[1] (Exhibit #5) is currently less than one and would need to be rising to suggest a recession is imminent.

Despite lingering trade wars, Brexit, a Japanese VAT tax and threats of border closings, there is **still plenty of constructive news including healthy levels of corporate cash, solid domestic earnings and strength in emerging markets.**

Corporate Cash Conundrum

While there is little debate about the cash windfall that companies realized in 2018 from tax cuts and repatriation, there is considerable debate about what corporations did with it and whether or not it was well spent. The latest political target is companies buying back stock. The belief is that U.S. corporations used nearly all of the savings from tax cuts for share buybacks even though they were "supposed" to use it to increase wages and invest in capital. But what is the reality of the situation? Exhibit #6 at right shows an estimate of the corporate benefit compared to the return of capital activity that is under scrutiny. Yes, a significant amount of the repatriations were returned to shareholders but this analysis shows a difference of almost $500 billion that was used in some other fashion. While some of windfall went to pay down debt, there was also a significant uptick in investment. The year over year increase in 2018 capital expenditures within the S&P 1500 was $115 billion, a 15% increase (Exhibit #7), almost four times the $32 billion increase in 2017, and the largest since 2011. This uptick was led by the Communication Services sector, with Energy, Finance, and Information Technology also experiencing significant acceleration in activity.

Since the bulk of the offshore cash hoard was in Communication Services, Information Technology, and Health Care companies, one might think that some of that cash went to higher research and development. After all, R&D for those three sectors is roughly the same size as capital expendi-

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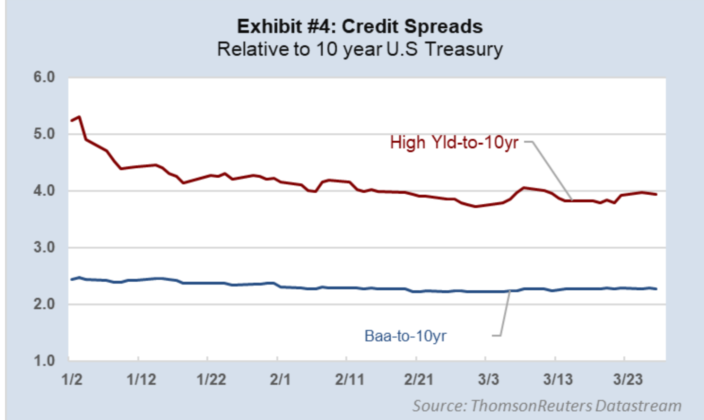
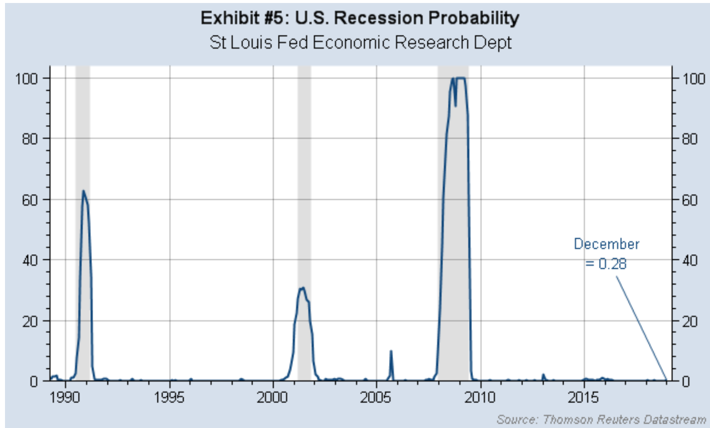
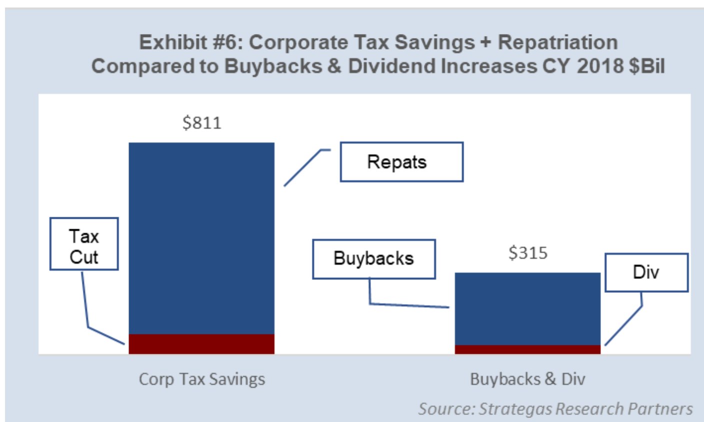






[1] a dynamic-factor markov-switching model applied to four monthly coincident variables: non-farm payroll employment, the index of industrial production, real personal income excluding transfer payments, and real manufacturing and trade sales

tures and innovation is their lifeblood. In fact, Communication Services companies did up their game (Exhibit #8) but the 11% increase in R&D by Health Care and Information Technology companies was little changed from 2017. The $40 billion aggregate R&D increase for S&P 1500 companies was higher than the $30 billion uptick last year but falls far short of the increase in capital expenditures and does little to explain how companies used their tax windfall.

As hoped for by the change in the tax code, private wage growth has picked up. Total private wages reported by the Bureau of Economic Analysis were $348 billion higher in 2018, which was a $118 billion uptick from the growth rate in 2017, representing a 4.9% increase. About half of employment growth is attributed to small businesses and thus should not be included in the corporate tax benefits calculation. Consequently, about half of the $118 billion (or $59 billion) uptick should be included as a use of corporate windfall from tax cuts and reparations.

One could say that the tax bill was successful in stimulating some of the things it was intended to boost. But even using a very generous estimate of buybacks, increases in dividends, R&D, capital expenditure, and an uptick in wage growth, the total of these categories does not come close to accounting for where the full corporate tax benefit was allocated. Thus **there is still buying power in corporate America**. With both capacity and the employment pool tightening there is still a need for investment in both physical and human capital. What is holding that investment back from fully realizing its potential is confidence. Both the NFIB and CEO confidence survey readings have slipped from the peaks achieved last year. Both are now at about their long-term average. While the spike in economic policy uncertainty we noted last quarter has moderated, some of the indicators are still at relatively high levels. In this environment business managers are more likely to invest on an as needed basis as opposed to being forward looking. In that regard, a resolution to trade tensions around the world would help. The ongoing soap opera of Brexit is not helping confidence in policymakers and it looks like there will continue to be questions around the U.K. relationship with Europe for some time to come. Muddling through is a good, if not generous, way to describe the current situation.

Exhibit #7: S&P 1500 Percentage Increase in Capital Expenditures

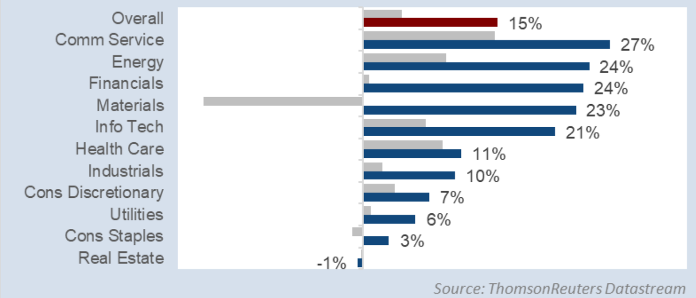


Exhibit #8: S&P 1500 Percentage Increase in Research & Development

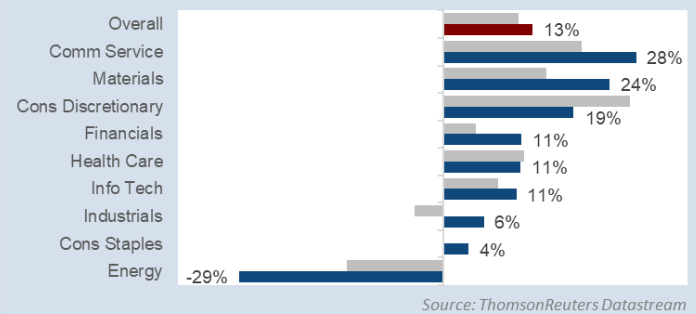
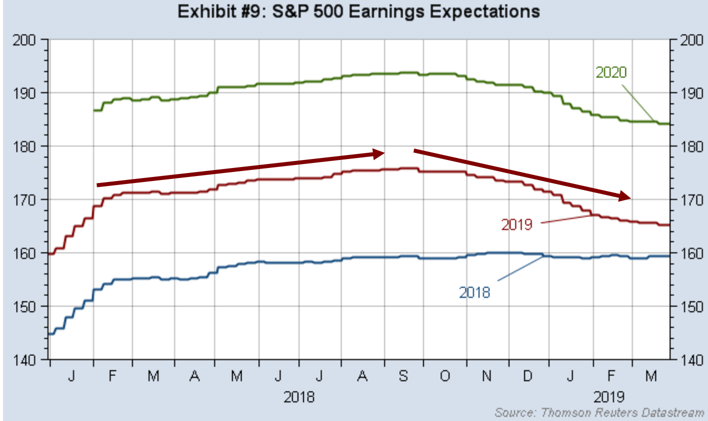


Exhibit #9: S&P 500 Earnings Expectations



Earnings Peaks & Valleys

For the first nine months of 2018 earnings expectations were in a solid uptrend. That changed in October and expectations sagged through February but have stabilized somewhat in March (Exhibit #9). Clearly, the December swoon was a reaction to a worsening economic and earnings environment and was over done on the downside. The January rebound corrected that excessive downside move, but the trajectory of stock prices continued to be positive even as expectations moderated in the first quarter. Stock prices rising as expectations are falling may on the surface sound inconsistent. Actually, that is quite normal. Historically, analysts start optimistic and become more realistic over time, yet stock prices have an upward bias despite those lower expectations. Much has been made of the possibility of an earnings recession in the first half of 2019 but as you can see in Exhibit #9 (on previous page) aggregate earnings for the full year are still expected to exceed 2018. We noted in our latest Earnings Update that growth expectations for the median S&P 500 company are considerably higher than the aggregate expectation and that earnings growth is supported by sales growth (see more detail at the research library at www.smithasset.com). Therefore, **the worries about an earnings recession for the majority of U.S. companies seem a bit overblown.**

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Is the Emerging Markets Trade Crowded

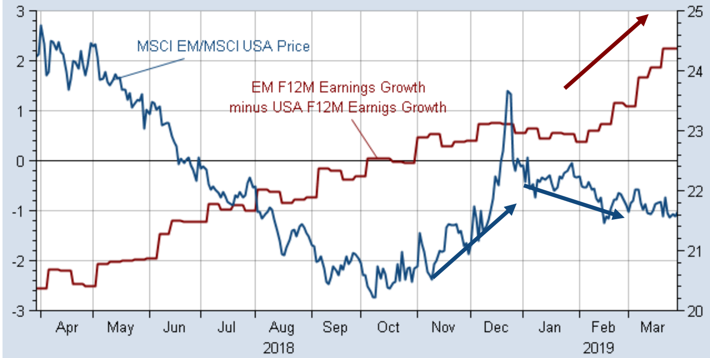
Last quarter, we noted that emerging market stock returns relative to U.S. stock returns turned positive at exactly the same time as their forward 12-month earnings growth expectations exceeded those of U.S. stocks. The improving growth profile provided a relative safe haven to the turmoil in domestic markets. Although the earnings growth gap continued to widen in first quarter, emerging market returns couldn't keep up with the torrid pace of the U.S. markets.

In addition to the **attractive earnings growth found in emerging markets**, a neutral U.S. central bank and steady U.S. dollar is also positive since many companies in these markets have dollar-denominated debt which weighs on earnings when the dollar gets more expensive and/or U.S. interest rates rise. While we are loath to be part of the consensus, the fundamentals of many emerging market companies in a low growth environment favor a bias to better relative returns.

Vigilance

Many of the worries that derailed earnings expectations at the end of last year are still around. Brexit has turned into a never-ending soap opera, Chinese-U.S. trade negotiators have made progress but a final solution is still elusive, Europe is a ship in search of a new captain and Japan is softly heading into a VAT tax increase. While those negative headlines make it difficult to be optimistic about the future, sometimes its best to own stocks when the news stops being negative. Fortunately, economic surprise indices are bottoming and beginning to improve and central bankers have backed off from further tightening to ward off non-existent inflation.

Exhibit #10: Emerging Markets vs USA
Relative Forward 12M Growth & Relative Price



Source: Thomson Reuters Datastream, MSCI

Disclosures

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