INVESTMENT OUTLOOK

A PUBLICATION OF QUADRANT CAPITAL MANAGEMENT

SECOND QUARTER 2018: ANIMAL SPIRITS AND HUMAN EMOTIONS

Well as giraffes say, you don't get no leaves
Unless you stick your neck out.
-Sid Waddell

Well known economist John Maynard Keynes used the term "animal spirits" to describe the intangible but very real sense among economic participants that times are sufficiently good, or promising, to warrant an increase in risk-taking. The phrase conveys the turn from human reason and logic to emotion and impulse.

Animal spirits were in evidence in US markets in the second quarter, where large cap stocks jumped by over 3%, and small caps roared ahead by almost 8%. Announced mergers and acquisitions for the first half of the year totaled a record-setting $2.35 trillion (57% higher than 2017!), according to *The Wall Street Journal*. Investors particularly stuck their necks out in the initial public offering market, where 120 companies were newly listed and raised $35.2 billion—the highest volume since 2014. And investors have continued to pour money into new cryptocurrency vehicles—490 initial coin offerings have raised an average of $24 million apiece.

International markets, by contrast, were left in the dust. Developed markets slipped 1%, and emerging markets tumbled nearly 8%.

How do we make sense of these disparate results? Narratives change quickly on the globe's bourses, and the so-2017 feel-good story of synchronized global growth gave way, felled by softer European economic data, escalating trade disputes, geopolitical concerns and the strengthening of the US dollar. By contrast, US markets were lifted by remarkable earnings growth in the first quarter and the impact of lower corporate and individual tax rates as they began to play through the economy.

Commercial real estate markets regained their footing, as interest rates crested and then fell back. The commodities picture was mixed, as oil prices were lifted by robust worldwide demand and both planned and unintentional supply constraints while soybeans plummeted on the threat of trade tariffs. Returns on cash crept higher.

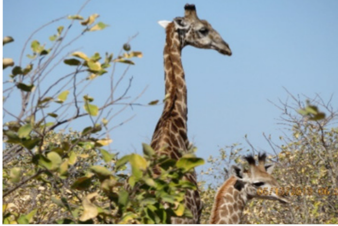
Asset Class	Index	2nd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	3.4%	2.3%
US Small Cap Stocks	Russell 2000	7.8%	7.7%
International Developed Stocks	MSCI EAFE	-1.2%	-2.8%
Emerging Markets Stocks	MSCI EM	-8.0%	-6.7%
Real Estate	MSCI US Real Estate	10.1%	1.2%
Commodities	Bloomberg Commodity	-0.1%	-0.9%
Bonds	Barclays US Aggregate	-0.2%	-1.6%
Cash	Citigroup 3-month US T-Bill	0.4%	0.8%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, CITIGROUP, MSCI, BLOOMBERG

FOLLOWING, NOT FIGHTING, THE FED

Hold your head even higher and into the fire we go…
Yes it's higher and higher and into the fire we go.
-The Scarlet Pimpernel

Ever since the Great Recession, global central banks have been desperately fighting deflationary threats, with both standard and unconventional tools: cutting rates, purchasing bonds, paying interest on reserves, and so on. Ten years later, their efforts appear not to have been entirely in vain. The Commerce Department recently reported that in May, prices rose 2.3% year over year.



New Fed chair Jerome Powell is following the interest rate normalization trail laid out by predecessor Janet Yellen. At a recent central bankers' pow-wow, Powell sounded decidedly hawkish as he suggested that the Fed remains on track for two additional interest rate increases this year—and three further increases in 2019.

The Fed has, with fair consistency, over-estimated economic growth and, in turn, its freedom to lift interest rates. Markets remain somewhat skeptical, as interest rate futures suggest expectations for one additional rate increase this year and perhaps two next year. This is merely quibbling, however. What matters most is the path of interest rates, more so than the pace. And that path is clearly heading up.

The tight correlation over the past ten years between asset prices and quantitative easing—the Fed's purchase of bonds, to suppress interest rates—suggests that an accommodative Fed effectively lifts asset prices. Now, however, the Fed has embraced a quantitative tightening regime, increasing interest rates and reducing its $4 trillion+ balance. It is on pace to allow $40 billion per month of maturing securities to run off its balance sheet rather than reinvesting those proceeds. So the question needs to be asked: if quantitative easing was supportive of equity markets (and riskier bonds), is it not logical to surmise that quantitative tightening will challenge equity markets?

The Fed is operating from a position of considerable strength. As it seeks to restock its ammunition (against a future recession) in the form of higher rates, it does so in the context of a US economy exhibiting its strongest growth in many years. Fiscal policy—both taxes and spending—is stimulative. Unemployment is low (near its lowest level in 18 years) and, likely, heading lower. Consumer sentiment is elevated, and spending is up, aided by wage growth, lower personal income tax rates, and employment gains. The housing market is sound, driven by limited supply and increased demand. Capital spending reached a first-quarter record of $158.8 billion. Shipments by truck and rail rose 11.9% in May, from the year-ago level, according to Cass Information Systems. And, notwithstanding the threat from trade disputes, exports were also strong in the second quarter.

All of which contribute to the highest inflation rates seen in years—more fodder for higher interest rates.

NEITHER BULL NOR BEAR

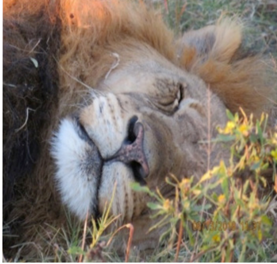
Hush my darling don't fear my darling
The lion sleeps tonight
Hush my darling don't fear my darling
The lion sleeps tonight
-The Lion Sleeps Tonight

Equity markets were remarkably quiescent in 2017, as volatility recorded all-time lows. Driven by accelerating global growth trends and a weaker US dollar, bourses around the world posted very strong gains.

In recent months, US equities recovered from first-quarter declines but overall have mostly marked time. Like lions after a big kill, markets are experiencing a period of digestion—a good slumber. That slumber could last a while.

The stock market is strongly supported by exceptionally high earnings growth. Profits for the S&P 500 were up 26%

in the first quarter, and analysts estimate that profits will rise 21% for the just-completed second quarter. Of course, the large corporate tax cut enacted last year accounts for the lion's share of the gains. That said, companies recorded robust revenue growth of 8% in the first quarter, and expectations are for similar strength in the current quarter.



The combination of elevated profit growth and a market correction in the first quarter puts US equity prices into muddle-valued territory. Stocks now trade roughly in line with average historical valuations—about 16 times projected earnings for the 12 months ahead. Equity prices are also being supported by record levels of stock buybacks--$178 billion in the first quarter—as companies repatriated overseas cash.

Against this attractive backdrop, we note some headwinds for equities as we look for them to awaken from their slumber. Perhaps most obviously, trade disputes could mushroom into outright trade wars. Almost all economists see protectionist actions as likely to slow economic growth. While many observers believe that President Trump has a strong hand to play as he seeks to negotiate better trade terms for the US, this is a high-stakes poker game with unpredictable players and, thus, an uncertain outcome.

High sales and profit expectations could set markets up for declines, should second quarter reports or earnings guidance fail to meet the high bar that has been set. Overall, investors expect earnings growth of 18% this year, and a further 7-8% next year—such lofty levels could well be a stretch.

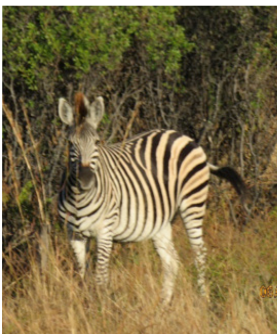
A more recent concern is the potential for higher inflation. With US unemployment at 4.0% and, generally, falling, wage pressures have been surprisingly modest, but could be poised to charge ahead. In the most recent inflation report from the Commerce Department, the Fed's 2% inflation target, measured by core Personal Consumption Expenditures, has been reached. The sharp rise in oil prices over the past few weeks, driven by higher global demand and supply disruptions (Venezuela, Iran, Libya) creates its own inflationary impulse. Businesses are reporting higher materials and shipping costs as well as labor shortages, and the imposition of trade tariffs would likely also prove to be inflationary.

Upcoming midterm elections add another element of uncertainty into the mix. And then, there's the usual array of geopolitical hotspots, from North Korea to Syria, a frayed European Union, and neo-nationalist movements around the world. Elections in Italy, Mexico and elsewhere suggest populist distrust of the current world order, without a roadmap for what might replace it.

In other words, Wall Street's proverbial wall of worry is as challenging to scale as ever.

AVOIDING PREDATORS

Can the Ethiopian change his skin, or the leopard his spots?
- the Bible (Jeremiah 13:23)



There are immutable laws of nature that don't have correlatives in financial markets.

In the bush, zebras and wildebeests are frequently found in the proximity of giraffes. In a touching display of inter-species cooperation, the grazing animals depend on the giraffes' superior long-necked vantage point to act as an early warning detection system, alerting them when predators are on the prowl.

In financial markets, indicators of danger are far less common, and far less clear, than giraffes. Predators come in many sizes and shapes, and may be well camouflaged.

As we position portfolios for the months and years ahead, we acknowledge heightened risks. This July marks the tenth year of this economic expansion, the second longest in the post-war era. Yet we are not seeing markets behave in accordance with late cycle trends—cyclical plays in commodities, materials, financials and industrials are lagging, not leading. Growth stocks are

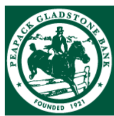
out-performing value stocks, by a wide margin. Falling copper prices—copper is often viewed as a sound predictor of future economic activity—warn of potential economic softness. The bond market is also sending a message of economic concern, as the flattening yield curve—a shrinking differential between short and long rates—threatens to invert. That is to say, short term rates could soon exceed long term rates—frequently a precursor to a downturn in the economy.

This suggests, at the margin, a more cautious approach. From an asset allocation perspective, it makes sense to consider reducing equity over-weightings. Within domestic equities, the action in industrial, financial and other value stocks, combined with the uncertain outlook for trade dispute resolution, suggests growth stocks in technology, health care and consumer discretionary sectors may continue to exhibit relative out-performance.

Internationally, emerging markets have been in the doldrums, following a stellar run in 2017. They have been dogged by US dollar strength and rising energy prices. Still, they are historically cheap, and comparatively inexpensive versus developed markets valuations.

In the fixed income arena, higher short-term rates have increased the attractiveness of short term bonds. It also provides an opportunity to trade up in quality, to acquire higher rated bonds with less of a give-up in yield. And the afore-mentioned yield curve flattening, with limited additional interest income for longer maturity bonds, argues for a focus on shorter maturity bonds.

Survival is the name of the game out in the bush. In the investment jungle, survival translates into risk management. Prudent risk management requires getting strategic asset allocations correct—and then perhaps over-laying value-adding tactical moves. It also requires taming the animal spirits—excessive enthusiasm, which translates into excessive risk-taking—and preventing animal spirits from overtaking our human capacity to plan, to reason, and to adhere to a sound plan. As stewards of capital, we remain committed to strategies that preserve and grow assets, for the next generation as well as this one.



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