INVESTMENT OUTLOOK

A QUADRANT CAPITAL MANAGEMENT PUBLICATION

THIRD QUARTER 2018: FEAR AND GREED, 10 YEARS AFTER THE FINANCIAL CRISIS

And the seasons they go round and round
And the painted ponies go up and down
We're captive on the carousel of time
We can't return we can only look behind
From where we came
And go round and round and round and round
In the circle game.
-Joni Mitchell

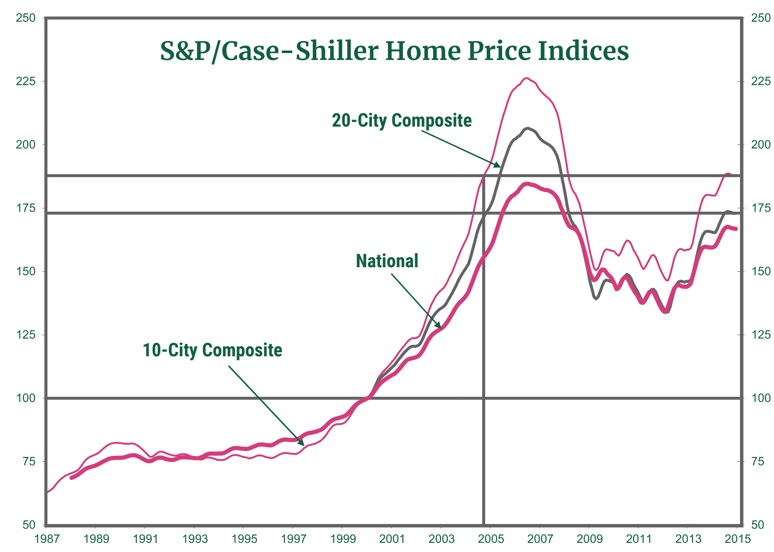
It's all about the cycle—a sequence of events that repeats itself. Seasonal cycles--summer gives way to autumn, autumn to winter, and so on. Fashion cycles—preppy gives way to grunge, grunge gives way to athleisure wear. Water cycles—water vapor gives way to clouds, clouds give way to precipitation, precipitation gives way to lakes and streams, and lakes and streams give way to water vapor.

And, of course, investment cycles, in which optimism gives way to greed, greed gives way to excess, excess gives way to value destruction, and value destruction gives way to fear. Wash, rinse, repeat.

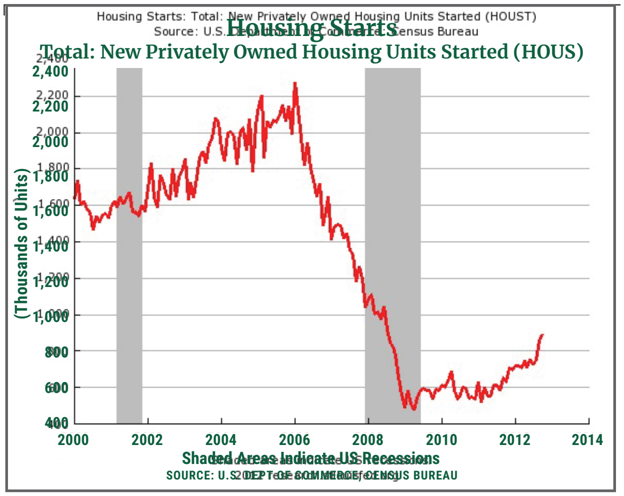
In the 1990's, advances in personal computing combined with an explosion in internet access led to extraordinary investor enthusiasm for technology stocks—a bubble that, as we all know, ended badly. Hot growth stocks with no earnings—indeed, no revenues, in some cases—went public, levitated, then crashed and burned. Chastened investors hung their heads and returned home.

Home. That's where investors were comfortable. So, in the 2000's, they invested in what they thought they knew: real estate. A ripple became a wave, and a wave became a tsunami. Ordinary citizens, real estate agents, mortgage brokers, bankers—nearly everyone got caught up in the enthusiasm. As with tech stocks a decade earlier, optimism gave way to greed and excess. The world was awash in mortgage debt, and when the party ended the pain was felt around the world—in Thailand, in a small village in Norway, on Wall Street, and most particularly on Main Street.

The noise volume of the real estate crash crescendoed in September 2008, when quasi-governmental mortgage guarantors Fannie Mae and Freddie Mac were effectively nationalized, Lehman Brothers failed, AIG was bailed



SOURCE: S&P DOW JONES INDICES AND CORELOGIC



out, Merrill Lynch held a fire sale, and the remaining investment banks scrambled to find financial backers. In subsequent months, Congress rejected and then approved TARP—depending on your perspective, either a bailout for the banks or a rescue of the failing financial system.

The Fed dropped interest rates, effectively to zero percent—and pinned rates there for years. Global central banks, including the Fed, purchased $22 trillion worth of bonds.

Following years of over-building, housing starts plummeted 75%. National average home values fell 30% from peak to trough. Unemployment soared to 10%. General Motors went bankrupt. Stocks tumbled, ultimately declining by more than 50%.

Recovery was slow, halting, spotty. Early suggestions of economic "green shoots" were ferociously mocked. Job creation was meager. About 5.5 million homes were foreclosed, according to CoreLogic. (Even now, nearly 1 in 10 home mortgages are "seriously under water," with mortgages at least 25% greater than home values.) Many people never recovered fully—or at all—from the financial setback. For them, it means nothing that, as the Federal Reserve recently reported, total household net worth reached $106.9 trillion in the second quarter.

Even as markets and the economy began to heal, many investors hung back, nursing their wounds. Some pundits have noted that this is "the most hated bull market in history."

RIDING THE BUCKING BULL

We must travel in the direction of our fear.
-John Berryman

Hated or loved, the bull market charged ahead in the third quarter. Solid economic data in the US and surpassingly good corporate profits drove domestic equity markets to record levels.

Asset Class	Index	3rd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	7.7%	10.6%
US Small-Mid Cap Stocks	Russell 2500	4.7%	10.4%
International Developed Stocks	MSCI EAFE	1.4%	-1.4%
Emerging Markets Stocks	MSCI EM	-1.1%	-7.7%
Real Estate	MSCI US Real Estate	1.1%	2.3%
Commodities	Bloomberg Commodity	-2.4%	-3.3%
Bonds	Bloomberg Barclays US Aggregate	0.0%	-1.6%
Cash	FTSE UST 90 day/3 month Bill Index	0.5%	1.3%

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

In the US, large cap stocks out-performed small caps, notwithstanding the more significant degree to which large cap companies are exposed to the vagaries of international trade. International equities continued to lag domestic stocks, with developed markets marginally in the green and emerging markets exhibiting continuing softness. Real estate marked time amid modestly rising interest rates, which held back bond returns, as well.

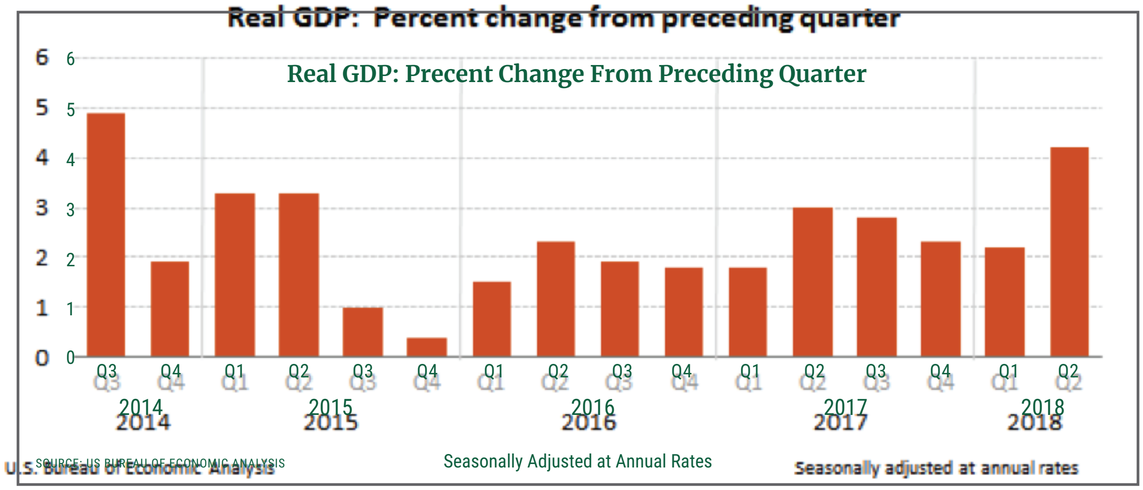
Commodities were the laggard, as copper and other industrial metals declined on concerns about slowing growth in China, and some agricultural commodities were losers to trade disputes.

For the year to date, domestic equities have posted solid returns, fueled by strong revenues and higher profits. International markets have been weaker, as economic growth decelerates and the strength of the US dollar hurts emerging markets. Higher yields held back gains on real estate securities gains, and resulted in negative returns from bonds. The stealth asset class has been cash, one clear beneficiary of the lift in interest rates—following many years of near zero returns.

THE GOOD TIMES ROLL

Now and then it's good to pause in our pursuit of happiness and just be happy.
-Guillaume Apollinaire

A wide array of metrics indicates the US economy is experiencing sound growth. GDP for the second quarter grew 4.2%, the strongest since 2014. The Atlanta Fed's GDPNow estimate for the third quarter is for 4.1% GDP growth; most economists forecast lesser though still strong GDP growth of 3.2%.



The labor economy is particularly robust. Unemployment is down to 3.7%, its lowest level since 2001. Businesses are generating about 200,000 new jobs each month, with most industries—healthcare, business services, construction, even retail—participating. Hours worked have increased, and wages grew 2.7% over the past year.

With more people employed and making more money, it shouldn't surprise us that the Conference Board reports that consumer confidence has soared to its highest level in 18 years. That confidence is translating into retail sales which, excluding autos, are up 6% over the last 12 months.

Manufacturing, too, is exhibiting strength. The Institute for Supply Management (ISM) manufacturing index measures 58.7; a reading above 50 indicates growth in the industrial sector. ISM's measure of the services economy, its nonmanufacturing index, rose to 61.6 in September, its highest reading on record going back to 2008.

The housing market picture is mixed. Home price appreciation has decelerated; the S&P Case Shiller 20 City Yearly Composite reflects 5.9% year over year growth. But new housing starts and permit applications have stalled, as homebuilders face high land costs, labor shortages, and rising interest rates. Building permits have fallen 9.3% from their cyclical peak; higher costs and higher interest rates are holding down sales of both new and existing homes.

The automobile market peaked in 2016, but remains fairly healthy. Industry experts see 2018 as the fourth consecutive year with total sales topping 17 million units.

Such a healthy economy could be expected to generate some inflationary pressures, but these are not yet evident. The Fed's preferred inflation gauge, core PCE, is up 2.0% over the past year—right in line with its target.

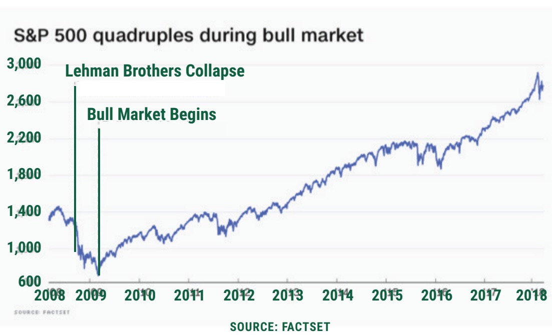
All in, it's a pretty constructive picture. The Conference Board's leading economic indicators are flashing green. Economists see little likelihood of a recession before 2020—and, at that, there's no visibility on a downturn even then.

SO WHAT COULD GO WRONG?

Be fearful when others are greedy, and greedy when others are fearful
-Warren Buffett

Since the nadir in March 2009, US markets have risen by 335%. By some measures, this is the second longest rally in the post war era, and the second largest upside move.

S&P 500 Quadruples During Bull Market



That tells us the bull market is long in the tooth—although it could clearly get longer still. Renowned investor Sir John Templeton explained years ago that bull markets don't die of old age—they get killed off by investor euphoria.

So, if we're trying to ride the bull but not get thrown, do we see signs of rally-killing euphoria? From a valuation perspective, not so much. US stocks trade about 14% above their 20-year average valuation—an acceptable premium in a low interest rate environment, especially given that earnings rose 25% in the second quarter. Small cap stocks, international developed and emerging equities all trade reasonably close to their long-term average valuations.

Strong profit growth, a healthy economy, modest inflation and reasonable valuations. Blue skies. Sounds like a prescription for further stock market appreciation.

Blue skies, indeed. But not, as the song would have it, nothing but blue skies. Here are the clouds:

• **Earnings expectations:** According to Thomson Reuters I/B/E/S analysts are forecasting 21.6% earnings growth for S&P 500 companies in the just-ended third quarter. Forecasts for 2019 are for an additional 11% rise in earnings. Failure to achieve earnings projections would call valuations into question. Profit margins today are at all-time highs—with rising transportation, materials input and labor costs, revenue growth will be critical—but top line growth, too, appears to have peaked.

• **Trade disputes:** Stocks rallied when the United States-Mexico-Canada Agreement (USMCA)—NAFTA 2.0, if you will—was announced, and US trade experts believe the Administration sees the agreement as a blueprint for future trade deals. The most troubling trading partner for the US is, of course, China, but it is questionable whether the US has the same negotiating power with China as it did with our North American trading partners. The USMCA, fundamentally, revolved around one issue—automobiles. By contrast, the trade dispute with China covers myriad products, but more importantly perhaps it's also about protecting intellectual property. Additionally, China may prove to be more willing to play a long game, as it is not as much a hostage to short election cycles and populist pressures. As tariffs, quotas, and other trade barriers rise, supply chains may be disrupted and inflation may heat up—a formula for reduced earnings growth.

• **Market excesses:** While we have observed that, on the surface, equity prices overall are only modestly rich, there are numerous other indicators of either investor complacency or excess. Here are a few:

- **Private equity:** According to industry tracker Preqin, private equity funds are sitting on "dry powder" totaling $1.1 trillion. That's a lot of cash chasing deals. The last time private equity funds were so awash in cash was 2007, when they overpaid for target companies and levered them with too much debt, resulting in multi-billion-dollar bankruptcies and restructurings.

- **Hot Initial Public Offerings (IPO's):** the IPO market is red hot this year, with 180 companies raising $50 billion. It's the strongest new issuance market since 2014 and, notably, stocks of money-losing companies have out-performed stocks with earnings.

- **Narrow spreads:** Spreads—the extra interest investors earn for investing in corporate bonds versus US Treasury bonds—are at historically low levels. This means that investors are receiving scant additional compensation for taking on more risk. This is the result of years of low interest rates and high levels of investor cash seeking better returns.

- **Debt explosion:** MarketWatch reports that total corporate bonds outstanding for US companies have increased by $2.7 trillion over the past five years, reaching a record $6.3 trillion. Consumers, too, have been borrowing freely—student loans and automobile loans outstanding now total $1.5 trillion and $1.2 trillion, respectively. We should recall what the aftermath of excessive debt looks like.

- **Market distortions:** M&A activity, corporate stock buybacks, and other financial engineering activities—combined with aggressive central banks' policies—have dramatically reduced the supply of equities in the market. So much so that the Wilshire 5000 Index contains only 3,492 stocks! The number of publicly listed US companies has fallen by half over the past 20 years, according to Credit Suisse.

• **Emerging markets:** The strong US dollar is a serious headwind for emerging markets with sizable US dollar denominated debt. Depreciated local currency makes it difficult for emerging economies to repay US dollar loans.

• **Inflation:** There are some indications of cyclical inflation. As we enter the third quarter earnings season, we will be listening especially closely for companies to comment on the degree to which they're seeing higher labor costs and higher input costs. It will also be telling to see whether they are able to pass along price increases.

• **Energy:** Oil prices have risen sharply, and may prove to be inflationary. Crude oil prices recently reached their highest levels since 2014, driven by imminent trade restrictions on Iranian barrels. And, according to the US Energy Information Agency, gasoline prices have nearly doubled from their lows in early 2016. Higher energy costs may well bleed into the broader economy.

• **Higher interest rates:** The Fed has lifted interest rates eight times since December 2015. It no longer views its policy as "accommodative." As interest rates rise, homebuying may pull back—mortgage rates are near seven-year highs—and corporate debt burdens may weigh more heavily on earnings.

THE WAY FORWARD: IT'S ALL ABOUT RISK MANAGEMENT

It is not the man who has too little, but the man who craves more, that is poor.
-Seneca the Younger

This is Emma. Emma is a golden retriever. Although she is absolutely a chow hound, there's no question that swimming is her favorite activity.

One fine steamy August day, Emma was lucky enough to be taken for a swim. She bristled with excitement, head and tail both held high. She strained at her leash, eager to take a dip in the river.

And then it happened. It happens a lot on humid summer evenings. Thunder.

That was it. No more swim. Poor dog—so afraid of thunder that it completely overwhelmed the joy of swimming. Tail down, she headed straight back to the comfort of the car.

As it goes with canines, so it goes with investors. Investors certainly experience a little frisson from rising portfolio values. But that pales in comparison with the distress they experience from declining portfolio values, when that happens.

So we need the portfolio equivalent of noise cancelling headphones to drown out the thunder, so that we can enjoy our investment swim.

That means it's a good time to monitor market exposures and review equity allocations. And to focus on quality, on companies with sustainable competitive advantages, strong balance sheets, and secular growth opportunities. Interest rate sensitive sectors with limited growth opportunities—utilities, REITs, consumer staples—are both cyclically and secularly challenged. Financial stocks face slow loan growth and net interest margin pressure. The health care sector appears to have better growth prospects, but is subject to potential political pressures. Disruption and technological change threaten profit margins in many industries—retailing, of course, but also financial services, media, and transportation, among others.

The outlook for real estate securities is mixed. Fundamentals for data centers, cell towers, and medical facilities are constructive, while office and retail properties are experiencing higher vacancies and softer rents. But higher interest rates are likely to hold back returns for the asset class as a whole.

Commodities remain troubled by growth deceleration in China and other emerging markets. A turnaround requires a better international growth story.

In bond portfolios, the Fed has been unambiguous about its intention to continue to raise rates. Chairman Powell, in a recent speech, described the US economic outlook as "remarkably positive." In such an environment, we think it makes sense to focus mostly on shorter maturities—generally less than five years. Given tight spreads for corporate and high yield debt instruments, we have a renewed appreciation for the appeal of US government and US government agency bonds.

Putting it all together, it feels like investors are moving into a FOMO (fear of missing out) stage. In other words—well, one--greed. Elevated consumer confidence, enthusiastic investors, risk seeking market participants. Optimism risks turning into euphoria—preparing the cycle to turn down.

Famed distressed debt investor Howard Marks, in his recently published book "Mastering the Market Cycles," observes that the source of cyclicality lies in human nature. "People get too excited and they commit errors to the upside. When the errors become clear, they adjust to the downside."

The cycle is turning. We note it. We don't experience FOMO. Instead, as stewards of your assets, we experience FOLC—fear of losing capital. So we emphasize high quality, financial strength, and sound fundamentals. And in our dual roles of protecting and growing capital, we don't unduly focus on the latter at the expense of the former.

It is too late to be greedy, even if it is perhaps premature to be fearful.

QUADRANT CAPITAL MANAGEMENT

A Subsidiary of Peapack-Gladstone Bank

100 PASSAIC AVENUE, SUITE 301, FAIRFIELD, NJ 07004
TEL (973) 276-0830 • WWW.QUADRANTCM.COM