INVESTMENT OUTLOOK

A QUADRANT CAPITAL MANAGEMENT PUBLICATION

FOURTH QUARTER 2018: THE PURSUIT OF HAPPINESS

Happiness? That's nothing more than health and a poor memory.
-Albert Schweitzer

The tiny Buddhist nation of Bhutan, high up in the Himalayas, leverages its lofty perch to advocate for the most expansive view of how the country is succeeding. Since 1972, Bhutan has emphasized the progress of its Gross National Happiness as the most significant measure of the well-being of its population. Inherent in this pursuit of maximizing happiness is a balance of material and spiritual or non-material values.

All well and good. A holistic and sustainable approach to development has a very 21st-century ring to it. The concept of measuring gross domestic product (GDP)—the market value of all final goods and services produced in a given period of time—dates back to the 1600's.

Alas, investors—seated at work stations with eyes glued on electronic screens—don't focus on spiritual matters and, arguably, retain that 17th century focus on GDP and other material matters. That limited vision brought tears to investors' eyes, as a host of worries beset markets. Among the most concerning: decelerating global growth (yep, the GDP thing), intensifying trade disputes, increasing geopolitical tensions, plummeting oil prices, and decreasing market liquidity.

Edvard Munch, The Scream (1893)

Bears circled the markets, growling and growing brave. Investors cowered, discarding stocks as they scurried and ran for cover.

The damage was widespread, as all risk assets sold off hard. US equities were particularly rocked, generating double digit losses, and international developed markets performed only modestly less poorly. Emerging markets, having performed poorly all year long, continued to turn down in the quarter. The story was no better for real estate and commodities, each down mid-single digits. The only refuges were bonds and cash, up low single digits.

Asset Class	Index	4th Quarter Returns	Full Year Returns
US Large Cap Stocks	S&P 500 Total Return	-13.5%	-4.4%
US Small Cap Stocks	Russell 2000	-20.2%	-11.0%
International Developed Markets Stocks	MSCI EAFE	-12.5%	-13.8%
Emerging Markets Stocks	MSCI EM	-7.4%	-14.6%
Real Estate	MSCI US Real Estate	-6.7%	-4.6%
Commodities	Bloomberg Commodities Futures	-7.6%	-10.6%
Bonds	Barclays US Aggregate	1.6%	0.01%
Cash	FTSE 3-month UST Bill	0.6%	1.9%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG, RUSSELL INVESTMENTS

The autumn market rout—a “glitch,” in presidential parlance—unwound prior advances in US equities and intensified losses in overseas markets. Large cap, small cap, domestic stocks, foreign stocks all sank in a red sea. Alternative asset classes—real estate and commodities—were similarly subject to investor fears. In short, 2018 was an unusual year in which investors failed to realize the benefits of diversification strategies.

Bonds ended the year flat, and only cash—cash!—generated positive returns. (Out-performing them all: salmon. A salmon index—the Norway OSE Benchmark—appreciated 2.8%. Who knew?)

The masters of the universe running hedge funds provided no shelter. Overall, hedge funds fell 4% for the year. Some of the most prominent large funds turned in much worse performance, with losses up to 34%.

Fortunately, markets—and investors—have a poor memory. As we turn the calendar to 2019, investors may forget the past year and hope for a better—and happier—future.

ECONOMIC CACOPHONY

I must learn to be content with being happier than I deserve.
-Jane Austen

In 2018, the domestic economy generated its strongest growth in ten years—perhaps more than we should count on, whether or not we deserve it. GDP expanded by 3%, driven by fiscal policy—increased government spending coupled with sizable tax cuts.

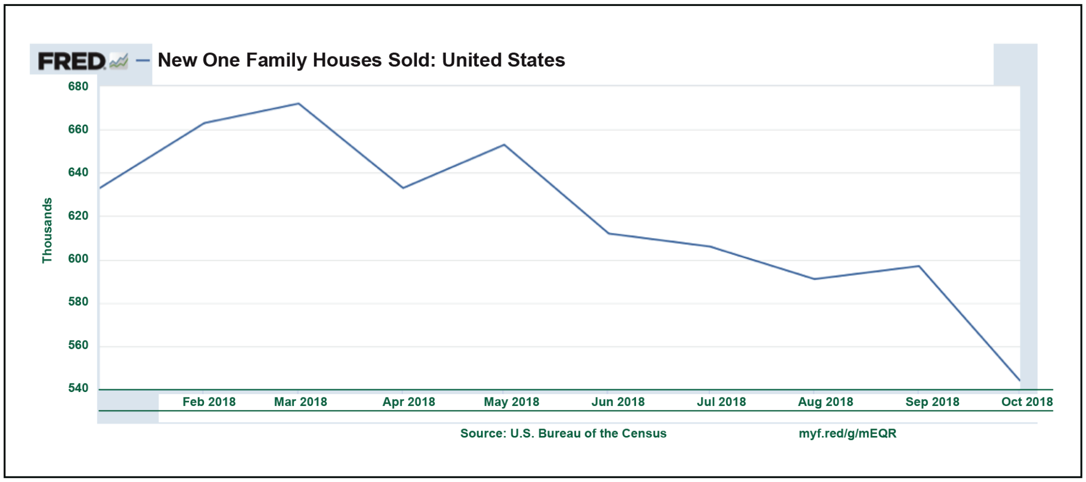
That said, growth peaked this summer; GDP grew by 4.2% in the second quarter, 3.4% in the third quarter, and the Atlanta Fed estimates 2.7% in the fourth quarter. Deceleration is in evidence—how much further growth slows remains an open question.

For much of last year, soft data—surveys of consumer sentiment, of small business sentiment, of CEO sentiment, of purchasing managers’ sentiment, of small business owners’ sentiment—have presented a more robust picture of the economy than hard data.

More recently, the soft data have, er, softened too. Consumer confidence fell in December, for the second month in a row. The Conference Board reports that CEO confidence has now declined for two consecutive quarters, as executives express concern about slower domestic growth. (Both current conditions and expectations contributed to the declines. Ongoing trade and tariff issues, volatility in the financial markets, cost of debt, and expectations of moderating global growth are heightening concerns.) The National Federation of Independent Businesses' Small Business Optimism Index peaked in August, and has declined each month since then.

Thus, softening soft data is beginning to align with softening hard data. Demand for durable goods produced by US factories showed signs of weakening. Excluding transportation, orders dropped 0.3% in November, and 0.1% when excluding military spending—the third such decline in a row, according to the Wall Street Journal. New orders for nondefense capital goods excluding aircraft, a common gauge of underlying business investment, fell 0.6% in November, the third decline in four months.

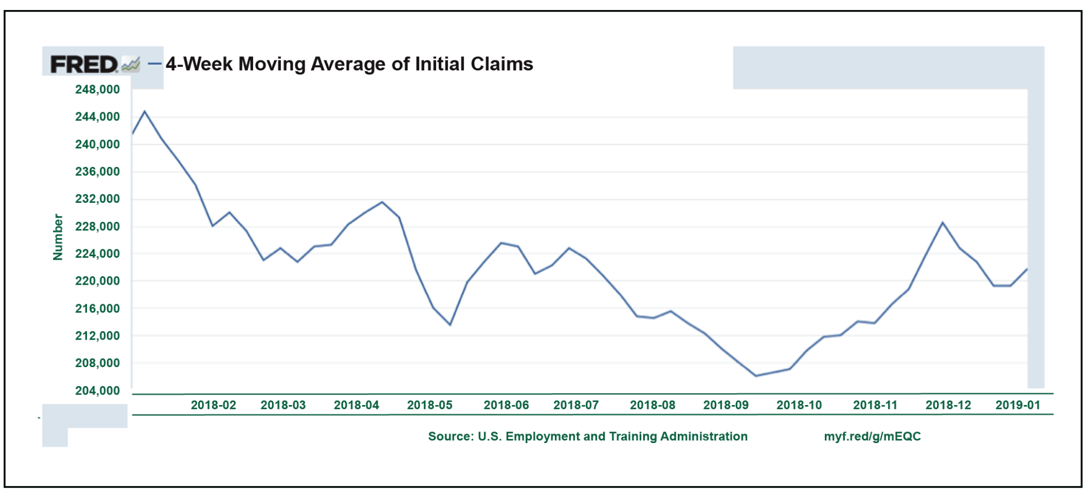
Real estate data have exhibited weakness for much of the past year, hurt by rising home prices and higher mortgage rates—translating as lower affordability, despite good news on the labor front. Pending homes sales index—contract signings for purchases of previously owned homes—fell 0.7% in November, down 7.7% from a year ago and the 11th straight monthly decline. New home sales have also declined throughout 2018.



The strongest economic data come from the labor market. Job growth remains strong, with average monthly net new jobs exceeding 200,000, the unemployment rate under 4%, and earnings up 3.2% over the past year. The broader U-6 measurement of unemployment, which includes discouraged workers and those working part time because they can't find full time work, also shows steadfast improvement, and is now down to 7.6%. Continued unemployment claims are also following a downward trajectory, and have fallen now to 1.6 million people.

A healthy labor market is a solid underpinning for consumer spending, which represents about 2/3 of the US economy. Consumer spending has increased 2.7% on average in the four quarters ended in September, consistent with the rise in disposable income.

Yet even on the labor front, beneath the surface, there are cracks. Corporate layoffs are up 29% in the past year, according to outplacement firm Challenger Christmas & Gray. And the four-week moving average of new unemployment claims, generally seen as a leading indicator, bottomed in September and has climbed since then.



On the international front, the pace of economic growth has clearly decelerated in both developed markets—notably Japan, France and the UK—and in emerging markets. There, China is the poster child for slower growth, as years of debt driven stimulus run their course while the labor force ages. Some effects from the tariff disputes with the US are likely a factor in the deceleration, as well. In December, one measure of the Chinese factory activity, the Caixin/Markit Manufacturing Index, showed outright contraction.

Lower commodity prices also suggest a weakening global growth picture. The price of copper, often cited for its utility as an economic indicator, fell 22% in the past six months; US crude oil prices, driven by over-production as well as demand worries, fell 38% in the fourth quarter alone.

All of that said, very few economists forecast a recession in the year ahead. Even if virtually all of them (outside of the Administration) are calling for slower US growth in 2019 (tax cut effects will wane, government expenditures will plateau, and business investment will contribute less to growth), it is a continuation of the economic expansion. The consensus view is for GDP growth of around 2.5%; the Federal Reserve recently revised downward its US growth expectation to 2.4%.

While we highlight some concerns on the economic front, we don't have a significantly variant view. The US economy is likely to expand in a range of 2.0 – 2.5%, anchored by healthy consumer spending. Upside may come from two important sources, a reduction in trade tension and a more dovish Fed. Hopefully, these forces will offset the effects of slower overseas growth on the US.

THE EARNINGS CUP RUNNETH OVER

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

For the third quarter, S&P 500 companies generated sales growth of 8.4% and earnings growth of 28.3%. These remarkably strong results follow earnings growth of 21% and 25% in the first and second quarters. Such shout-it-out growth reflects the stronger US economy in 2018, substantially aided by reduced corporate tax rates, and by repatriated overseas cash employed for stock buybacks.

Yet investors did not live in the moment, and did not experience any joy from gushing profits.

Insofar as corporate profits drive stock profits, we might have anticipated much more robust stock market appreciation in 2018. But, as market strategist Ed Yardeni observed, "You had a bear market in the P/E multiple, but a bull market in earnings." In other words, profits ballooned but investors were not willing to pay as much for those earnings.

Why not? Perhaps it's because corporate profit growth may not have been as strong as it appears. More than half of this year's profit gain owes to tax cuts and stock buybacks. The tax cuts helped to offset pressure on margins from rising labor, materials, and shipping costs. Negative effects from the trade war are only beginning to show up in corporate profits.

Additionally, that profit growth is not sustainable. According to FactSet, S&P 500 companies are expected to post a profit increase of 11.3% in the fourth quarter (and down from a forecast of 14% at the beginning of December.) That's still historically strong, but less than in prior quarters. Looking ahead, profit growth is projected to drop by more than half this year, with FactSet projecting an 8.3% earnings expansion rate (down from nearly 21% this year). With rising labor costs, that may well prove to be too optimistic. Some of Wall Street's gloomier forecasters warn of an outright earnings recession—a decline in year over year earnings—in 2019.

As we await fourth quarter earnings over coming weeks, pre-announcements are concerning. FedEx warned of lower earnings due to difficult conditions in Europe. Verizon announced plans to reduce its workforce by 10,400 jobs, and General Motors is cutting 14,000 positions. Apple reported that sales in China are falling far short of expectations. Delta and American pre-announced less friendly skies.

A reminder that Wall Street does not live in the moment—mindfulness is subjugated to worries about the future.

THE ROLE OF GOVERNMENT: TRADE DOWN AND FED UP

The reason people find it so hard to be happy is that they always see the past better than it was, the present worse than it is, and the future less resolved than it will be.
-Marcel Pagnol

While corporate profits may be the mother's milk of stock prices, they're not the only driver of markets. Government policies always play a role, too, and have been particularly prominent, even determinative, in recent market action.

On the trade front, disputes with China and with Europe have created substantial uncertainty in the business community. The imposition of tariffs is increasing costs and forcing companies to reconsider supply chains. It may well result in businesses deferring investment decisions as they adopt a wait-and-see mentality. That said, the trade imbalance has been deteriorating—the Wall Street Journal reports that through October 2018 the US trade deficit has widened to $503 billion, from $451 billion in the comparable year-ago period.

On balance, we agree with most analysts that the likeliest outcome is a negotiated agreement that may fall short of grander ambitions but serves to reduce tensions as modest improvements are implemented.

Likely the greater and more durable impact on both the economy and on financial markets is Federal Reserve policies and the communications surrounding those policies. The Fed, after its strenuous policy interventions in the economy following the Great Recession, has been engaged in normalizing policy through removal of prior accommodation. That normalization is taking two forms: raising interest rates (four times in 2018 and nine times since December 2015), and allowing maturing bonds to roll off its balance sheet. Fed funds rates are now 2.25%-2.50%, and two additional quarter point increases are penciled in for 2019. The Fed has reduced its balance sheet from $4.5 trillion to $4.1 trillion, and it is on pace to further reduce it to $3.6 trillion this year.

The Fed has argued that the US economy is exhibiting good growth, buoyed by consumer spending and tight labor markets. Its policy response has been, effectively, to remove loose monetary conditions. And, as excess liquidity gets soaked up, asset markets have responded. Higher interest rates increase the attractiveness of safer assets and decrease investors' willingness to pay up for risk assets.

That said, the Fed's most recent beige book characterized the pace of economic expansion as only modest to moderate. Amid a hail of criticism, it has also tempered its hawkish language of late last year, now emphasizing that it is prepared to be "patient" as it looks to incoming economic data to guide future policy moves.

Thus, two major pain points for markets last year—trade and interest rates—appear to have good potential to resolve more favorably in 2019.

INVESTING IN THE YEAR OF THE PIG

When one door of happiness closes, another opens, but often we look so long at the closed door that we do not see the one that has been opened for us.
-Helen Keller

As noted, 2018 was a challenging year for investors, with markets turning in their worst performance in ten years. But the past is not prologue, and we need to look forward, not back. According to the Chinese zodiac, 2019 is the year of the pig. This has been interpreted as a symbol of luck, overall good fortune, wealth, honesty, and general prosperity. May it prove so.

That said, astrology is not the primary determinant of investment strategy. As we look to manage portfolios in 2019, we are informed by these observations:

- The Fed is closer to the elusive "neutral" policy rate, and thus will perhaps play a diminished role as a market force. (Unless inflation picks up. We will be watching upcoming corporate earnings reports for indications of rising input costs, notably labor and tariff-influenced materials, but slower global growth and lower energy costs are pushing in the opposite direction.)

- A resolution on the trade front could result in a near term market melt-up but is unlikely to sustain growth on its own.
- Higher global indebtedness (world debt is now $250 trillion—three times what it was two decades ago, according to Citigroup analysis of data from the Institute of International Finance) combined with the cumulative and lagged effects of higher US interest rates—and the cessation of European Central Bank bond buying—will weigh on global growth. So will nationalist/populist sentiment, Brexit, commodities price deflation, and trade wars.
- Both stock and bond markets have re-priced in recognition of these developments. US equities now sell for about 15 times projected earnings, down from 19 times a year ago. 10-year US Treasury yields retreated from a peak of 3.23% in October to 2.65% recently. Overseas equities markets are substantially cheaper, at 13 times projected profits. Overseas bond markets feature dramatically lower yields than in the US, with many bonds still at negative interest rates.

In such an environment, we are offering this investment perspective:

- Looking at both the recent correction in equities—making valuations more attractive—and ongoing geopolitical concerns, we see risks and rewards as roughly balanced. Equities appear to be capable of delivering modestly positive returns in 2019. The economic expansion continues but notably more gradually.
- In the bond market, we maintain a distinct bias toward higher quality corporate and municipal bonds as well as sovereign bonds.
- A similarly distinct bias in equity portfolios toward higher quality, too. This means strong balance sheets with manageable debt loads, decreasing leverage prospects and strong cash flow generation. It also means businesses with recurring revenues, good order backlogs, and defensible competitive positions.

Volatility is back in vogue. We are reminded in the year of the pig of the old Wall Street saw that pigs get fat but hogs get slaughtered.

It's an appropriate warning about the need for investors to guard against being greedy. But it also reminds us as investment advisors that our ultimate mission is to help clients achieve goals. Short term market movements are not part of that framework. All this uproar and wailing and gnashing of teeth about the potential pace of gross domestic product growth and Fed policy! Better to focus on increasing happiness. It's an ongoing and long-term focus. We, as Sherpas guiding your financial well-being, ultimately measure ourselves by success in leading you to your high-altitude financial destinations.

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