Market Update – October 28, 2018

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After hitting all-time highs about a month ago, the equity markets have come under meaningful pressure over the last three weeks, dropping almost 10% over that time and essentially erasing their gains for the year. After record low volatility in 2017, this year has now seen short-term declines of around 10%+ on two occasions (the other occurred back in February when the market dropped ~12%). In light of this increase in volatility, we wanted to update you on what has transpired over the last few weeks, share our views on what has happened, and remind you of tools that we have at our disposal to preserve capital should the need to do so arise. While more specifics on our views are detailed below, the key messages that we want to relay are:

1. The ***underlying health in the US economy and corporate profits is sound***. While we would expect some moderation in growth in 2019, we do still expect solid growth in the US. That should bode well for US markets.

2. The typical cause of a major decline in the markets (i.e. 2008) is an economic recession. We believe that the ***likelihood of a recession in the US in 2019 is small***.

3. If the situation changes, ***we have tools that can be deployed in client accounts to help preserve capital.***

What Has Happened?

- The S&P 500 hit an all-time high on September 21st at a level of 2940.91. At the close of business on Friday, October 26th, the S&P 500 stood at 2658.69, a decrease of 9.6% over that relatively short period of time.

- The primary cause of this decline is increasing investor concern about the growth outlook for the US. There are two reasons why those concerns have increased:

    1. ***Tariffs*** – Discussions around US trade with its partners have impacted the market all year, typically resulting in market declines on days when investors believe tensions are rising and market rallies on days when investors believe tensions are falling. While trade agreements have been established between the US, Mexico, and Canada, and trade tensions have eased notably between the US and Europe compared to earlier in the year, investor concern has

increasingly focused on a lack of progress with China. In their earnings reports for the third quarter (currently being reported now), a growing number of management teams have highlighted the potential negative impact of tariffs on their future business.

- *Our View* – We are not proponents of tariffs, as they serve to raise costs within the system to either businesses or consumers (or both) and generally result in hurting economic activity. As it relates to China, **most of the tariffs have only been proposed, not implemented**, and trade negotiations between the US and China should take place before the proposed tariffs are fully implemented. This is the same tactic that the Trump Administration used effectively with both Mexico and Canada in its negotiations for a better trade deal. As such, we believe the Trump Administration is pursuing the same approach with China, and a trade deal of some kind will ultimately be reached. If we are wrong and all proposed tariffs are implemented, it would have a meaningfully negative impact on US economic growth (estimated at ~1.2% worst case). However, the effects of the recent tax law changes (already gone into effect) reduce the negative impact to around 0.3% to 0.4%. That would suggest that economic growth in 2019 would be between 2.0% and 2.5% instead of the current ~3.0%. While not ideal, the US should still see healthy growth even if the proposed tariffs fully go into effect.

2. ***Rising Interest Rates*** – Interest rates have been increasing in 2018 thanks to the strength of the US economy and early signs that inflation may be starting to emerge. The yield on the US 10-Year Treasury began 2018 at 2.41% and currently sits at 3.08%. The Federal Reserve, under the new leadership of Chairman Jerome Powell, has raised the Fed Funds rate three times already in 2018, and has indicated that it will raise the Fed Funds rate by another 0.25% in December. Further, the current Fed outlook suggests an additional three rate hikes in 2019. Investors believe that rates could rise too high and too quickly, which would hurt businesses and consumers and potentially weigh on economic growth.

    - *Our View* – The Fed has a very difficult job trying to encourage strong economic growth while protecting the economy from the dangers of high inflation. Interest rates have been kept artificially low since the financial crisis in 2008-2009, and the Fed is eager to "normalize" rates since we are no longer in the midst of a financial crisis. However, the Fed governors have consistently said that their actions will be "data dependent," meaning that they will use economic data to determine how to adjust rates. While the Fed's bias may be to increase rates, we believe that the Fed will not do so if the data suggest that doing so would increase the risk of putting the US economy into recession.

What is Our Market View Now?

At the risk of sounding like a Pollyanna, we believe that the current decline in the market, while unpleasant, is a normal pullback that does not merit a change in one's strategic asset allocation. We do

not know how much lower the market will go, but we do not believe the market is setting up for a major decline similar to those that occurred in 2000 and 2008.

Historically, the biggest market declines have occurred (a) when the US was about to enter into an economic recession, and (b) when valuations in the market were high. Neither of those conditions exists currently. Specifically, we note that:

- In our opinion, ***the US economy remains in very good shape.*** Indeed, the initial estimate for US economic growth in the third quarter was just announced at 3.5%. That was better than expected and comes on top of 4.2% growth in the second quarter. As a result, the US economy for the full year 2018 should grow at a rate of 3.0%+. While conditions can change, often quickly, it would be highly unusual for the economy to grow at 3.0% in 2018, then turn around and have a recession in 2019. The economy is simply too big to turn that quickly given its current momentum. As a result, we think the likelihood of a recession in 2019 is small. The US will have a recession again at some point in the future, but our view is that the earliest one could come is in 2020. Note that a recession in 2020 is not our base case, it is simply the earliest that we believe one is possible. We note that similar fears gripped the market in early 2016, causing a ~12% decline in a roughly six-week period, only to see equities eventually rally back. So this current type of fear in the market is not unusual from time to time.

- ***Valuations in the US market are currently below historical averages***. Specifically, as of October 26th, the S&P 500 trades at a valuation of 15x projected earnings. The historical average for the market is a valuation of 16x projected earnings. Putting that into the context of the last major market declines….in 2000, the market was trading at a valuation of approximately 29x projected earnings. Prior to the decline in 2008, the market was trading at approximately 24x projected earnings. It is possible that projected earnings will come down in the future, but the valuation risk in the market is much lower today than it was in 2000 or 2008.

Tools We Can Use to Preserve Capital

If our outlook on the economy changes, or if conditions in the market deteriorate further, we do have tools that can be deployed that help preserve capital in client portfolios. That does not mean that client portfolios will go up in a declining market, but we can utilize tools that can mitigate the declines. Specifically:

- ***The best, most proven methodology to mitigate risk in client portfolios is diversification***. At a high level, our client accounts have typically been diversified based on their investment objectives, which determine the allocation to cash, bonds, and equities. At a lower level, we seek to further diversify client accounts among different types of bonds, equities, etc. Based on where we are in the business cycle, we may be introducing additional asset classes into client accounts to help lessen risk and potentially increase returns.

- We use cash strategically in client accounts, as cash is the first line of defense if we believe the equity markets will be increasing in volatility. We may raise cash as a tactical measure to lessen short-term exposure to equities.

- We may hedge a portion of the equity exposure in an account by investing in instruments that typically increase in value when the underlying market declines.

As always, please feel free to reach out to us at any time should you have any questions or concerns about your account.