2018 Themes and Outlook

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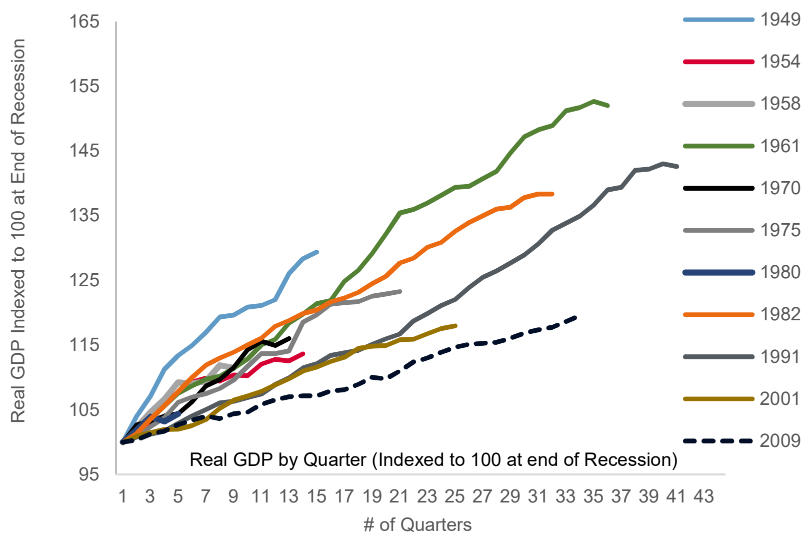
Theme 1: From the Lehman Lost Decade of Growth to a Future of Organic Growth

This year (2018) will mark the 10-year anniversary of the worst corporate bankruptcy in U.S. history. After a long weekend of pleading with potential buyers, Lehman Brothers, founded over a century ago, fell victim to the housing market collapse and in the early morning of September 15, 2008 filed for bankruptcy. Its filing set off a ripple effect of frantic mergers (e.g. Bank of America and Merrill Lynch, to name a couple), money market mutual funds "breaking the buck," the federal government taking over Fannie Mae and Freddie Mac, the government bailout of one of the world's biggest insurers (AIG) and the worst one-day point decline in the Dow Jones Industrial Average since the September 11th attacks.

The failure of Lehman Brothers exacerbated what was already emerging as a deep recession and contributed to a global credit crunch that compounded the effects of weakening growth. While the U.S. government and Federal Reserve took extraordinary and nontraditional measures to stabilize the global financial system, the recession has been labeled the "Great Recession," with the worst and longest contraction in economic activity since the "Great Depression."

Chart 1: Comparing Historical Economic Recoveries



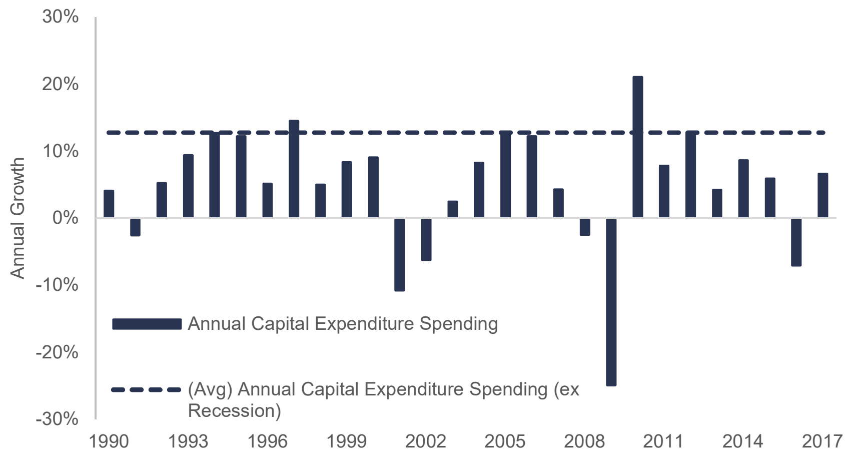
Footnotes: Current recovery from 2Q09 – 3Q17. Time period is all economic cycles from 1949 to present. Cycle ends when a recession occurs.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

While the drastic government and central bank measures helped the economy to emerge from recession in 2Q09, the economic recovery has not only been one of the longest in history but also one of the most disappointing (chart 1). While assets (e.g. equities, home prices), corporate earnings and consumer net worth have all returned and even exceeded pre-crisis levels, underlying economic activity has been challenged by weak corporate investment, government sequestration, strict regulations, a cautious and frugal consumer, an uneven labor market recovery (e.g. labor force participation still near 1970's levels) and stagnant wage growth.

Logic and history would suggest that this economic recovery is getting long in the tooth, especially since the nontraditional measures that were taken during the "Great Recession" are being unwound. The Federal Reserve has officially begun the unprecedented task of reducing their record high balance sheet and they have lifted the Fed funds rate for the fifth time in 2017. Using history as a guide, since the post WWII era, the U.S. economy has entered recession approximately three years (on average) after the Fed begins their tightening cycle (12/16/18 would be three years since the Fed first raised rates). However, we remain optimistic that the recovery still has legs and can continue through 2018 and at a slightly faster pace than investors have been accustomed to in recent years. Growth in 2018 is expected to be driven by the following five factors:

Corporate spending to accelerate: Corporate spending decelerated sharply during the "Great Recession." In fact, on an annual basis, during the recession (2009), spending on capital expenditures contracted at the fastest pace since 1949. While spending accelerated as the economy exited recession, the annual growth has been well below what is typically seen outside of a recessionary period (chart 2). However, with business confidence at the highest level since 1983, corporate earnings at a record high, economic growth accelerating, and corporate friendly tax reform to take effect in 2018, capex spending should accelerate and support economic growth.

Chart 2: Annual Growth in Corporate Capital Expenditures



Footnotes: 2017 is year to date as of 3Q17.
Source: Bloomberg Finance LP, Federal Reserve, Verdence Capital Advisors.

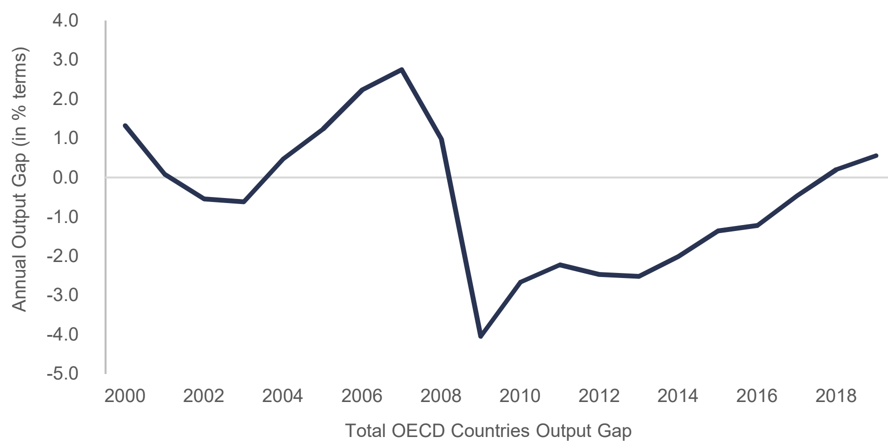
Consumer to be a driver: Personal consumption has historically made up 65-70% of U.S. GDP. With net worth at a record high and the unemployment rate at the lowest level since 2000, consumer spending should support U.S. GDP. In addition, forward looking indicators on consumer spending such as confidence suggest consumer spending should be healthy in 2018. Lastly, as the labor market continues to heal, the economy accelerates, and businesses benefit from corporate tax reform, we expect wages to rise and boost consumer spending.

Government to add to GDP: With the current administration successfully passing the biggest overhaul of the U.S. tax system since the 1980's, the other major items on the agenda that impact growth may be through infrastructure and military spending. While current law limits the defense budget (to $549 billion), President Trump is asking for over $100 billion more for defense spending. In addition, he campaigned on a $1 trillion infrastructure plan to improve our aging infrastructure. While the likelihood of this getting passed is uncertain after such a massive tax package, if it does get passed this could be a major boost to government spending and GDP (government spending makes up ~20% of nominal GDP). Lastly, from a regulation perspective, the current administration has been aggressively cutting regulation to speed up the economic expansion. It is estimated that regulatory burdens have cost U.S. manufacturers nearly $2 trillion per year, which equates to ~10% of GDP.[1]

Housing is back: While residential investment may only make a small portion of GDP (3-5% of nominal GDP), housing activity has far reaching tentacles in many aspects of the U.S. economy through the labor market, materials, technology and furnishings. The housing market should be supported due to demographics (e.g. millennials buying homes), weather related rebuilding (e.g. hurricanes, wildfires), the low level of housing inventories and homebuyer affordability that is well above the historical average.

Global synchronized recovery: The U.S. is benefitting from a global synchronized recovery in 2017 that is expected to continue through 2018 and 2019, at least. According to OECD projections, 2017 was the first year since 2007 that not one of the OECD countries saw economic activity decline and not one of the OECD countries is expected to see annual economic contraction until 2019 at the earliest.[2] In fact, after seeing economic activity fall below its potential GDP (output gap) for the past nine years, the total OECD output gap is expected to turn positive in 2018 and remain positive through 2019, at least (chart 3). A global synchronized recovery helps the U.S. economy through global trade, especially since U.S. corporations obtain ~40% of their revenues from overseas sales.

Chart 3: Global Economic Recovery to Continue



Footnotes: According to OECD projections as of November 2017.
Source: OECD, Verdence Capital Advisors.

Theme 2: The Great Unwind Underway — Navigating our Way Through the End of the 30YR Bond Bull Market

U.S. Treasury bonds have experienced a 30+ year bull market (chart 4) due to falling inflation and potential economic growth rates, demographics, globalization, low global yields (pushing global investors into Treasuries), five bear markets in equities (since 1980), one market crash (1987), the worst terrorist attack on U.S. soil since 1945 (9/11), five recessions including the worst recession since the "Great Depression," and most recently, nontraditional monetary policy (i.e. quantitative easing).

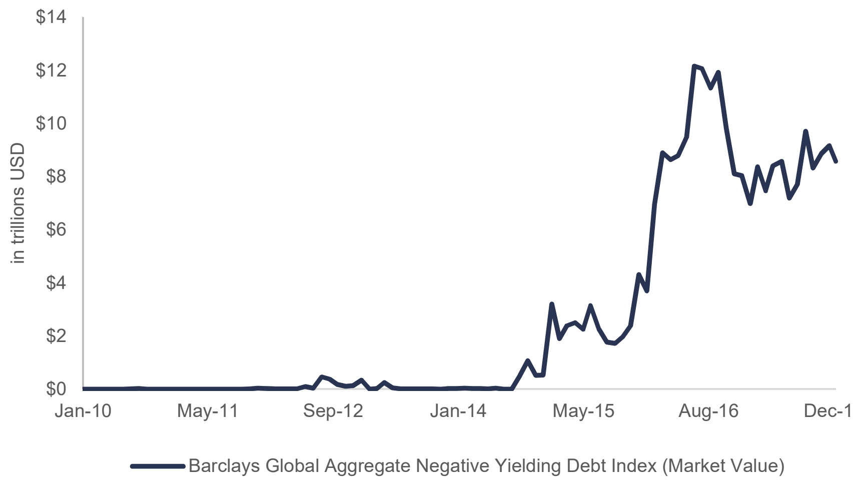
Chart 4: 10YR U.S. Treasury Yield

Footnotes: Data as of January 8, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

While yields should move higher over the next 12 months, we expect a gradual increase as opposed to a rapid rise higher in rates that may threaten the economic recovery. It is important to note that while the Federal Reserve is unwinding their emergency measures, some developed central banks are expected to maintain their ultra accommodative policy. The ECB is scheduled to slow their purchases of government bonds (e.g. tapering QE) in 2018 but the Bank of Japan remains on the defensive side given their disappointing inflation environment. In addition, the nearly $10 trillion of negative yielding debt (chart 5), globally, makes U.S. Treasuries attractive to international investors. With monetary policy normalizing in the U.S., fundamentals should return as a driver of yields.

Keep in mind that since the Federal Reserve intervened in the Treasury market to drive rates lower (i.e. QE in 4Q08), the historical relationship between the nominal growth rate of GDP and the 10YR Treasury yield has been distorted. In fact, the Fed's actions likely supressed the level of Treasury yields by 80-100 bps below where economic fundamentals would suggest they should be. As the Fed begins to unwind the balance sheet, yields should move towards where they are fundamentally justified given economic growth and inflation. Some other factors that should push yields higher include:

Chart 5: Negative Yielding Global Debt

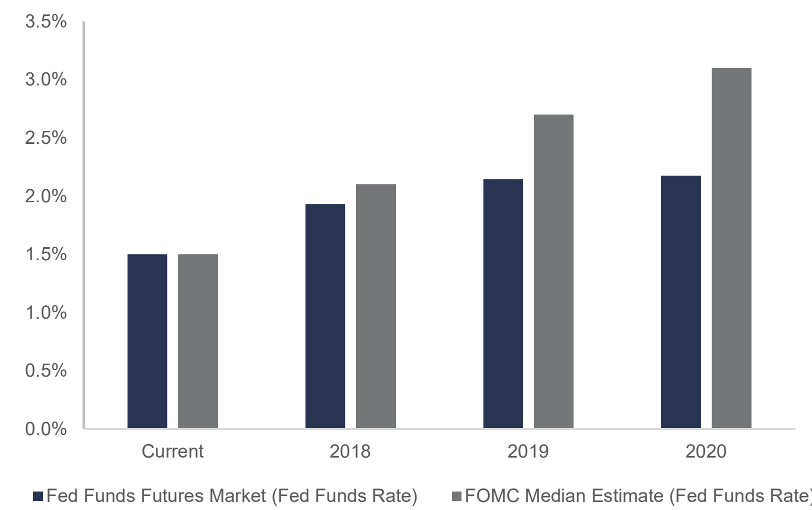


Footnotes: Data is monthly and as of December 2017.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Inflation likely troughing: The disinflationary environment that the U.S. economy has experienced in recent years is likely to be replaced by gradually higher inflation. Fading base effects (e.g. telecom prices), rising wages, fiscal expansion and better economic growth should push inflation higher. As a result, interest rates should increase.

Fed policy: The Federal reserve is expected to continue raising rates in the coming years as growth improves and inflation accelerates. As a result, broad interest rates should move higher. It is also important to note that there is a disconnect between where the Federal Reserve is expecting the Fed funds rate to rise to and what the futures market is expecting. As seen in chart 6, according to the median estimates by Fed officials, they are expecting higher rates than what the market is currently pricing in. This could result in volatility in yields over the next 12 months, at least.

Chart 6: Fed Funds Rate to Move Higher

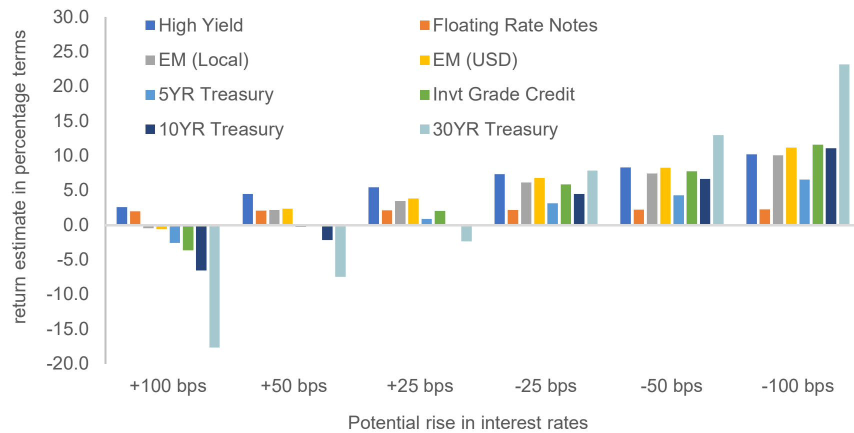


Footnotes: Data as of January 8, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Supply headwind: Treasuries will also face the headwind of less Fed support (i.e. QE unwind) and higher issuance as the U.S. government may need to increase issuance to pay for the recent tax reform and budget deficit. In addition, according to the Treasury maturity schedule, the Treasury department will need to roll over ~$7 trillion in debt in the next three years.

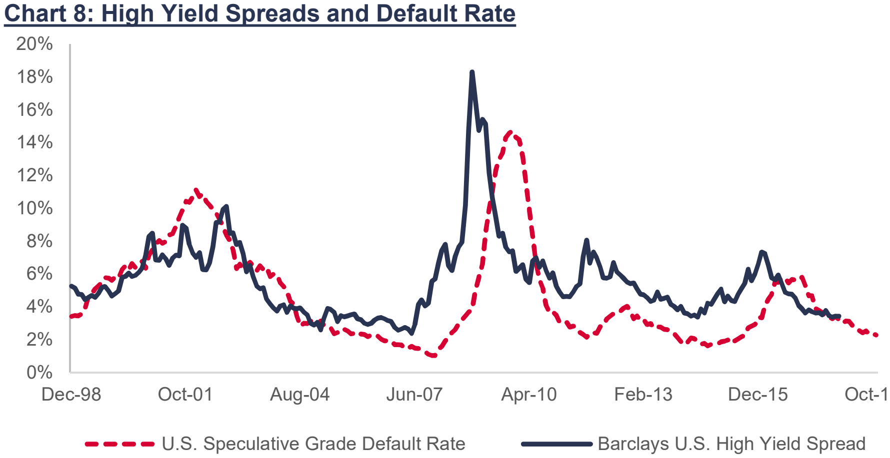
Given our base case economic scenario we recommend equities over fixed income. With interest rates rising due to better economic growth, a gradual move higher in inflation, a recession unlikely, solid risk appetite and strong credit conditions we would only recommend lower duration fixed income investments (e.g. floating rate bonds). The historically low level of interest rates leaves investors with a significant amount of interest rate risk, especially in core sovereign yields. For example, the duration of a 10YR Treasury is nearly 9 years. Therefore, 25 bps mover higher in the 10YR yield over the next year leaves an investors will little if any return above the coupon (chart 7).

Chart 7: Interest Rate Sensitivity



Footnotes: Data as of January 4, 2017.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 8: High Yield Spreads and Default Rate



Footnotes: High yield spread is as of December 2017. Estimate for defaults as of November 2017.
Source: Bloomberg Finance LP, Moody's, Verdence Capital Advisors.

While high yield characteristically has a shorter duration and default rates are expected to decline further, credit spreads are still historically low. From a valuation perspective, high yield spreads historically have traded ~100 bps above the default rate for speculative grade debt. Currently, the spread is more than 100 bps above the forecasted default rate (chart 8). Therefore, there may be room for modest price appreciation as well as the coupon. However, the risk reward is not attractive at this time and we would wait for a better entry point before adding to traditional high yield bonds. We will continue to look for unique credit opportunities in the private equity space which may look more attractive than traditional high yield bonds at this time. Emerging market debt may benefit from the global synchronized economic recovery, lower inflation and a stabilizaion in emerging market currencies.

Theme 3: Finding Opportunity in a Fully Valued World

The current bull market in equities is the second longest in history (chart 9) and has been driven by the historically low level of interest rates, low volatility, influx of liquidity (e.g. central bank intervention), restructuring of corporate balance sheets and the global synchronized recovery. Since the Great Depression, there has only been one other bull market in the U.S. that has had a longer tenure and that is the bull market that led up to the dot com bubble (1990-2000). If this bull market continues through 2018, it will surpass the 1990-2000 bull market to be the longest and potentially strongest bull market in history. The equity rally has been a global phenomenon with the MSCI AC World Index making nearly 70 record highs in 2017 and countries such as Germany, UK, Brazil and Mexico all making fresh record highs in 2017.

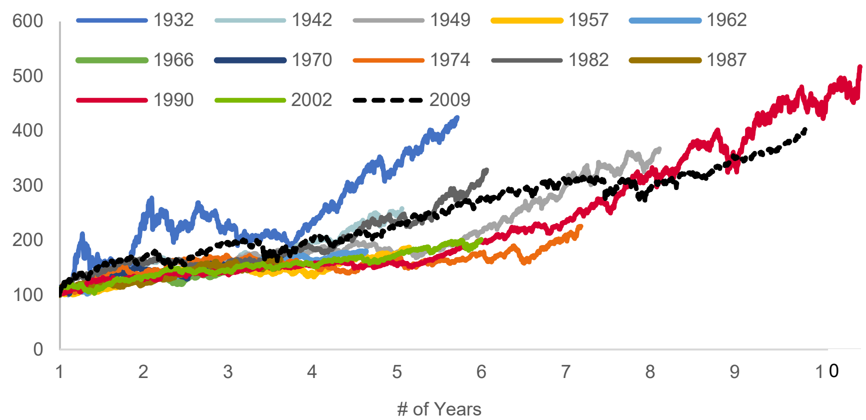
Some of the factors that should support equities in 2018 include:

Tax reform: The Tax Cuts and Jobs Act that was signed into law at the end of 2017 should benefit corporate earnings in 2018. We expect the actual tax cut and full, immediate expensing of capital investments to be the biggest beneficiary to earnings and will likely result in double digit earnings growth for U.S. equities in 2018. In addition, using history as a guide, companies used the tax cuts from 2003 for shareholder friendly activities. Buybacks grew over 70% in 2004 (chart 10) and dividends grew in the double digit range in 2004, 2005 and 2006. Lastly, the nearly $3 trillion in cash overseas that can be repatriated should result in an increase in M&A activity.

Global synchronized recovery: The global synchronized recovery should benefit not only U.S. equities as they receive ~40% of their earnings from overseas but also those export driven equity markets (e.g. Japan, Germany, Asia). According to consensus estimates, all the major global equity indices are expected to see upper single to lower double digit earnings growth.

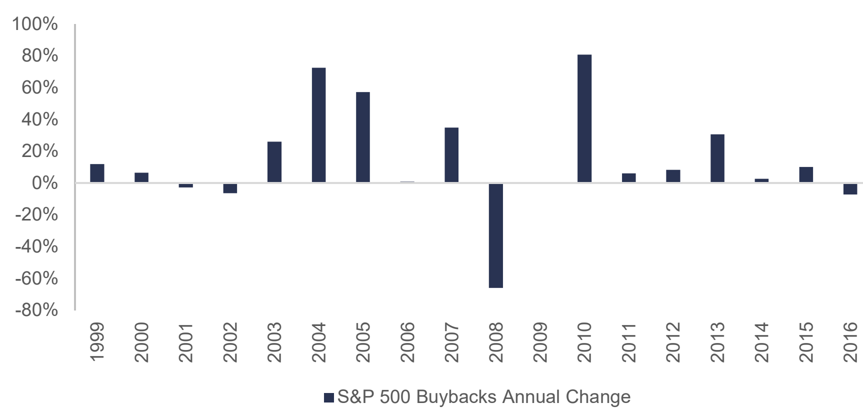
Relative to bonds; equities are attractive: Internationally, the dividend yield of many major indices exceeds its long term sovereign yield, making equities look attracitve versus bonds. In the U.S., the earnings yield (inverse of P/E) of the S&P 500 is significantly higher than the 10YR U.S. Treasury yield (chart 11). The relative attractiveness of equities over bonds combined with strong risk appetite should support equities in 2018.

Chart 9: Bull Markets Since Great Depression



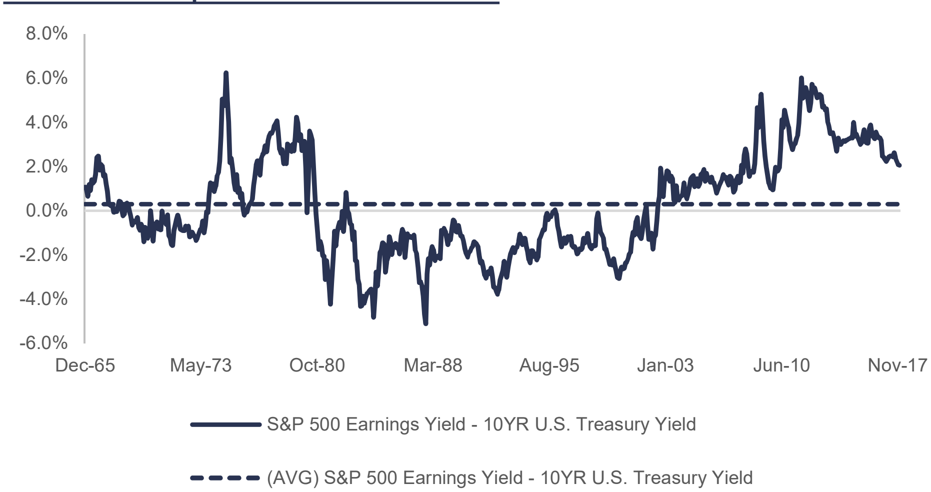
Footnotes: Time period reflects all bull markets since 1932. Current bull market as of January 5, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisers.

Chart 10: S&P 500 Buybacks Annual Change



Footnotes: Calculation uses rolling four quarter sum, year over year.
Source: Strategas Research Partners, Verdence Capital Advisers.

Chart 11: U.S. Equities Attractive vs. Bonds



Footnotes: Data is monthly and as of December 2017.
Source: Bloomberg Finance LP, Verdence Capital Advisers.

Past performance is not indicative of future returns.

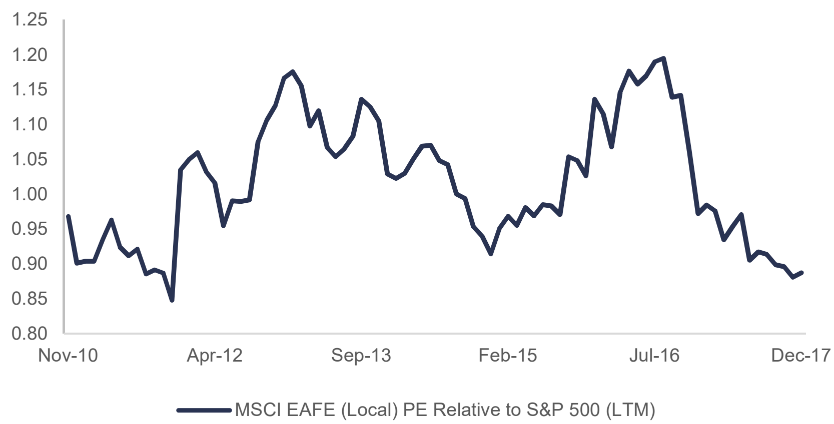
From a regional perspective, the environment for global equities looks attractive but international equities have some advantages over U.S. equities in 2018.

U.S. further in tightening cycle: While the Fed is committed to a gradual normalization of monetary policy, the ECB and BoJ remain accommodative. This divergence in monetary policy favors Europe and Japan equities over U.S. equities.

Valuations more attractive: When looking at the MSCI EAFE which includes all the major equity regions outside of the U.S., on a relative basis, valuations look more attractive than the U.S. (chart 12). In addition, while the tax cut should help U.S. companies, rising wages and inflation as well as higher interest rates will likely pressure margins over the next 12 -18 months. However, Europe still has room for margin expansion (chart 13).

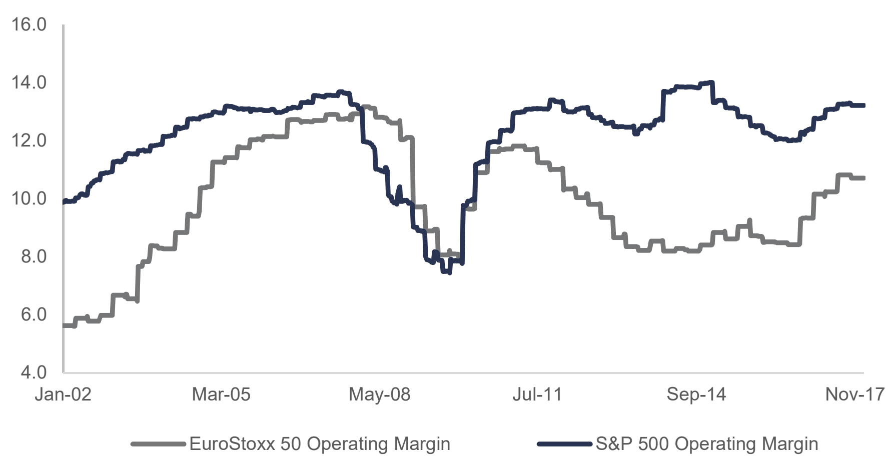
Relative attractiveness better in international equities than in U.S. equities: When simply looking at a region's dividend yield compared to its sovereign yield, international equities look more attractive than U.S. equities. Given that the ECB and BoJ have benchmark yields near or below zero, their sovereign yields have fallen below the dividend yield offered in their respecitve equity markets (chart 14). For example, an investor in the UK can get over 200 bps more if they invest in the FTSE 100 compared to buying the UK 10YR Gilt. This makes equities more attractive than bonds in respective regions. In the U.S., given the recent rise in sovereign yields, the S&P 500 dividend yield is below the 10 YR Treasury yield by ~60 bps.

Chart 12: MSCI EAFE (Local) PE Relative to S&P 500 (LTM)



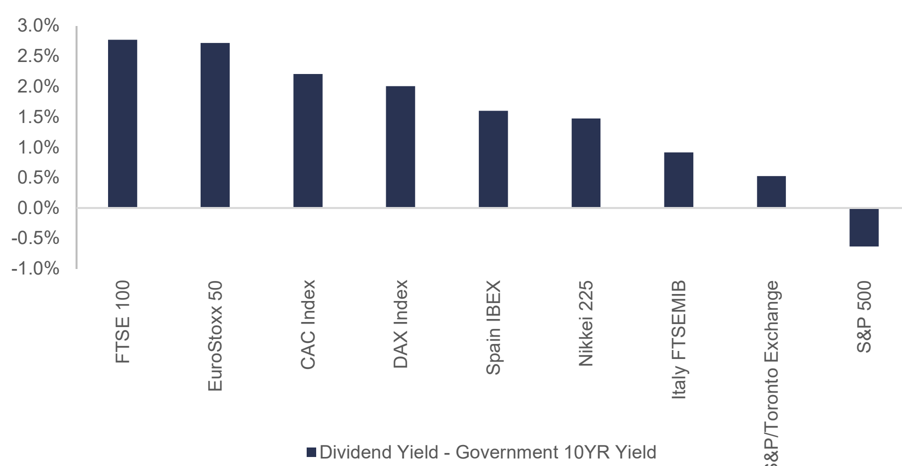
Footnotes: Data is as of December 2017.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 13: U.S. Peak Margins?



Footnotes: Data is weekly and as of January 5, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 14: Dividend Yield - Government 10YR Yield



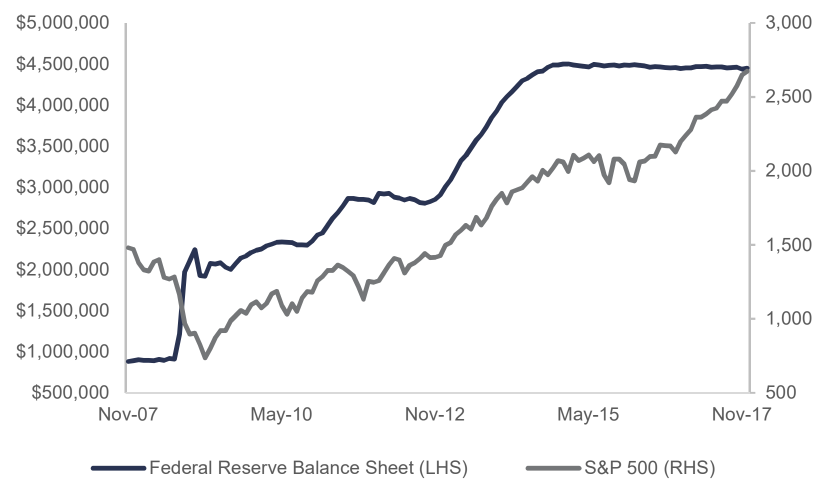
Footnotes: Data is as of January 8, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

While we expect the global economic environment in 2018 (e.g. improving growth, no recession on the horizon and slow increase in interest rates) to be supportive of an ongoing rally in global equities and increase in earnings, the road higher will be much choppier than what investors have been accumstomed to in recent years. In addition, as the economic cycle matures and interest rates increase, investors should accept a more historically normal magnitude of returns (5-10% with dividends in the U.S.) as opposed to the outsized returns that have been seen in recent years. At current levels, the equity market may be pricing in perfection from an economic, political and interest rate environment and borrowing returns from next year. In fact, there is a strong likelihood that price to earning multiples will contract in 2018 as interest rates and inflation accelerate. As we move into the late cycle and as the Fed continues raising rates, in aggregate, we would favor value over growth. However, select growth sectors can benefit from the tax reform. For example, tech should benefit from the tax repatriation (biggest sector with cash held overseas) while discretionary may benefit from additional consumer spending. In addition, consumer discretionary is not just traditional brick and mortar stores. The sector also holds major media and online retailers. These are just some of the reasons why active management is important in 2018 compared to passive management.

Theme 4: Complacency is Provoking the Sleeping Volatility Giant

Volatility in many different asset classes has been driven to record lows due to the improving global economic environment, strong risk appetite, an abundance of liquidity by central banks and low correlations among individual stocks. While our base case scenario is that the global economy should continue to accelerate, earnings should rise at a double digit pace and equities should outperform bonds, there are many market forces that may be poking the sleeping bear of volatility. As a result, we expect the rise higher in global risk assets to be more volatile in 2018. This presents a good opportunity for active management and given our base case scenario for economic growth, we maintain a buy on the dip mentality as opposed to a sell on strength. Some of the factors that can push volatility higher include:

Chart 15: Fed's Influence on Equities



Footnotes: Data is monthly and as of December 2017.
Source: Bloomberg Finance LP, Verdence Capital Advisers.

Unwind of QE: There has been a historical correlation between the expansion in the Fed balance sheet and the climb higher in the S&P 500 (chart 15). While equities have absorbed the gradual normalization in interest rates (five rate hikes since 2015), the unwind of over $4 trillion of Treasuries, agencies and mortgages may be more than the market can handle. Especially if it results in a more chaotic move higher in interest rates. This can disrupt credit markets by tightening credit conditions and threaten the economic expansion.

Good news is old news: The much anticipated corporate tax reform was signed into law before Christmas and was delivered earlier than most had expected. While analysts are still calculating the increase to 2018 earnings because of the tax reform, the majority believe it can add between $5-$20 on intial estimates for S&P 500 earnings. It is important to note that markets are efficient and most likely are already reflecting the tax bill and expected increase to economic growth.

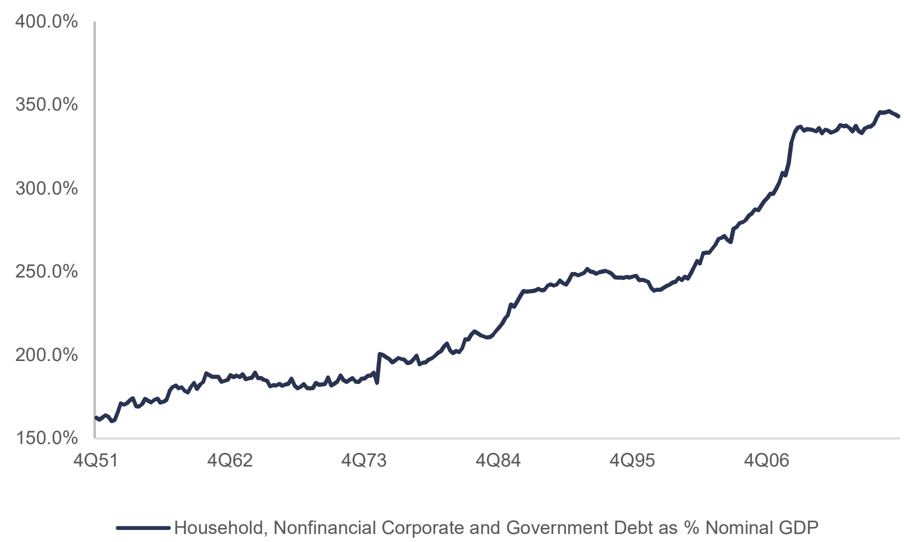
Debt overload: The U.S. debt to GDP has been overlooked as the global euphoria over central bank intervention has driven risky assets higher. However, public debt as a percentage of U.S. GDP has increased from 38% at the end of 2008 to 77%, currently. In addition, if you look at total debt at the household, business and government level it is nearly 350% of GDP (chart 16). With the tax bill most likely to be deficit expansionary, global investors may begin to get nervous about the fiscal health of the U.S. This could result in a disorderly rise higher in yields which could threaten the recovery and increase recession risks.

Global political risks: In Europe, Brexit negotiations are still ongoing and the surprise Catalonian elections results at the end of December increase the political risks in 2018. In the U.S., we are entering a midterm election year and with President Trump's historically low approval rating, there is increasing risk that the Republicans will lose control of Congress. In fact, historically, the President's party loses, on average, 30 seats in the House and four in the Senate in their first midterm election year.

Geopolitical risks: North Korea continues to be an ongoing threat. Especially given how unpredictable both leaders (U.S. and North Korea) are perceived. While the market has absorbed over 20 missle launches from North Korea in 2017, if the situation escalates this could disrupt equity markets.

Heightened valuations: Sometimes, market contractions are not driven by a single event but a valuation scare. With valuations stretched using a variety of metrics in the U.S., there is concern that investors may begin taking profits and fund outflows may be exacerbated as the market declines.

Chart 16: Total U.S. Debt vs GDP



Footnotes: Time period reflects 4Q51 to 3Q17.
Source: Federal Reserve, Verdence Capital Advisers.

Enter 2018 Cautiously Optimistic:

As we enter 2018, it is important to reiterate that the threat of a recession in the U.S. seems muted over the next 12 months. As a result, equities should outperform bonds for the seventh consecutive year. However, achieving returns in the global capital markets will be more difficult than investors have been accustomed to since the end of the "Great Recession." The 30+ year bull market in bonds is likely behind us and equity valuations at current levels may already be reflecting the stimulus in the U.S. and strong expected global growth. In addition, risks that may disrupt not only the bull market but the economic expansion are growing so we expect a more volatile year for investors. In fact, while we expect markets to end higher in 2018, we do not rule out the possibility of at least a 5 or 10% correction before the market moves higher again. In this environment, hedging vehicles and active management should outperform a more passive investment strategy. We will continue to evaluate our recommended asset allocation and make changes if warranted.

[1] National Association of Manufacturers 2017 estimate.
[2] OECD stands for Organisation for Economic Co-operation and Development. See OECD.org for list of OECD countries.

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