The Economic Party Continues

Who Invited Volatility?

As we enter 2Q18, let's take a step back. Step over 3,000 days back and remember where we were at the start of 2Q09. It was the final quarter of the longest and worst recession since the Great Depression. Unemployment was still at the highest level since 1983, the percentage of Americans that wanted to work full time but were forced to work part time was climbing into the double digits, wages were sliding at a rapid pace, manufacturing was contracting at the fastest pace since 1980. Small business optimism was at the lowest level in nearly three decades and future corporate spending plans had vanished. In addition, the housing market was still frozen with existing home sales making a new record low and prospective buyer traffic was basically non-existent. The consumer was taking drastic measures after watching their net worth slide $12.8 trillion. They cut spending on everything from autos, clothing, furniture and even slashed spending at grocery stores at a record pace. Instead, they let their savings rate climb to a 16-year high and opted to park what was left of their savings into money market mutual funds...and in retrospect it was one of the greatest moments in history to buy equities!

Fast forward to a far different second quarter. As we enter 2Q18, the economy has come full circle from the depths of the worst recession since the Great Depression. We are witnessing an economy that is finally proving that it can flourish without emergency central bank support. The Fed has been able to raise interest rates six times since December 2015 and will likely raise them another two to three times this year. In addition, they have entered the unchartered territory of unwinding a balance sheet that has ballooned to the size of the German economy! Consumers are back in full swing along with record high net worth and confidence is near the highest level in almost two decades. Lastly, business confidence is at the highest level since 1983, earnings are growing in the double digits and corporations are starting to spend once again!

The Party Can Still Roll On!

From a timing perspective it is fair to say that the current economic expansion is getting long in the tooth. Since 1933, the average economic expansion has lasted 50 months. By the end of this year the current expansion will have spanned 114 months. This is the second longest expansion, right behind the 1991-2001 expansion; however, **there are six main catalysts that suggest this economic party still has room to run.**

1 The central bank hasn't stopped paying the party bill.

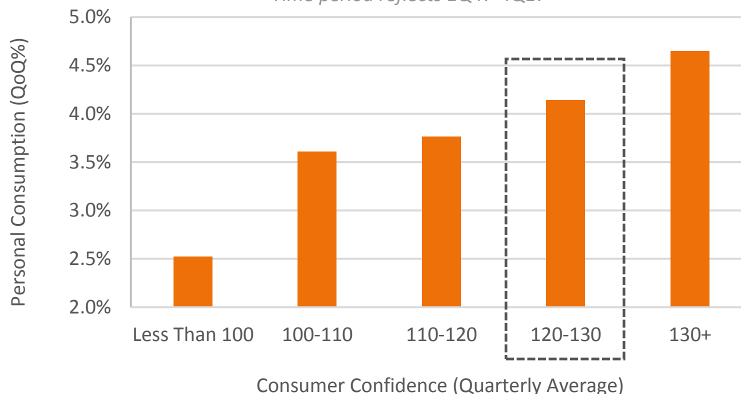
One of the quickest ways to choke an economic recovery is a Federal Reserve that over tightens monetary policy. Going back to 1945, the U.S. economy has, on average, entered a recession ~2.5 years after the Fed starts tightening monetary policy. Using history as a guide, it would suggest a recession could occur by the second half of this year. However, this cycle is unique given the historically low level of interest rates, especially real interest rates (accounting for inflation). When looking at the past six recessions, the real Fed Funds rate rises on average, to ~3% in the 12 months and ~5% in the six months before a recession. However, in this cycle, because the Fed has been so gradual with rate hikes, the real Fed Funds rate is basically flat.[1] In fact, it has not been in positive territory since March 2008. Therefore, central bank tightening is a long way away from closing the economic party down.

2 The consumer is dancing the night away.

The consumer makes up nearly 70% of GDP and historically there has been a solid correlation between consumer confidence and spending. With the labor market the strongest it has been in this economic cycle, lower taxes and wages finally rising, consumer confidence has increased to the highest level since 2000. Historically, when confidence is hovering around these elevated levels (120-130), consumer spending tends to grow ~4% per quarter (annualized) **(Chart 1).**

Chart 1: Consumer Confidence Suggests Solid Consumption

Source: Bloomberg Finance LP, Verdence Capital Advisors, Time period reflects 1Q47-4Q17



Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

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3 Businesses just got to the party.

There is a trifecta of strength in U.S. business confidence as being seen through small business and CEO confidence at cyclical highs as well as the number of new startups at the highest level since 1996 **(Chart 2).** Strong confidence and favorable tax reform should continue to boost business spending in the coming quarters. It is estimated that the amount of money that can be repatriated to the U.S. due to the tax changes on overseas earnings could amount to ~$500 billion.[2] Some of this money will be used for stock repurchases and dividends but some will likely be used for additional capex spending.

4 Manufacturing has been the life of the party.

Manufacturing is receiving a boost domestically but also from the global synchronized recovery. In fact, the U.S. manufacturing gauge (ISM) has been in expansion territory for 24 out of the past 25 months and reached the highest level since 2004. Going back to 1948, when the ISM Manufacturing Index is within the recent range (55-60), GDP has grown, on average, 4-5% per quarter (annualized) **(Chart 3).**

5 There's a lack of excess party favors.

There is little indication of excesses in the economy that have historically led to a recession. For example, companies are not holding significant amounts of inventory that would result in a pullback of investment/spending if growth started to weaken **(Chart 4).**

6 The government finally got the invite!

The U.S. government just passed a $1.3 trillion omnibus spending bill that includes a $500 billion increase in new federal spending. After years of sequestration and muted spending, the Government is expected to be additive to GDP this year. The spending bill is earmarked for many social programs but also for defense spending and ~$1 billion for construction of the Mexico/U.S. border wall.

Chart 2: Start Ups at the Highest Level Since 1996

Source: The Kauffman Index, Verdence Capital Advisors, Data as of May 2017

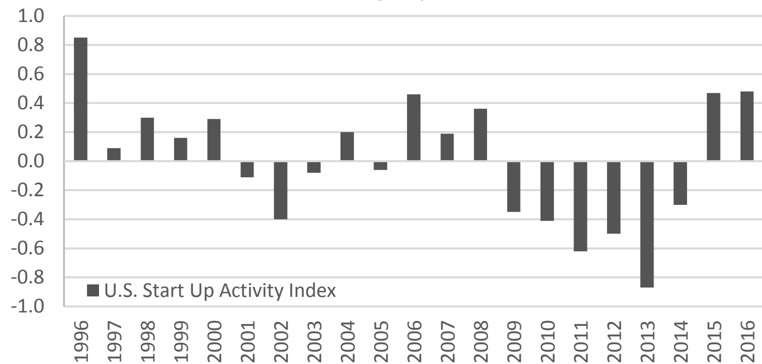


Chart 3: Manufacturing Should Support Growth

Source: Bloomberg Finance LP, Verdence Capital Advisors, Time period reflects 1Q48 to 4Q17

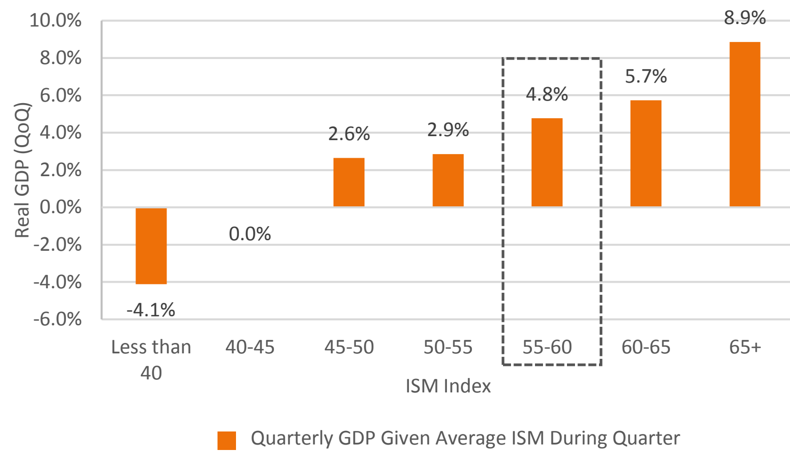


Chart 4: No Signs of Inventory Overhang

Source: Bloomberg Finance LP, Verdence Capital Advisors, Time period reflects Dec 1980 – Jan 2018

Fixed Income:
Defense is the Best Offense!

As the economy has proven its underlying strength, fixed income investors have begun to feel the pain of the end of the 30+ year bond bull market. Through the first quarter, the Bloomberg Barclays Treasury Index was off to its worst start to a new year in nine years **(Chart 5)** and even the two-year Treasury note, which traditionally carries less interest rate risk than longer term bonds, has declined for the past two consecutive quarters. To put this in perspective, the two-year Treasury note has posted positive performance for ~90% of the quarters since the early 1980s.[3]

This gradual unwind should continue because in a historical context, interest rates are still extremely low. For example, even with the ~150 bps increase in the 10 YR Treasury yield since the 2016 low, the yield is in the 4% percentile compared to history.[4] In other words, the 10YR Treasury yield has been higher 96% of the time since its inception in the early 1960s. There are several factors that should contribute to the ongoing unwind of the decades long bond bull market.

- **Getting back to traditional bond fundamentals:**
  Interest rates typically take their direction from three factors: inflation, growth and credit risk. However, since the end of the Great Recession of '08/09, they have taken their direction from massive global central bank buying. Since Treasuries are considered the highest of credit quality, the move in rates is expected to be attributed to solid economic growth and a gradual increase in inflation. Not only is the U.S. economy expected to produce some of the best growth rates that we have experienced during this economic expansion but the output gap (difference between actual growth and potential growth) turned positive in 2017 and is expected to continue to improve before peaking in 2019 **(Chart 6).** The closing of the output gap, combined with wages growing and producer prices near the highest level in seven years (eventually should filter to the consumer) should push inflation and ultimately interest rates higher.

Chart 5: 10YR Treasury Note Off to Worst Start to a New Year Since 2009

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data as of 3/31 per calendar year

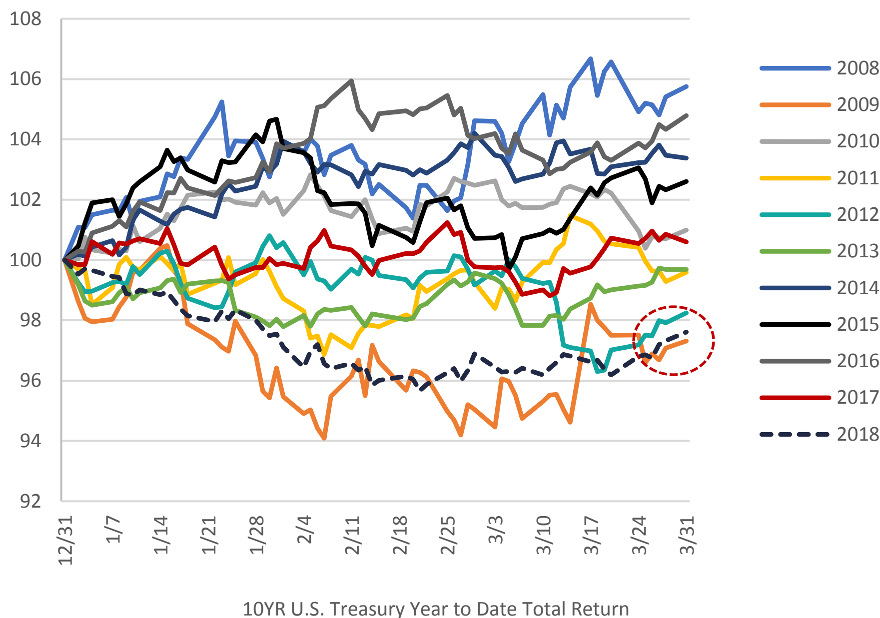
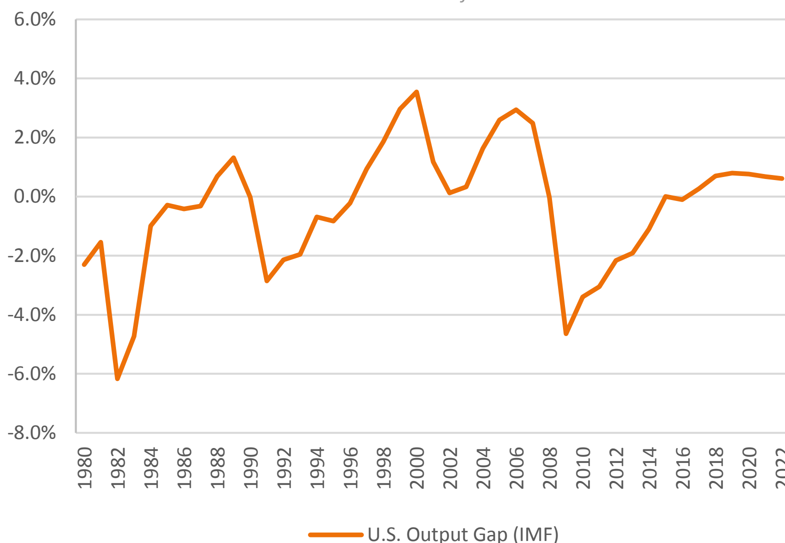


Chart 6: Output Gap Has Closed

Source: Bloomberg Finance LP, IMF, Verdence Capital Advisors, Data and estimates as of March 2018



Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

- **Systematic normalization:**
  The Federal Reserve is not only raising the benchmark rate, but they are also "passively" reducing their balance sheet (allowing current holdings to mature). This is an unprecedented endeavour given the size of the Fed's balance sheet which has ballooned to ~20% of nominal GDP. In fact, by holding $2.4 trillion in U.S. Treasuries, the Federal Reserve holds more Treasuries than China and Japan combined. This process will likely take several years before the balance sheet is considered in more neutral territory, therefore volatility in interest rates is likely to continue. An investor can already witness the unwind and its effect. Since the Fed announced their intention to reduce their balance sheet (Sept. 2017) the 10-year Treasury yield has increased ~60 bps **(Chart 7).**

- **Be careful being in the wrong place at the wrong time:**
  The demand dynamics for Treasuries is changing (end of QE globally) at the same time that investors should be concerned with an increase in supply in the Treasury market. The Federal government's recent tax reform package and omnibus spending bill is expected to increase the federal deficit. As a result, Treasury issuance is expected to approach $1 trillion this year but also exceed $1 trillion in 2019 and 2020. The last time the government needed to float over $1 trillion in federal debt per year was in the aftermath of the Great Recession **(Chart 8).**

These factors, combined with the relatively low level of interest rates creates a dangerous environment for fixed income investors and should alter the way that investors see traditional fixed income as a hedge against risk. We recommend investors be defensive in fixed income from a credit quality and duration perspective. While we do not expect a significant spike in default rates (e.g. strong economy, healthy corporate balance sheets), high yield spreads near historical lows leave investors with little reward for the additional risk **(Chart 9).** As a result, we would move up the credit quality ladder and choose investment grade as opposed to high yield. From a duration perspective, we recommend short term, floating rate investments that may reduce an investor's interest rate sensitivity.

Chart 7: Fed Reducing Support of Treasury Market
Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is weekly and as of April 4, 2018

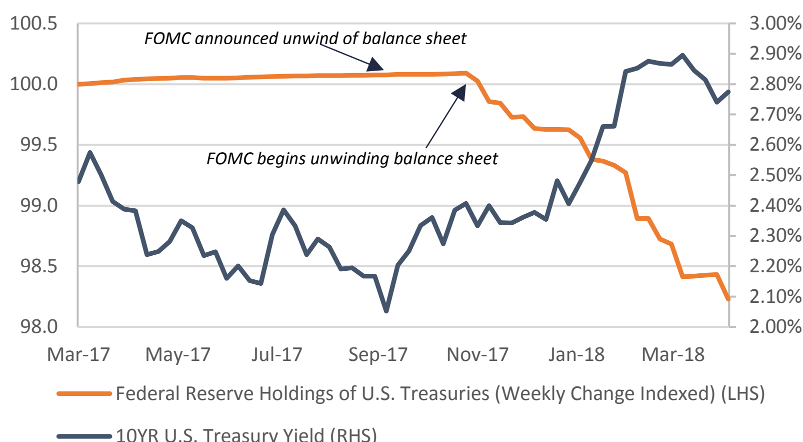


Chart 8: Expect Additional Treasury Issuance
Source: Bloomberg Finance LP, Verdence Capital Advisors, Data are estimates as of March 2018

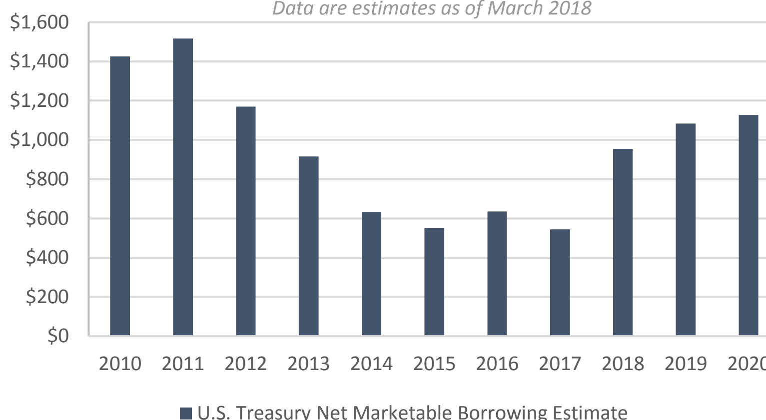


Chart 9: High Yield Risk/Reward Not Attractive
Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is as of March 30, 2018

Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

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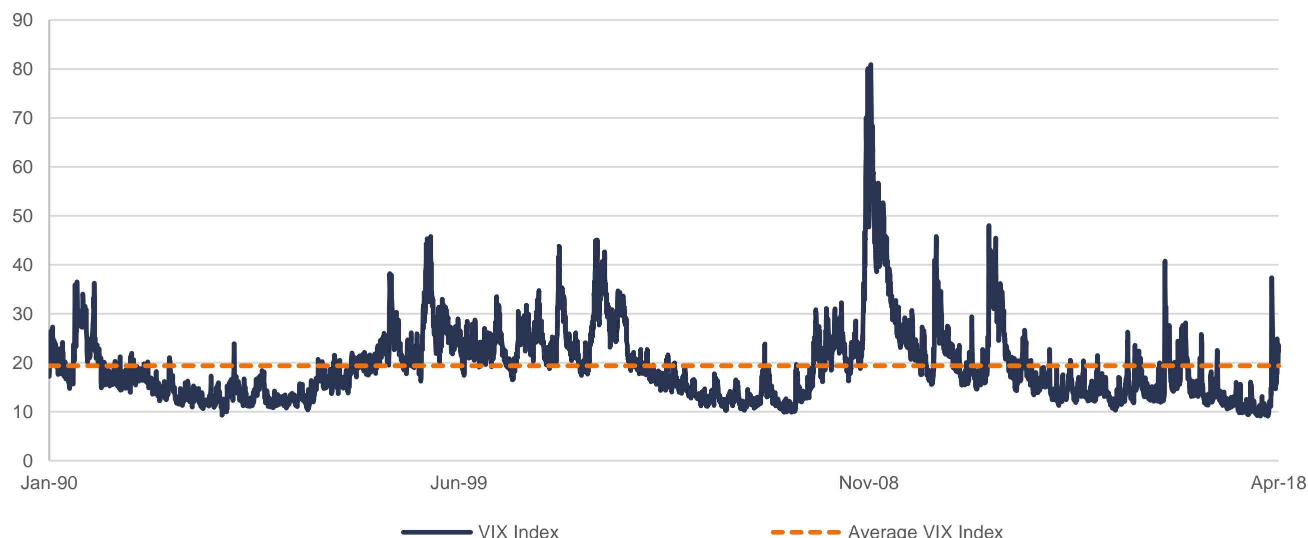
Chart 10: Volatility is Back!

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is as of April 2, 2018



Global equities: The Three V's— Volatility, Valuations and Veracity

For equity investors, the start to 2018 has been frustrating, painful and even eye-opening but in our view, what sums up the first quarter of 2018 is a reversion to the mean **(Chart 10).** It is likely that when we look back at the most recent years of record low volatility, outsized equity returns and heightened valuations, that those years will be considered an anomaly that was driven by temporary exogenous factors (e.g. excess liquidity created by the Fed, record low interest rates). These factors are beginning to unwind this year. Therefore, at this late stage of the bull market, investors should be prepared for more average returns with much higher volatility.

- **"V"olatility is healthy, warranted and welcome.**
  Up until early February, the S&P 500 had gone over 400 days without a 5% correction. That was the third longest amount of time between a 5% or more correction in history. In addition, the Volatility Index (VIX) hit a record low in 2017 and the S&P 500 only encountered eight trading days with a 1% or more move (up or down). That was the least amount of days with daily moves of that magnitude (1% up or down) in a calendar year since 1965. That type of environment was abnormal, and investors should get used to the type of volatility seen thus far this year. Volatility should not necessarily be feared but viewed as healthy, especially in the late stages of a bull market. It weeds out excesses, reduces investor complacency and creates more attractive pricing.

- **"V"aluations are important.**
  Despite the pullbacks this year, valuations for the S&P 500 still look fully valued. Earnings and dividends will be the most contributing factors to total return this year and should be supported by corporate tax reform and an improving economy. However, we caution investors against getting complacent simply because the pullbacks this year have made valuations look more attractive than they did at the start of the year. Think about this. At the start of the year the S&P 500 trailing P/E was trading at a 20-25% premium to its 20-year average. With the recent weakness in equities, it is now trading at a 10-15% premium. No matter which way you look at it, it is still trading at a premium to its historical average. Therefore, equities may be less expensive than at the start of the year, but they are still expensive! We would rather wait until we don't have to pay a premium to get aggressive with our equity allocation.

- **Embrace "V"eracity.**
  Veracity refers to truth. Investors need to embrace the painful reality that the bull market cannot trudge on forever and most of the total return in this bull market is likely behind us. Investors need to expect more pullbacks, more muted returns and choose active management over passive investing.

With full valuations, selection is important at the individual stock, sector and regional level. We believe valuations and fundamentals favor international equities over U.S. equities. From a fundamental basis the Fed is in its third year of a tightening cycle and reducing its balance sheet in a systematic fashion while the ECB and BoJ are just beginning to entertain their normalization process.

Most importantly, from a valuation perspective, international equities are trading at the steepest discount to the S&P 500 since 2008. In addition, when looking at long term performance, it looks like a changing of the guard may be ahead. On a trailing 10-year basis, the S&P 500 has been outperforming the MSCI EAFE for the past five years. However, more favorable monetary policy and being earlier in the economic and earnings acceleration than the U.S. may result in a changing of the guard with international equities outperforming U.S. equities **(Chart 11).**

Chart 11: Changing of the Guard Ahead?
Source: Bloomberg Finance LP, Verdence Capital Advisors, Data as of 1Q18

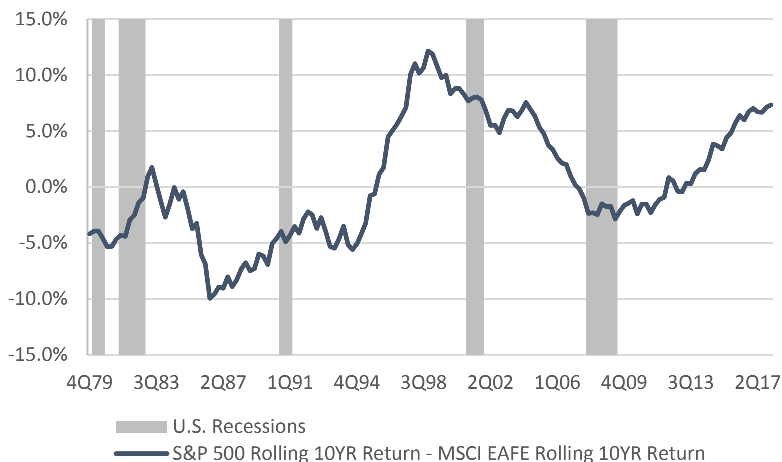
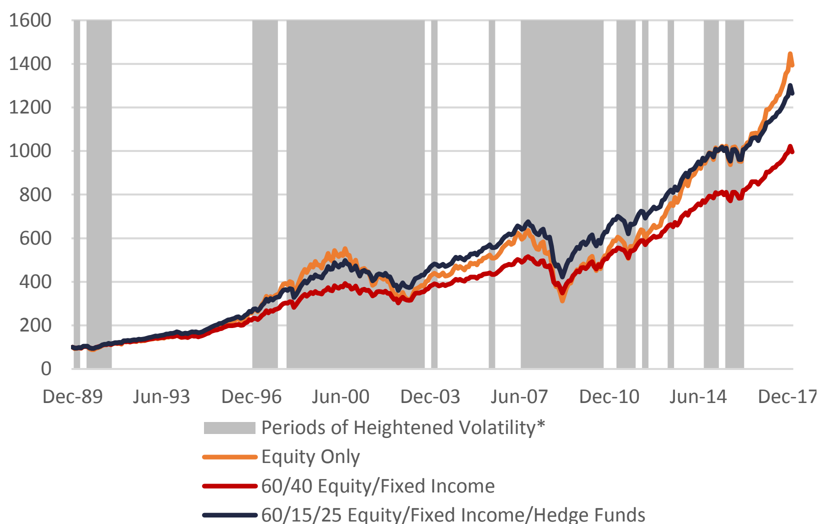


Chart 12: Hedge Funds Add Value in Volatile Times
*Source: Bloomberg Finance LP, Verdence Capital Advisors, Data as of Feb 2018. *Periods of heightened volatility are quarters with above average daily moves of 1% or more (up or down)*



Being Active. Times are Changing!

As investors try to navigate through the late stages of the second longest equity bull market in history and a Treasury market that is beginning to unwind its 30+ year bull market, a passive portfolio strategy will be challenged and active management is crucial. Not only when it comes to stock, sector and style selection but also at the regional, asset class level and employing a disciplined due diligence process around investment vehicles. Traditional portfolio diversification may no longer serve clients given the unchartered territory we are entering (e.g. Fed reducing balance sheet, massive government spending). Simply using equity and fixed income to diversify a portfolio could leave investors less hedged against risky asset volatility as the unwind of the bond bull market continues. Investors should consider adding hedging vehicles to compliment fixed income exposure to reduce risk and potentially add return. For example, adding hedge funds to a portfolio not only reduces the overall risk of the portfolio but has proven to outperform in most periods of heightened volatility. As seen in **Chart 12,** investors who employed a 60%/40% equity and bond portfolio would have underperformed a portfolio that had 25% in hedge funds in periods of heightened volatility.

In addition, evaluating your overall asset allocation to make sure that you have vehicles that may help hedge inflation risk (e.g. real assets) is important. Traditional TIPS may not be the best choice as they still carry a component that is a Treasury yield and is susceptible to losses as rates rise. Products such a real estate and income producing private equity should be considered as alternative ways to hedge portfolios from rising rates and inflation.

The Bottom Line:

As we navigate through the second longest equity bull market and economic expansion, it is important to expect volatility to continue this year. With the gradual normalization of monetary policy, fixed income getting back to pricing fundamentals as opposed to central bank support, political risks/headlines creating some uncertainty about future earnings and geopolitical risks an ongoing concern, investors are truly entering unchartered territory.

It is also important to remember that the economy is not the stock market. While all signs point to a continued economic expansion in 2018, equities are forward looking and tend to start to deteriorate well in advance of economic growth. Looking at the past 12 bear markets since 1937, the S&P 500 peaked ~12 months, on average, before the economy officially entered a recession. As a result, we would recommend staying close to neutral your global equity allocation. We will continue to monitor the economic and earnings outlook as well as valuations and make changes as we see warranted. In addition, investors must be flexible and accept the fact that a simple 60/40% stock/bond portfolio allocation is not suitable for the environment we are in where we are unwinding a 30+ year bond bull market. This type of mentality may be detrimental for investors as the bull market winds down and interest rates continue to rise. Instead, we favor exposure to hedging vehicles and income producing private equity as an alternative choice.

[1] Using PCE core as of February 2018 and lower bound of Fed Funds range (1.5%)
[2] Strategas Research Partners as of March 2018.
[3] Data as of March 31, 2018.
[4] Data as of March 29, 2018

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Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com