Curveballs Confusing the Market

Halfway Through 2018 and a Half Dozen Questions from Investors

The term "curveball" has many different meanings in sports and in life. For baseball lovers, it is that fateful pitch that is meant to keep hitters off-balance to have them swing too early.[1] In life, this baseball terminology has become a popular way to describe something that is unexpected or disruptive. When we evaluate how to describe the markets in 2Q18, some would think Sandy Koufax is out there throwing his famous curveballs to investors to test sentiment and keep investors on edge.[2]

Whether it was the intensifying trade spats between the U.S. and its major trading partners, the potential for a complete denuclearization of the Korean peninsula or a resurgence of the uncertainty surrounding the longevity of the European Union, there was no shortage of political curveballs thrown at investors in 2Q18. These curveballs overshadowed the robust earnings from U.S. corporations and some of the strongest and most broad based economic data the U.S. has seen in the current expansion. In fact, current estimates are suggesting U.S. GDP in 2Q18 rose at the fastest pace in four years! From an investment perspective, discipline was tested as investors tried to navigate the tug of war between political uncertainty but solid underlying fundamentals. Long term bond yields were pushed to a four year high as inflation began to surface and the Fed reiterated their tightening plans, only to be shoved lower as trade fears intensified. Small cap stocks made 23 record highs for the year in 2Q18 and outperformed large cap stocks by the widest margin in six quarters as investors shunned multi nationals in anticipation of ongoing trade rifts. Economic uncertainty intensified in the most export driven economies (e.g. Europe). Politics and trade fears brought the bears out with Chinese and Brazilian equities falling into bear market territory while European equities underperformed U.S. equities by the widest margin in almost four years. With headlines dominating reason in 2Q18, we wanted to step back and use this quarterly commentary to answer a half dozen of the most pressing questions on investor's minds.

Will Curveballs Strike out the U.S. Economy?

Despite the political curveballs, the U.S. economy remains strong and its resiliency is expected to continue for several reasons:

1 Consumer — The Powerhouse of GDP Remains Powerful.

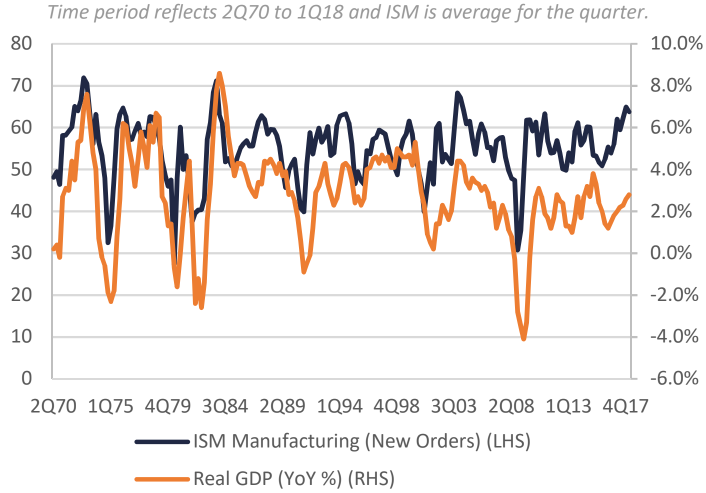
The $0.40 rise in gasoline prices year to date equates to a ~$40 billion reduction in annual buying power for the consumer. However, there is little evidence that it is phazing the consumer as the added benefit from tax cuts and solid job prospects has overshadowed the rise in gas prices. Consumer confidence remains near a cyclical high, the unemployment rate is near the lowest level since the late 1960's and retail sales (excluding gas and autos) are growing near the fastest pace since 2014. Consumer net worth continues to make fresh record highs as investments and home values rise. In fact, in 1Q18 homeowners officially recouped the losses in their homeowner equity from the housing crisis as homeowner equity in real estate rose to the highest level since 4Q05.

2 Manufacturing Shrugging off Trade Concerns.

The U.S. manufacturing sector has been in expansion territory for 22 consecutive months and while it likely reached a cyclical peak in February of this year, it remains well above the historical average seen in all the economic expansions since 1948. In addition, there is little proof that the trade disputes are impacting orders as new orders are at a cyclical high. Going back to 1970, when ISM new orders are coming in above current levels (a level of 55 or higher), real GDP has historically grown between 3.0%-4.0% on a year over year basis. **(Chart 1).**

Chart 1: Manufacturing Points to Economic Acceleration

Source: Bloomberg Finance LP, Verdence Capital Advisors, Time period reflects 2Q70 to 1Q18 and ISM is average for the quarter.



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3 Businesses Bringing Money Home. Not only is business confidence near cyclical highs but businesses are starting to bring money back to the U.S. In 1Q18, businesses brought back a record amount of cash from overseas as a percent of nominal GDP **(Chart 2).** Some of this is expected to be used to pay down debt and shareholder friendly activities (e.g. M&A , dividends and buybacks) but also towards capex spending. It is estimated that companies may bring back $500-700 billion this year.[3] To put this in perspective, $700 billion is more than the market cap of Exxon Mobil and Bank of America combined.[4]

4 Global synchronized recovery remains in tact.

International economic data has disappointed the elevated expectations coming into 2018. This is most evident by looking at the Citigroup Economic Surprise Index for Europe and the emerging markets. These indices have been in negative territory for the majority of the second quarter. **(Chart 3).** Another factor that has caused concern is that trade uncertainty may be filtering into the manufacturing sectors which have been slowing. We looked at 20 major developed and emerging economies and saw that 13 of the 20 countries have seen their manufacturing indicators decline from year end 2017. However, a cyclical peak does not mean a recession is imminent. In fact, all but three of them (i.e. Turkey, Korea and Brazil) remain in expansion territory. **(Chart 4).** In addition, according to the IMF, while trade concerns pose a risk to global growth, their current estimates show that growth is expected to continue to accelerate this year in the majority of the global economies. Of the ~130 countries that they give estimates for, ~75% of them are expected to see growth accelerate in 2018 compared to their past three year average.

Chart 2: Tax Reform Showing Up in Data

Source: Federal Reserve, Strategas Research Partners, Verdence Capital Advisors, Data as of 1Q18.

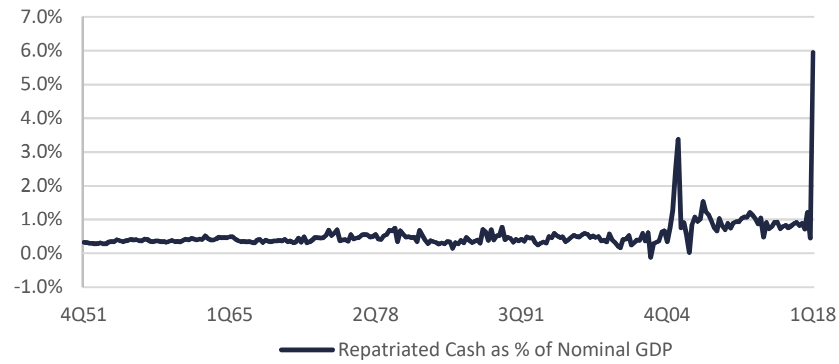


Chart 3: International Data Missing Expectations

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data as of June 25, 2018.

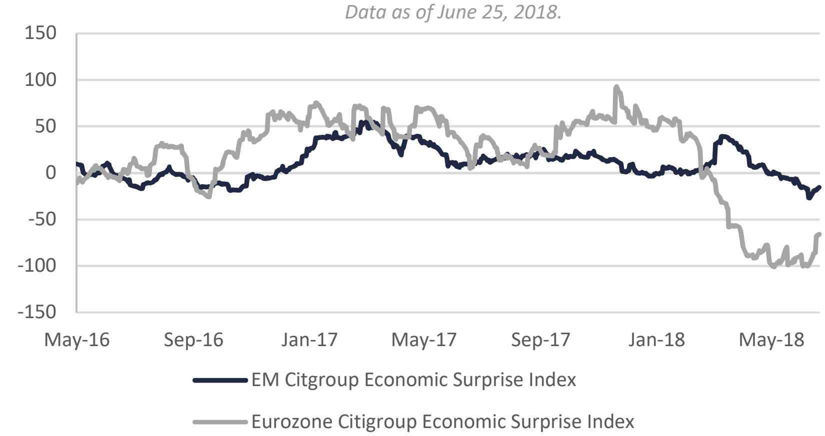
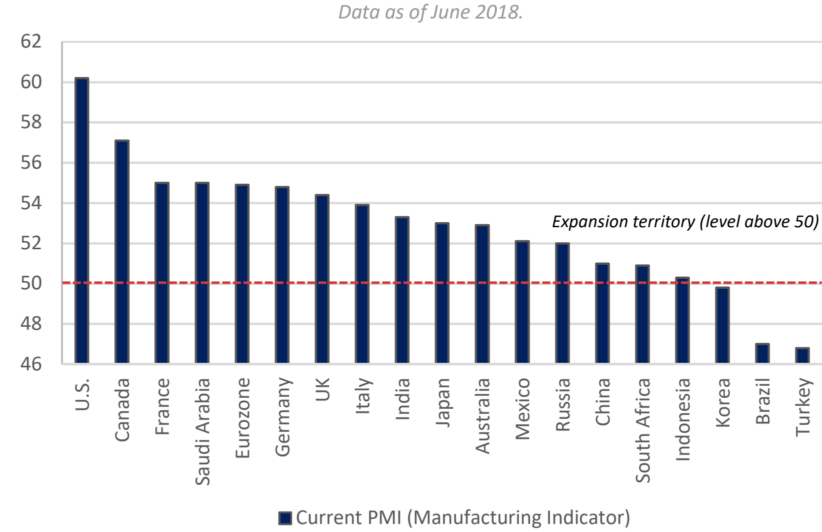


Chart 4: Manufacturing in Expansion Territory

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data as of June 2018.



Is the Yield Curve Telling Us Something?

The yield curve as measured in many different ways (10YR-2YR, 10YR- Fed Funds and 30YR – 5YR) is narrowing to levels that have not been seen since 2007. This is causing concern for investors, especially since the past five recessions have been predicated by a flattening and ultimately, an inverted yield curve. **(Chart 5).**

However, it is important to understand what has been driving the yield curve to narrow. First, better growth and the emergence of inflation has resulted in the market pricing in more Fed rate hikes than anticipated a year ago. Second, the Treasury has been using the Treasury bill market to fund government spending over the past year (e.g. tax reform). On a rolling 12 month basis, Treasury bill issuance is rising at the fastest pace since 2009. **(Chart 6).** Lastly, with our major developed international counterparts keeping rates anchored near historic lows, investors have looked to Treasuries for yield.

We are not complacent either. While both short and long term yields are rising (albeit at different speeds) we believe the yield curve is telling us the following:

- **We are in the late stages of the economic cycle.** It is not abnormal for the yield curve to flatten at this stage of the economic and Fed tightening cycle. History tells us that the yield curve can flatten for an extended period of time before a recession occurs. In fact, in the past five recessions, the curve actually inverted, on average, 15 months before a recession occurred.
- **Remain defensive in fixed income.** Given the flattening in the yield curve, investors are not being rewarded for taking the additional interest rate risk by purchasing long term Treasuries. Given, that the 30+ year bond bull market is in the midst of unwinding and the 10YR Treasury yield is still well below what history would suggest its fair value should be, we favor short duration fixed income. Even within the credit space, investors are not being rewarded for taking on additional credit risk. Currently, the ratio of the yield on high yield debt to the yield on investment grade debt is below average and near the lowest level since 2007 **(Chart 7).**

Chart 5: Yield Curve Narrowing

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data as of June 25, 2018.

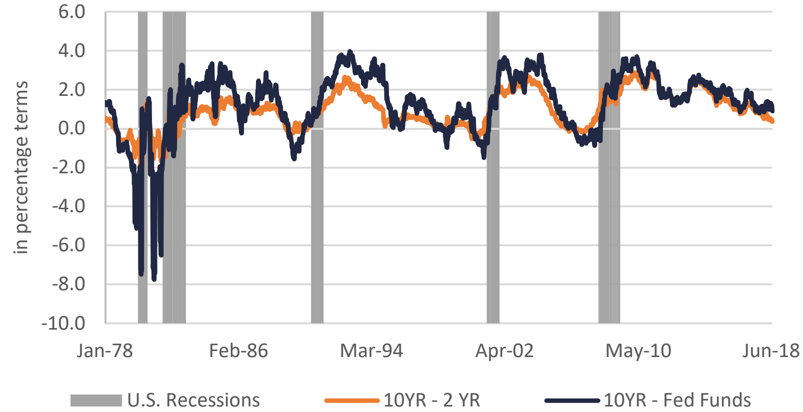


Chart 6: Surge in Bill Issuance a Factor in Flattening Yield Curve

Source: SIFMA, Verdence Capital Advisors, Data is monthly and as of May 2018.

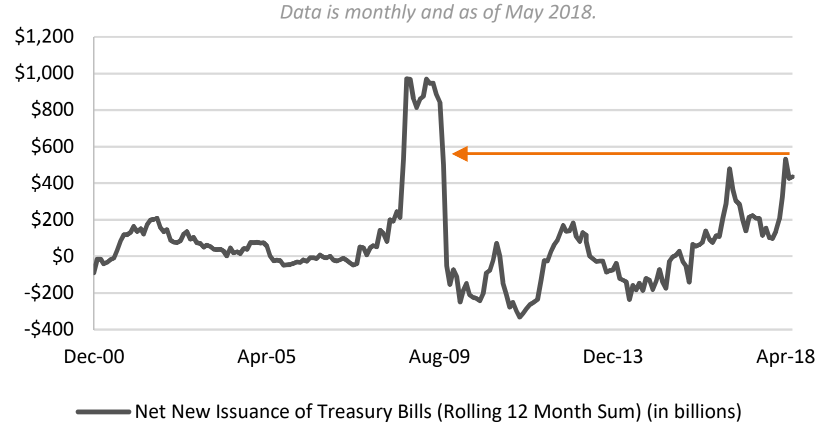


Chart 7: Investors Not Rewarded for Credit Risk in Fixed Income

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is monthly and as of June 2018.

As a result, we would recommend being defensive in credit exposure. Focus on high credit quality as opposed to moving down in credit rating. In addition, credit alternative hedge funds may offer investors lower risk, upside potential and attractive income.

Where is the Value in a Lean Market?

The current bull market is the second longest in U.S. history and the Wilshire 5000 market cap stands at the highest percentage of nominal GDP since the end of the first longest bull market in U.S. history (1990-2000). **(Chart 8).** Given our base case scenario that a recession is not likely until late 2019/early 2020 and that tax reform should benefit U.S. corporations, equities should produce modest gains this year. However, while the equity market has experienced healthy pullbacks this year, valuations still remain stretched, select sectors and investing styles are reaching two standard deviation moves and it is increasingly challenging to find good long term value. Therefore, within the U.S. equity market we would recommend the following:

- **Value over Growth.** Value has been out of favor for most of this equity bull market. In fact, on a rolling 5YR basis, large cap growth has been outperforming large cap value at the strongest pace since 2000. **(Chart 9).** This is unlikely sustainable, especially at this stage of the economic cycle.
- **Small and Mid Cap over Large Cap.** Small caps as seen by the Russell 2000 are off to the best start to a new year in five years as investors have used small caps as a way to avoid the volatility that stems from the trade war rhetoric. While valuations look stretched for core small cap stocks, value at the midcap and small cap level look attractive not only on a valuation basis **(chart 10)** but also earnings growth looks solid and earnings momentum is strong (upward earnings revisions).
- **Do not forget to go private.** Investors should also look towards private equity vs. public equity for value. Not only are valuations in the private market less expensive than valuations in the public market but private equity balance sheets are healthy when looking at leverage and coverage ratios and history shows attractive long term return potential.

Chart 8: Equity Rally in its Late Stages

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is quarterly and as of 1Q18.

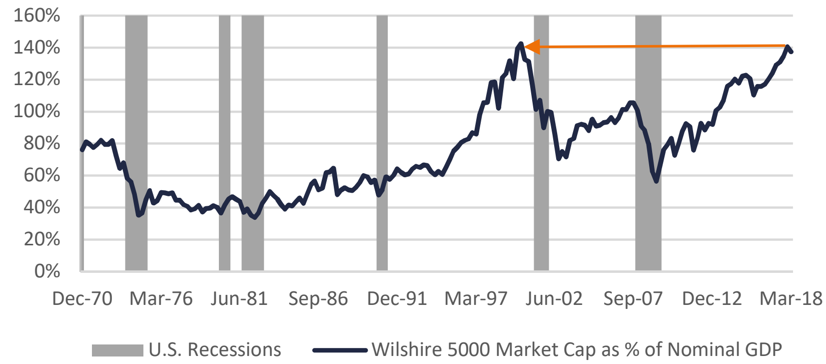


Chart 9: Growth Outperformance Unlikely Sustainable

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is monthly as of June 2018.

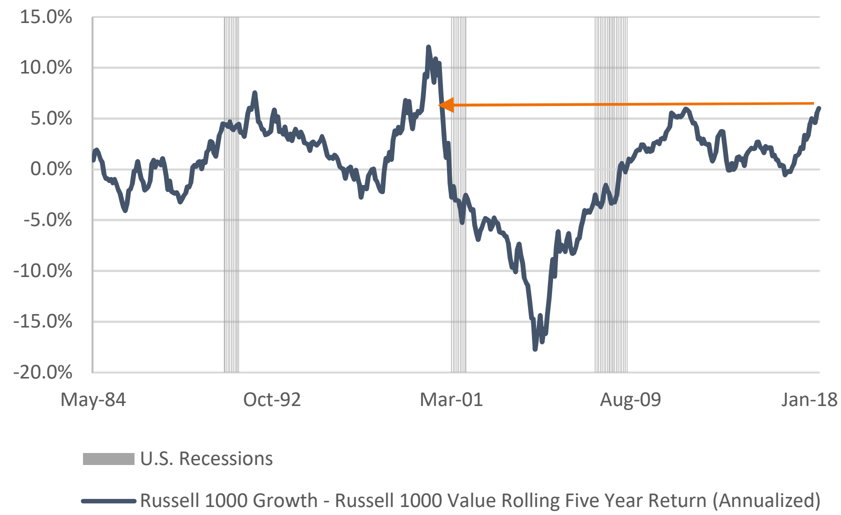
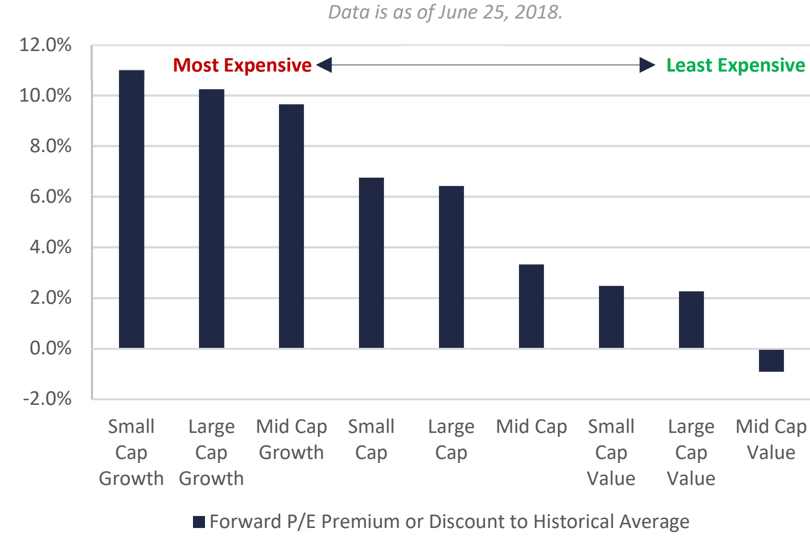


Chart 10: Valuations Across Styles and Market Cap

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is as of June 25, 2018.



Private equity has been positive 87% of the years since 1987, compared to 75% in public equity. Private equity has also outperformed public equity over 60% of the years since 1987 **(Chart 11).**

- **Do not get caught following the crowd.** Momentum has taken over logic in some instances during this bull market, especially as investors have chased investments with little fundamental reason. This can be seen by the euphoria that drove bitcoin up 1745% since the end of 2016 and then we have all witnessed its rapid slide from its December 2017 peak (down ~70%). In addition, there are select investment styles and/or market caps that are trading two standard deviations from the historical mean. This is most evident between growth and value. Typically a two standard deviation move is of historical importance and has often led to a reversal of the trend. **(Chart 12).**

Chart 11: Look at Private Equity to Find Value

Source: Bloomberg Finance LP, Cambridge, Verdence Capital Advisors, Data is annual as of 2017.

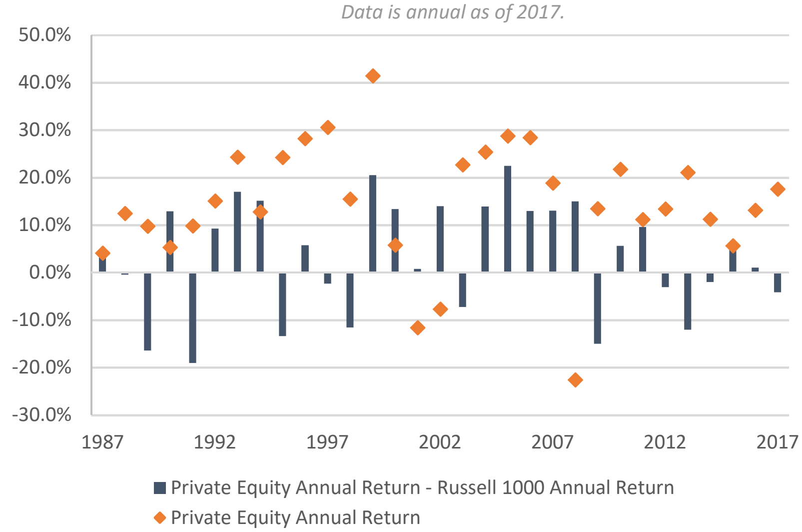
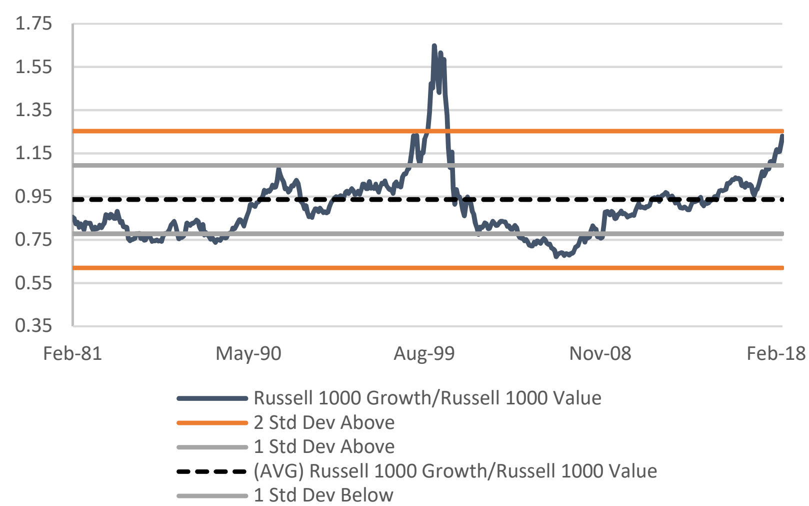


Chart 12: Two Standard Deviation Moves are Not Normal

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is monthly and as of June 2018.



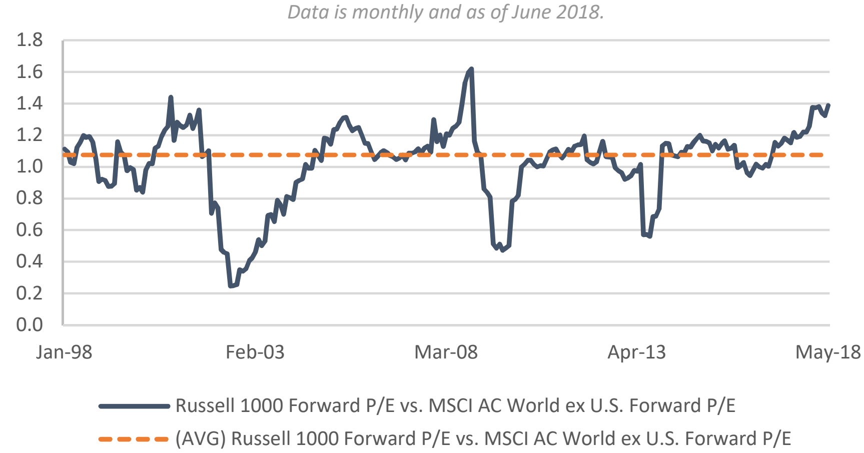
Stay Home or Invest Abroad?

International equities as measured by the MSCI AC World Index ex U.S. are underperforming the Russell 1000 by over 700 bps YTD. Disappointing economic data, trade war fears and political uncertainty have weighed on international markets from China to Brazil, from Italy to Germany and most international markets in between. Despite the underperformance we recommend international equities for the following reasons.

- **Valuations:** The underperformance of international equities versus U.S. equities has made the U.S. valutionas look the most expensive versus international valuations since November 2008. **(Chart 13).**
- **Relative value more attractive:** Equities look more attractive overseas relative to bonds than in the U.S. While the EuroStoxx 50 dividend yield is nearly 400 bps above the 5YR German bund yield, the dividend yield on the Russell 1000 is below the 5YR Treasury yield.

Chart 13: U.S. Expensive versus International Equities

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is monthly and as of June 2018.



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- **Central bank policy.** While the U.S. is in a tightening cycle, Europe's benchmark rate is not expected to even turn positive until 2020. In addition, if economic data continues to disappoint, the ECB may be forced to stay accommodative for longer. This supports European equities over U.S. equities.

- **Earnings and economic growth favor EM.** While trade war rhetoric and volatility in the dollar can continue to weigh on EM equities in the near term, our long-term view supports EM equities. Superior economic and earnings growth and attractive valuations should boost EM equities in the long run. **(Chart 14).** However, active management is crucial in EM equities given political and currency risks.

To Hedge or Not to Hedge?

At this stage of the economic and bull market and given the fact that we are embracing the end of the 30+ year bond bull market, investors should have a healthy allocation to hedge funds in their portfolios for the following reasons:

- **Volatility.** Going back to 1990, in periods where the S&P 500 sees above average daily moves of 1% or more, a portfolio that had a larger allocation to hedge funds than bonds outperformed a traditional portfolio of just bonds and equities.

- **Equity weakness.** We expect the equity market to be choppy and investors should get accustomed to periods where equities post negative monthly and quarterly returns. Since 2009, in the months that the S&P 500 is negative, hedge funds outperform by, on average ~2% per month.

- **Rising rates.** Bonds should not be viewed as a hedge in periods of equity volatility given the rising rate environment. Since 2003, in the prior five periods of rising interest rates, hedge funds have outperformed bonds by, on average, 16%. **(Chart 15).**

Chart 14: Earning Growth Favors EM

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data as of June 25, 2018.

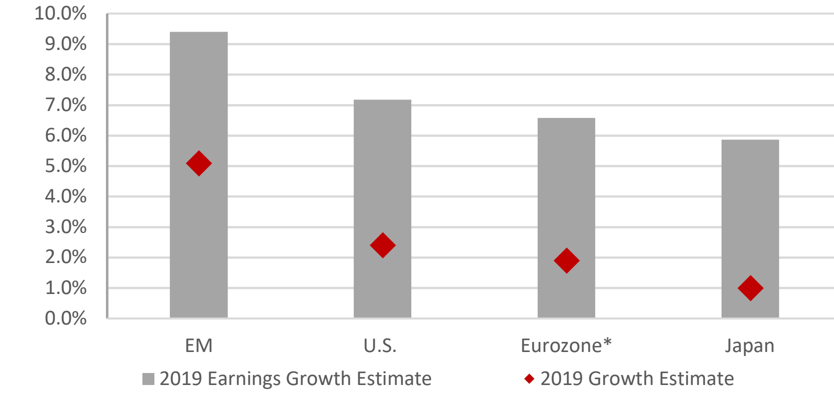
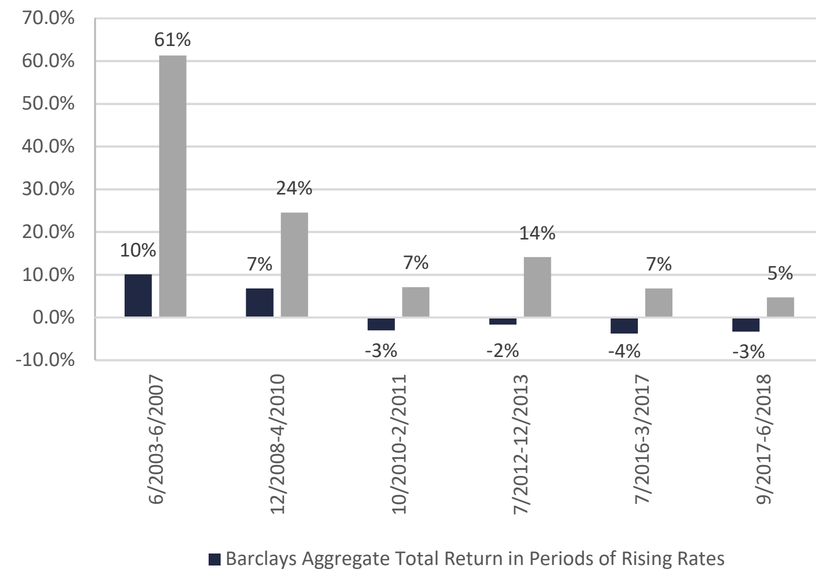


Chart 15: Hedge Funds and a Rising Interest Rate Environment

Source: Bloomberg Finance LP, Verdence Capital Advisors, June 2018 performance is using hedge fund performance as of May 2018.



Inflation is Here! How do I Mitigate the Risk?

Core inflation in the U.S. is finally breaking above its 50+ year downtrend and is expected to continue to move higher. **(Chart 16).** Economic growth, fiscal stimulus and a tight labor market are leading to the gradual rise in inflation pressures. In addition, global demand and trade war risks have pushed many commodity prices higher which has been filtering into the prices that producers pay. Eventually, higher producer prices will likely be passed on to consumers.

While we do not anticipate a 70's or 80's style hyper-inflation environment, investors should be aware of the risk that even modest inflation can have on their investment portfolio. At this stage of the economic and interest rate cycle, we believe real assets offer an attractive way to mitigate the risk of inflation.

Real assets are a broad category and include investments that are tangible and physical. These investments include but are not limited to, commodities, real estate, land, timber and infrastructure and have historically outpaced inflation. In addition, they have generally been uncorrelated to traditional equity, so they add another layer of diversification for investors. These products are offered in both the public and private markets.

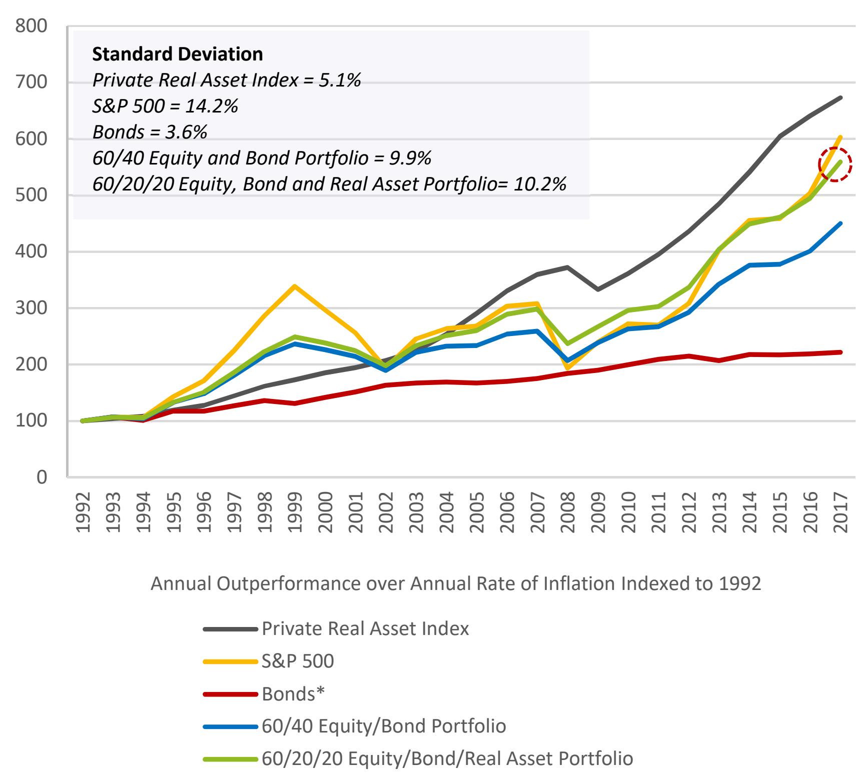
As can be seen by **chart 17**, over time, a portfolio that incorporates real assets into its overall allocation has outpaced inflation at a more rapid pace than a portfolio in only stocks and bonds and has only had to take on minimal additional risk.

Chart 16: Core Inflation Breaks a 50+ Year Downtrend

Source: Bloomberg Finance LP, Verdence Capital Advisors, Data is as of May 2018.

Chart 17: Adding Real Assets to Overall Asset Allocation to Hedge Inflation

*Source: Bloomberg Finance LP, Versus Capital, Verdence Capital Advisors, Data is yearly and as of 2017. *Bonds is the Bloomberg Barclays Aggregate Index, Standard deviations are from 1992-2017.*



The Bottom Line:

At Verdence, we understand how the large daily swings we have witnessed in the global capital markets this year and seemingly endless curveballs thrown at investors can be unsettling. At this stage of the bull market and economic cycle, it can be dangerous to chase market returns and we believe a more defensive asset allocation is warranted at this time. While the U.S. economic expansion is likely to continue over the next 12-18 months, it is clear to us that upside risks are likely exhausted and already priced in with valuations at current levels. We will continue to search for sectors/styles that offer value and will rely on our strict due diligence process of our underlying managers to ensure we are positioned appropriately.

What is important for investors to remember is that despite politics being a driver of volatility in 2Q18, at this stage of the economic cycle and bull market it is not abnormal to see volatility return to the markets. In addition, it is normal to see asset classes/regions/sectors/styles start to diverge after correlations have been high in recent years. Therefore, it is more important now than ever to remain disciplined to your long-term investing goals, stick with an active investment management style as opposed to passive and caution that it could be detrimental to make investment decisions off news headlines as headlines have been known to change quickly this year.

[1] mlb.com/glossary
[2] Sandy Koufax has been reported by many sports outlets to be one of the best curveball pitchers of all time.
[3] According to Strategas Research Partners as of May 29, 2018.
[4] As of June 26, 2018.

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