October 10, 2018 | **2018 Q3 Market Commentary**

Factoring the Five “D’s”

How to Invest in the Late Stages of an Historic Bull Market

VERDENCE CAPITAL ADVISORS

*As we reflect on the third quarter of 2018 and look forward to the duration of 2018, there are five words starting with the letter “**D**” that come to mind. We should be finding opportunities in **D**ivergencies and unwarranted **D**islocations. An investor must be **D**isciplined but **D**aring and always **D**iversify. Economic growth in the U.S. has surged past its developed counterparts, the Federal Reserve is tightening monetary policy while the rest of the world remains accommodative, U.S. fiscal spending is at historic highs and U.S. equity markets are hovering near record highs. All these factors have contributed to an environment where the U.S. is diverging from its international counterparts. This divergence has resulted in historic price discrepancies, valuation inconsistencies, complacency but also ample opportunity. It is important to highlight that even in an environment of euphoria like has been seen by the S&P 500 making 19 new record highs this year, we believe there are value opportunities in this market. At this late stage of the bull market, it is important to be disciplined, have the courage to be daring, and look for investments that have been left behind exhibiting dislocations that offer opportunity. As always, adhere to a well-diversified approach to your portfolio.*

U.S. Economic Expansion – Determined to Carry on no Matter the Distractions

The data coming from the U.S. economy has been better than expected and has resulted in Economists upgrading U.S. GDP estimates for this year and next year. **(Chart 1)** Despite the ongoing political distractions, not only are many economic indicators making new cyclical highs, but some are even making fresh record highs. The major indicators suggest that the expansion can continue for at least another 12-18 months which would make it the longest economic expansion in U.S. history. It will surpass the second longest expansion (1991-2001) in mid-2019. Some of the factors supporting the ongoing economic expansion include:

- **Manufacturing Points to Solid Growth:** The ISM Manufacturing Index has been in expansion territory for the past 25 consecutive months and at current levels is more consistent with being mid-way through a business cycle. In fact, the 12-month average of the ISM Manufacturing Index is ~10% higher than it historically has been at the onset of a recession. One of the components of the manufacturing index that has a high correlation with GDP is the production component. As can be seen in **Chart 2**, production at current levels is suggestive of year over year GDP

Chart 1: U.S. GDP Estimates Revised Higher

Footnotes: Data is weekly and as of September 28, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

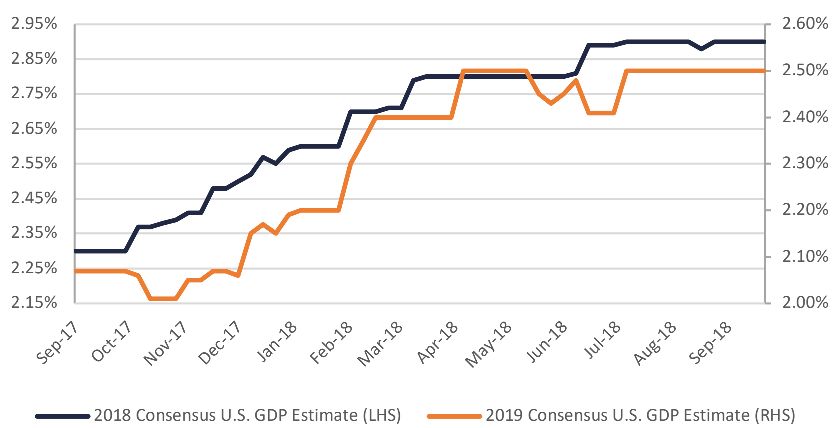
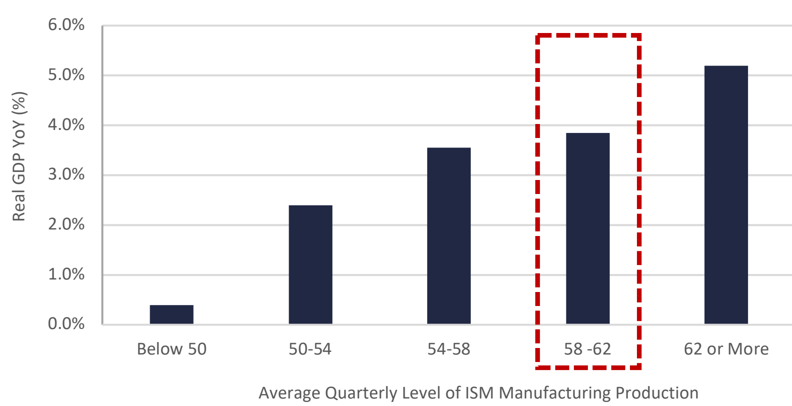


Chart 2: Manufacturing Production Suggests Stronger Growth Ahead

Footnotes: Time period reflects 3Q60-3Q18.
Source: Bloomberg Finance LP, Verdence Capital Advisors



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

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

Past performance is not indicative of future returns

Discover true independence.

growth of 3.5-4.0% (current year over year growth is 2.9%).

- **Spending at all Levels of the Economy:** Confidence is a leading indicator of spending at both the consumer and business level. While record net worth, rising wages, solid labor market prospects and lower taxes has helped consumer confidence surge to the highest level since 2000, personal spending has not been as robust. **(Chart 3).** In fact, going back to 2000, the last time consumer confidence was near current levels (early 2000s), personal spending was growing ~5.00% (YoY). However, the annual growth in personal consumption has been stuck near 3.00% this year. This is important because consumer spending makes up ~70% of GDP. Therefore, if confidence remains strong, spending should also accelerate. Like the consumer, business spending at the small and large business level has been surging to new cyclical highs. In the case of small business optimism, the tax reform package and an improving economy has pushed confidence to the highest level on record. Better confidence has also led many regional manufacturing surveys to show companies plan to increase capex spending. However, there is a difference between the survey data and the actual equipment spending that has been seen. **(Chart 4).** We expect that difference to narrow and capital expenditures to rise further.

- **Companies Bringing Money Home:** It has been estimated that companies will bring back between $500-$700 billion in 2018 because of the favorable tax changes to overseas earnings.[1] Thus far in the first half of 2018, U.S. companies have brought ~$550 billion from overseas revenue back to the U.S. **(chart 5).** Some of this money is being used for shareholder friendly activities (e.g. buybacks, dividends). However, companies are also repairing balance sheets by paying down debt and freeing up cash to increase capital expenditures and raise wages. A healthier corporate America should translate into a longer economic expansion.

Chart 3: Confidence and Spending Dislocation

Footnotes: Data as of August 2018.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

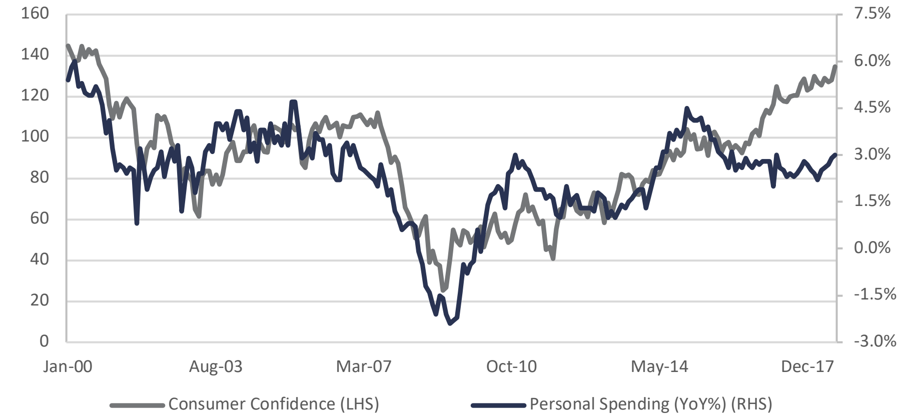


Chart 4: Additional Business Spending Ahead

Footnotes: Data as of 2Q18.

Source: Strategas Research Partners, Bloomberg Finance LP, Verdence Capital Advisors.

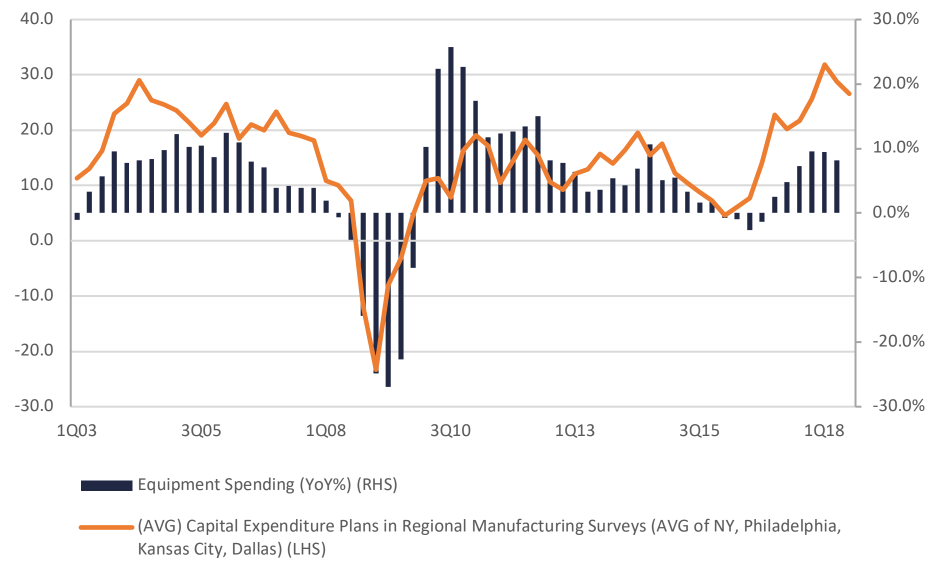
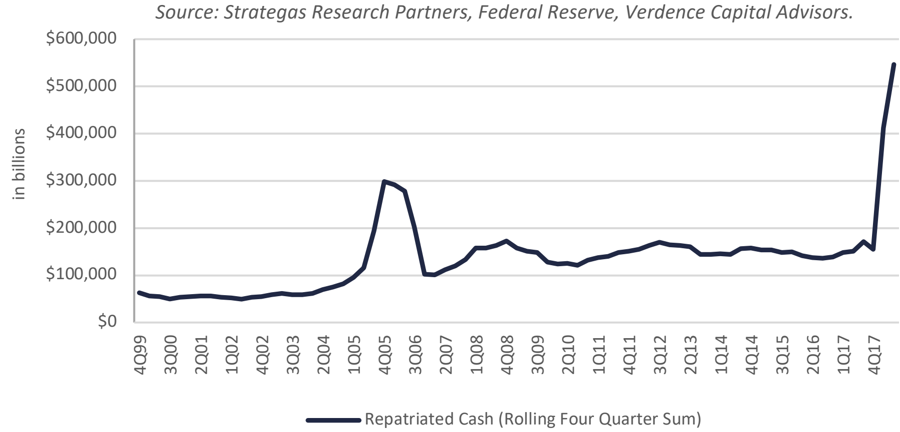


Chart 5: Money Coming Home!

Footnotes: Data as of 2Q18, rolling four quarter sum.

Source: Strategas Research Partners, Federal Reserve, Verdence Capital Advisors.



- **Fed Removes Accommodative Language but Still Looks Accommodative:**
  The Federal Reserve raised interest rates for the eighth time since 2015 in 3Q18 and officially removed the word "accommodative" from their statement. As a result, the real Fed Funds rate moved into positive territory for the first time since March 2008 **(chart 6).** However, the Fed funds rate still looks highly accommodative by historical standards. As can be seen in **chart 7**, the current tightening cycle is much more muted than what has been seen in past tightening cycles. This December, we will mark the third-year anniversary of the tightening cycle and our real Fed funds rate will be almost 2.5% below what is historically seen at this stage of a tightening cycle. This reminds us of the quote by many famous Economists, "neither economic expansions nor equity bull markets in the U.S. die of old age; they are murdered by the Fed."[2] Given the historically low level of the Fed funds rate, there is no visible evidence at this time that the expansion will be "murdered" by the Fed in the near future.

Fixed Income – Fixed Income Diverting from Being a Traditional Safe Haven

The solid economic environment has gradually pushed U.S. Treasury yields from their historically low levels, but the missing piece that had limited the rise in yields in recent years has been inflation. Now that wages are increasing, commodity prices are higher, and growth continues to improve, inflation is emerging. In fact, core inflation (PCE) grew over 2.0% on a year over year basis for the first time in six years in 3Q18. As a result, long term Treasury yields have moved sustainably above their long-term downward trend line **(chart 8).** In fact, the 10YR Treasury note posted a quarterly loss for the fourth consecutive quarter in 3Q18. To put this in perspective, the 10YR Treasury note has only lost value for four consecutive quarters in two other occurrences over the past 30 years (i.e. 1994 and 2013).

Given the strength of the U.S. economy, increasing inflation pressures and Fed tightening cycle, the reversal of the 30+ year bond bull market is likely to continue. Investors need to accept little return over coupon for bonds over the next 12-18

Chart 6: Real Fed Funds Rate Finally in Positive Territory

Footnotes: Data uses Fed funds rate as of September 30, 2018 and PCE core (YoY) as of August 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

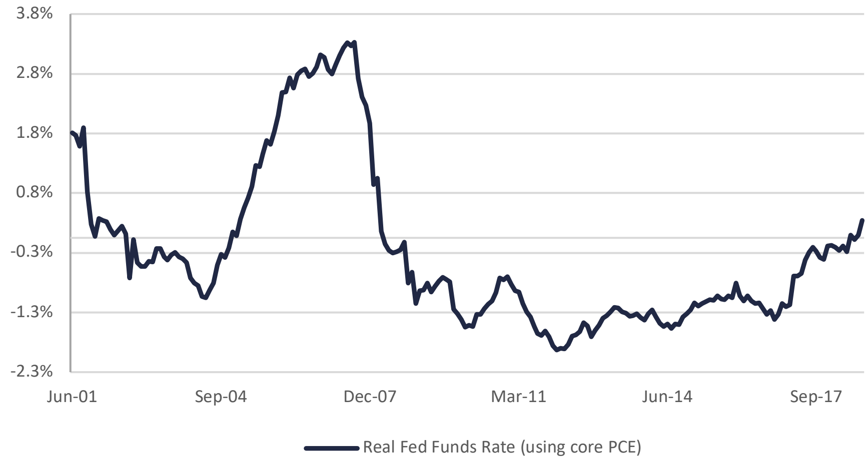


Chart 7: Is it Really a Tightening Cycle?

Footnotes: Time period reflects 1967 - 2004. Data for current tightening cycle is using 2019 estimates inflation and Fed Funds rate as of October 3, 2018. Inflation is PCE core (YoY %).
Source: Bloomberg Finance LP

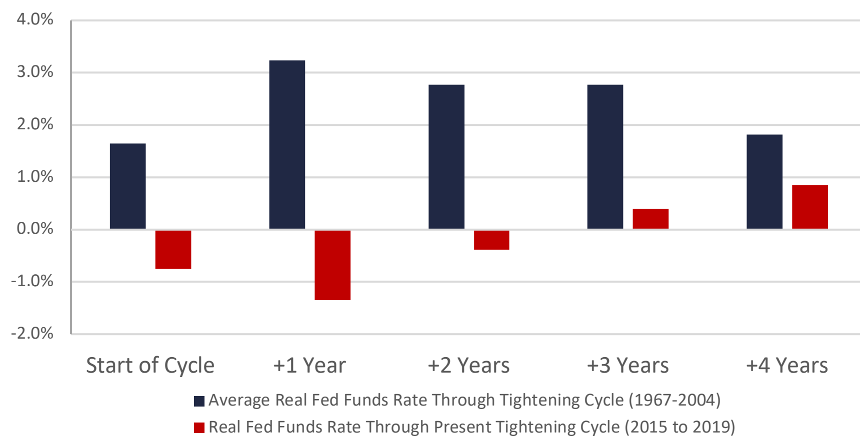
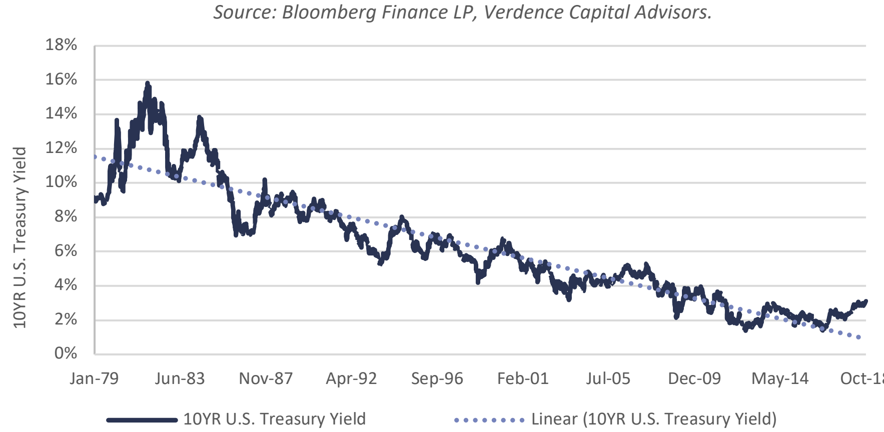


Chart 8: Treasury Yields Well Above Long Term Downward Trend Line

Footnotes: Data as of October 1, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



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

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

months which is quite different than what they have been accustomed to over the past 30 years. For example, as can be seen in **chart 9** bond investors have only seen the broad fixed income asset class decline on an annual basis three times over the past 30 years (i.e. 1994, 1999 and 2013). This year fixed income is on pace to post the fourth year of negative returns in the past 30 years. An investor in a 60/40 portfolio (S&P 500/Barclays Aggregate) has enjoyed the benefit of bonds as a hedge in times of equity weakness. However, with the equity bull market likely in its late stages and rates expected to continue to normalize, bonds may no longer be that hedge that they once were. While bonds should always be used as a diversifier, in the current environment we would make the following recommendations with fixed income exposure:

- **Remain defensive:**
  With the yield curve (difference between 10YR Treasury yield and 2 YR Treasury yield) near the narrowest level seen since 2007 investors are not being rewarded for taking on duration risk with long term bonds. In addition, with the expectation that the Fed will continue raising rates, we recommend short duration and floating rate bonds.

- **Quality over Coupon!**
  High yield debt has attracted investors due to the stable credit environment, higher yields and attractive coupon. However, spreads (extra yield over Treasuries that investors demand to own high yield debt) at the lowest level since July 2007 do not offer investors attractive risk/reward potential. **(chart 10).** In addition, while credit default rates are likely to remain low over the next 12 months, credit covenants are getting looser and refinancing risk is a concern as interest rates rise. Investment grade credit and credit opportunities in the hedge fund and/or private equity space offer a better risk return profile at this stage of the credit cycle.

Chart 9: Bonds No Longer a Hedge?

Footnotes: Data for 2018 is as of October 1, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

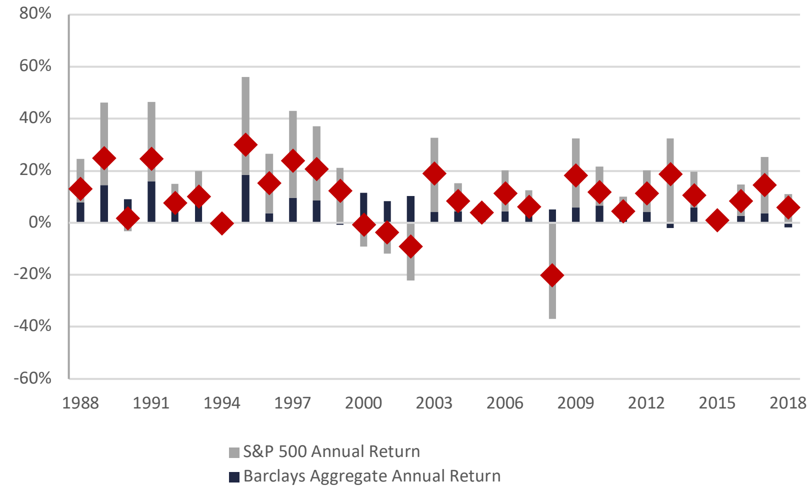
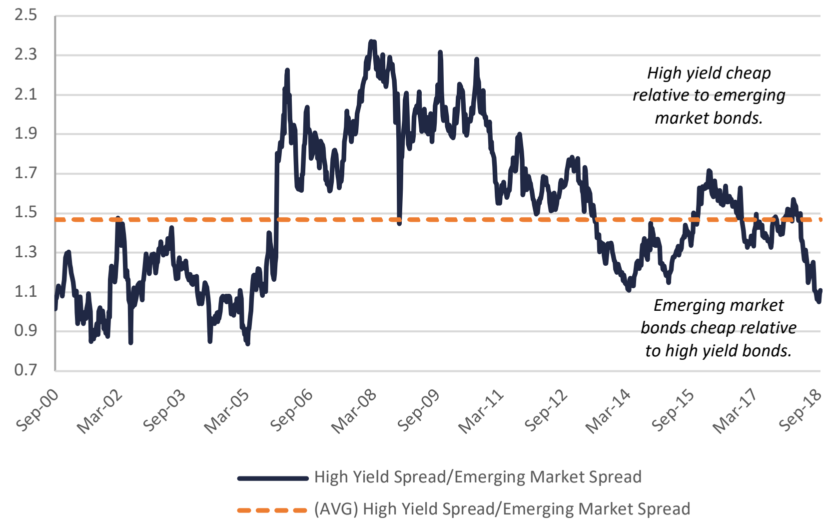


Chart 10: No Reward for Taking on Credit Risk

Footnotes: October 2018 is as of October 2, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

- **Deviate from the U.S.**
  Emerging market bonds have suffered in 2018 due to currency volatility, rising U.S. Treasury rates, trade fears and uncertainty surrounding fiscal health. However, we think the weakness has been overdone and do not see the recent volatility in select emerging market currencies as a reason to be concerned with widespread defaults in the emerging market space. As can be seen in **chart 11**, the ratio of high yield spreads to emerging market spreads is near the lowest level since 2005. Therefore, on a relative basis, investors may want to consider moving away from U.S. high yield and into emerging market bonds.

Chart 11: EM Cheap Compared to High Yield
Footnotes: Data is weekly and as of September 28, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

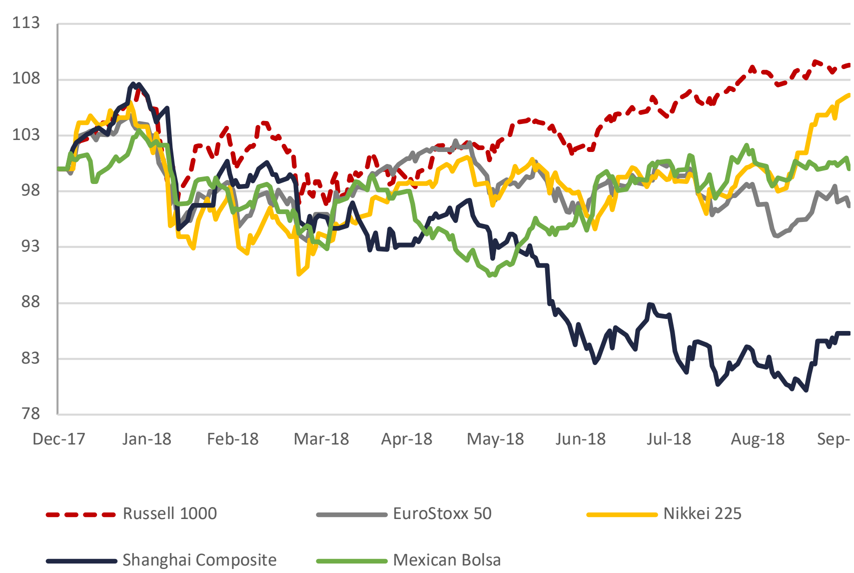


Global Equities: The Great Divide Delivers Opportunity

U.S. equities continue to pull above the rest of the world and have created a divergence between global equity returns. In 3Q18, the S&P 500, the Nasdaq, the Russell 2000, the Russell 2500 and the Dow Jones Industrial Average are all just examples of U.S. Indices that made fresh new record highs. In contrast, most major international markets have lagged and in the case of China, it has entered bear market territory **(chart 12).** While the U.S. has benefitted from above trend growth, a gradual tightening of monetary policy, record earnings, surging confidence and expansive fiscal policy (tax reform), its international counterparts have struggled with an uncertain economic outlook, fiscal tightening, political uncertainty and fears over trade war ramifications.

This great divide has not only been isolated to the global equity markets. Within the U.S. the divide continues to widen at the style level with growth outperforming value for the seventh consecutive quarter in 3Q18. This is the longest period of consecutive quarterly outperformance since the Russell Growth and Value Indices were launched (4Q78). In this environment with U.S. equity markets near or at record highs and great division between regions, styles, market cap and sectors we recommend investors go where the rest of the investors have

Chart 12: U.S. Pulls Above the Rest of the World
Footnotes: Data is monthly as of October 2, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



abandoned. Be daring, diverge from the crowd and find value in the unwanted. For example:

- **Go Abroad!**

  A one standard deviation move is abnormal; however, a two standard is extraordinarily rare. Fortunately for those investors that would like to go in the opposite direction of the crowd, there is ample opportunity to be a contrarian. When looking at the Russell 1000 relative to the MSCI EAFE, the Russell 1000 is more than two standard deviations more expensive than the MSCI EAFE **(chart 13).** This has not occurred since at least 1999. In addition, the U.S. looks historically expensive versus itself. As can be seen in **chart 14,** the Wilshire 5000 as a percent of nominal GDP surpassed the prior high (2000) to make a fresh new record high in 3Q18. Historically, heightened levels of this indicator have preceded a pullback. The other factors that support international developed equities are its central bank accommodative monetary policy, a stable Euro, muted inflation pressures, attractive valuations, solid earnings growth, and a modest but expansionary growth environment. While risks have emerged from trade uncertainty and banking fears in select countries, we believe valuations reflect the uncertainty and see more upside potential than U.S. equities. Emerging market equities also look attractive on a valuation basis given the underperformance this year. However, we will continue to evaluate the sector and consider increasing exposure in a gradual manner. We would prefer, until we see clarity around earnings and the economic outlook, to ease our way into the emerging market space through the bond market.

- **Value over Growth:**

  There is always a great debate about growth vs. value investing. Large cap value is lagging large cap growth on a rolling five-year basis by the widest margin since the Great Recession. (**chart 15).** In addition, like international and U.S. equities, the Russell 1000 Growth is trading near two standard deviations above the Russell 1000 Value. However, we favor value at this stage of the economic and bull market because of the following reasons:

Chart 13: Historic Price Differentials - U.S. vs. International Counterparts

Footnotes: Data as of September 28, 2018.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

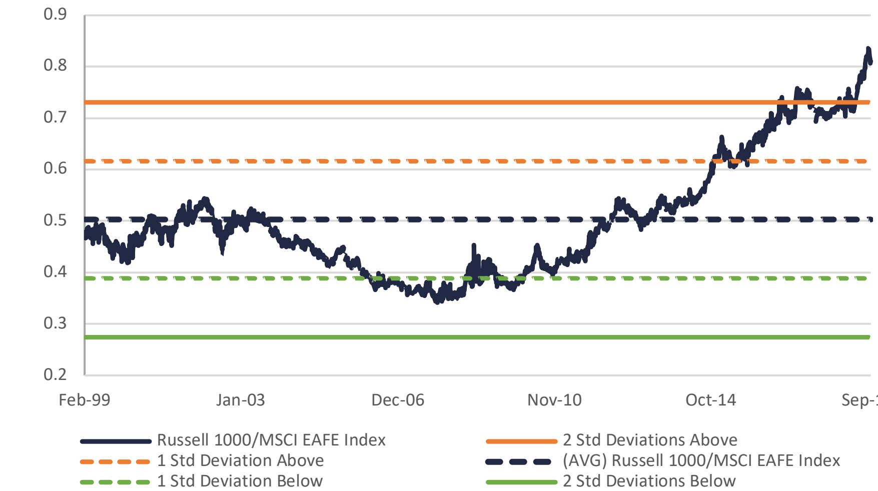


Chart 14: Broad U.S. Markets Historically Expensive

Footnotes: Data is quarterly and 3Q18 is using consensus estimate for nominal GDP.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

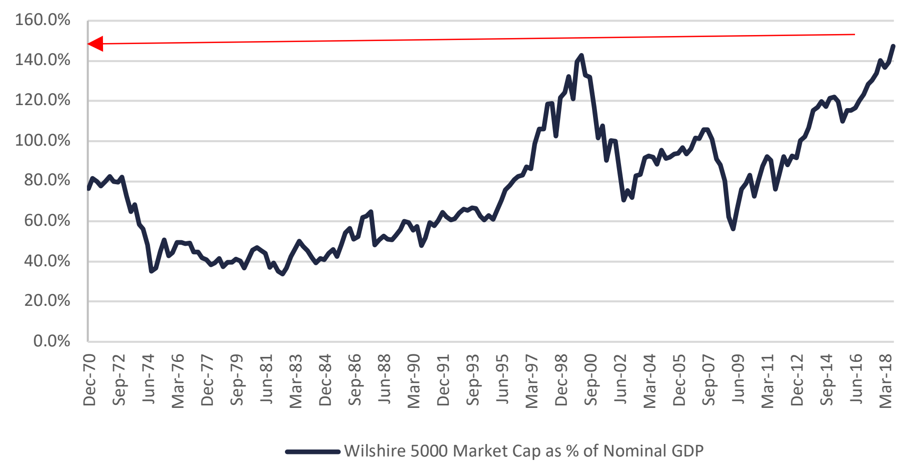
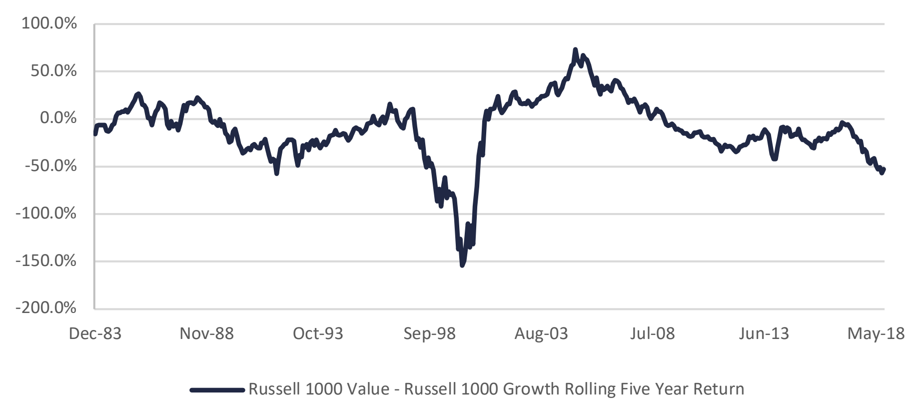


Chart 15: Large Cap Value Lagging Large Cap Growth

Footnotes: Data as of September 2018.

Source: Bloomberg Finance LP, Verdence Capital Advsiors.



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

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

- **Bubble Déjà vu:** The rally in growth is concentrated in a select few "growth" names. For example, Amazon, Apple, Microsoft, Netflix and Visa make up approximately half of the total return of the Russell 1000 Growth Index year to date (keep in mind there are 545 companies in the Russell 1000 Growth Index).[3] These names are so overvalued that if you look at the average trailing P/E of those five names over the past year and compare it to what the S&P 500 Financials Index looked like before the Great Recession and the S&P 500 Info Tech Index prior to the dotcom bubble bursting, it looks like complacency may be setting in and momentum is pushing those names higher**. (chart 16).**

- **Valuations Favor Value over Growth:** When looking at the forward P/E multiple of the Russell 1000 Growth in relation to the Russell 1000 Value, growth is the most expensive versus value since January 2006. **(chart 17).** Other valuation metrics like the price to book value or the price to cash flow are also historically expensive for growth compared to value.

- **Go Small or Go Home!**
Large cap stocks have led the rally over the past 12 months due to better economic growth, tax reform and solid earnings. Even though small cap stocks have put on an impressive rally year to date due to ongoing trade uncertainty (small cap stocks get less revenues overseas), large cap has still been the leader. This has left a wide dispersion of returns at the market cap level and opportunity for investors. In addition, when looking at earnings estimates for 2019, the midcap and small cap space are expected to produce better earnings than large cap stocks.

Chart 16: Is this Another Bubble?
Footnotes: Data for current companies is average of trailing P/E over past one year time period as of October 2, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

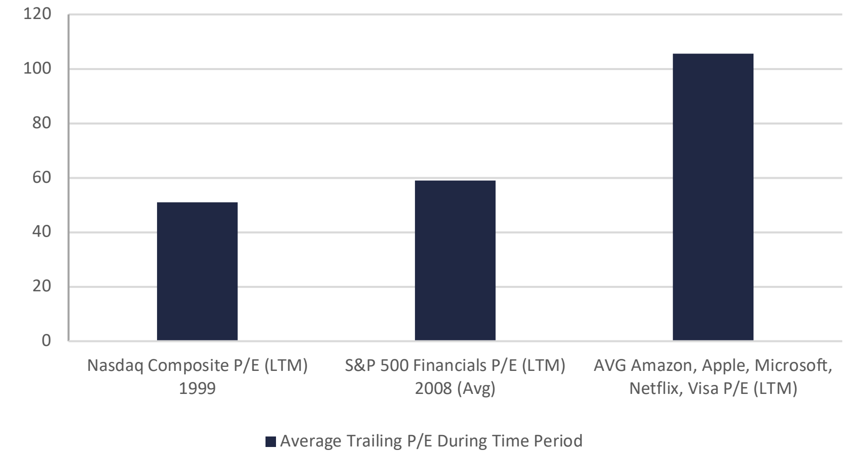


Chart 17: Growth Historically Expensive vs. Value
Footnotes: Data as of October 2, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

The Bottom Line:

At Verdence, we believe the U.S. economic cycle has room to run and will likely go down in history books as the longest U.S. expansion on record. The current bull market in equities is already being recorded as the longest bull market in history. While the economic environment and favorable fiscal policies suggest the equity bull will likely continue, there are several indicators that lead us to believe we are approaching the end of the bull market. Heightened valuations, rising inflation, growing corporate debt and higher interest rates should all put pressure on multiples, earnings and margins for U.S. corporations. As a result, volatility is likely to pick up as we move through the final quarter of 2018. Keep in mind, investors have enjoyed a relatively quiet period for volatility in 3Q18. There was not one day that the S&P 500 had a move of 1% or more (up or down) in 3Q18. That has only occurred one other time since 2Q89 (last occurred in 4Q17).

It is important at these late stages of the economic and bull market that investors remain disciplined with their long-term risk objectives, but we also believe in being a bit daring as to look to regions (e.g. International over US) and styles (Value over Growth) that most investors have neglected in this momentum driven late cycle rally. While divergencies are not uncommon between economies/regions/sector and styles, some of the unwarranted dislocation can also present opportunity. Most importantly, it is crucial at this stage of the economic and bull market and with valuations across many asset classes looking stretched to be well diversified, especially with uncorrelated assets like hedge funds and private equity. Hedge funds have proven to be a stable force in portfolios in periods of heightened volatility. A 60/40 (stock/bond) portfolio that diversifies with an allocation in hedge funds has historically performed better than just a traditional stock and bond allocation. In addition, private equity not only can be uncorrelated but also select private equity has more attractive valuations than the public market with healthy balance sheets. At this time, we would recommend income producing private equity and would avoid venture capital due to less attractive valuations and higher risk.

At Verdence, we will continue to monitor all aspects of the global equity and bond markets to look for attractive long-term opportunities for investors. We adhere to an active management style of investing as opposed to passive given this stage of the bull market, heightened valuations and dislocations in many regions/sectors/asset classes. Lastly, as always, we look at an investor's risk tolerance before making asset allocation decisions.

1 Estimate as of Strategas Research Partners as of September 20, 2018.

2 Quoted by Ben Bernanke at the Carlyle Group Investor Conference September 2018. Quoted by Steve Einhorn at Omega Capital in November 2017. Various other Economists have used iterations of the quote.

3 Data compiled by Bloomberg and as of October 3, 2018.

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

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com