Finding a Second Wind in the Last Leg

Expansion Has Room to Run in 2019; Be Flexible and Disciplined

Last year was expected to be a year for the record books. Coming off the biggest tax reform package in U.S. history, analysts forecasted the S&P 500 would rally for the 10th consecutive year. It was expected to go down in history books as the first time the Index accomplished such a consecutive annual winning streak. In fact, in the first American Association of Individual Investors Survey for 2018, those investors that were bullish on the stock market surged to an eight-year high! The equity market did not disappoint, at first! The S&P 500 kicked off with its best start to a new year since 1987 (through January 26). Investors were paying up for stocks in ways not seen since the dotcom bubble as euphoria took over discipline and investors chased returns. Major dislocations were formed across market caps, regions and investing styles (e.g. growth vs. value, U.S. vs. International stocks) and computer based algorithmic trading seemed to be in control.

That is until the volatility giant we warned of in our 2018 themes reared its ugly head and shattered investor optimism. The S&P 500 encountered its first 10% correction in over 400 trading days, the longest span between such a correction since 1989. For the year, the S&P 500 saw 64 days with a move of 1% (up or down) compared to only eight days in 2017. Interest rates rose to seven-year highs, credit spreads surged, and commodities were thrown into a deep bear market. In fact, by years end, there was nowhere for investors to hide. If it were not for a 0.01% increase in the Bloomberg Barclays Aggregate Index, it would have been the first year since at least 1977 that all three major asset classes declined (i.e. stocks, bonds and commodities).[1]

However, one positive takeaway from the worst year for the equity market since the Great Recession is that it brought valuations to more reasonable levels and, in some instances, even attractive levels. Instead of chasing equity returns, investors can now focus on fundamentals, discipline and due diligence and find attractive long-term investment opportunities. Below we offered four main themes across the economic environment and asset classes for 2019.

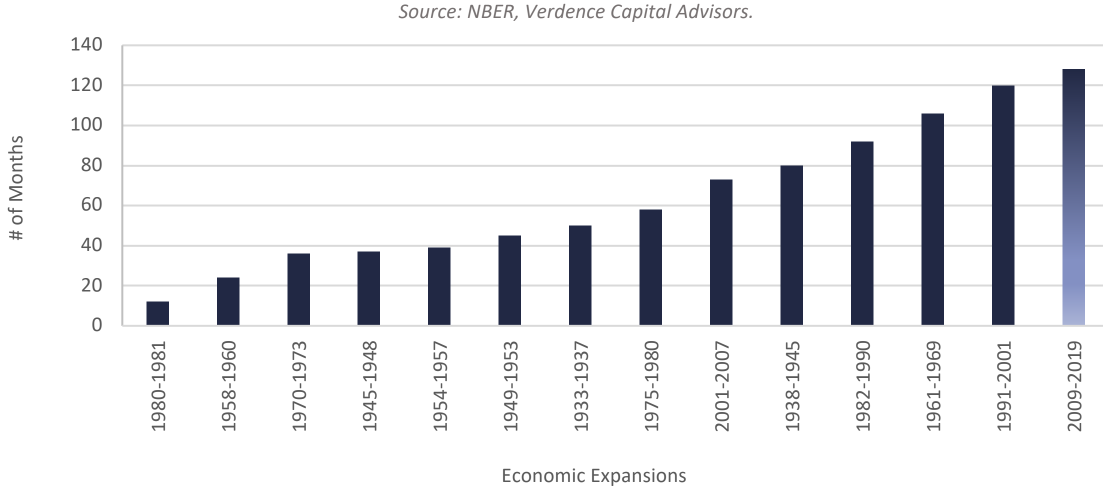
Theme 1: U.S. Economy Getting Fatigued but Not Done Yet!

There was a disconnect between the broad decline in the capital markets and the performance of the U.S. economy in 2018. Whether it was the intensifying trade war with its international counterparts, a global growth slowdown, impeachment talk or nearly three quarters of the U.S. population having an unfavorable rating of the U.S. Government, the U.S. economy likely posted its best year over year growth in this economic cycle. Our base case is that U.S. economic growth will slow in 2019 because of higher interest rates, slower global growth, and political uncertainties. However, the expansion still has many supportive factors and we expect by the end of 2019 this expansion will go down as the longest economic expansion on record. **(Chart 1)**. Some of the supportive factors include:

Chart 1: Economic Expansion to Break Record

Footnotes: Data is assuming expansion goes through 4Q19.

Source: NBER, Verdence Capital Advisors.



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

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

- **All factors favor the consumer:** A solid labor market, surging consumer confidence and tax reform has made the consumer the bright spot in 2018, making up 69.7% of GDP which is the highest contribution on record. The ongoing positive effect from tax cuts, strong consumer confidence, the best job market since the late 1960's and rising wages should all contribute to solid consumer spending in 2019. In addition, the sharp drop in gasoline prices over the past year serves as an additional tax cut for consumers. **(Chart 2)** The general rule of thumb is that for every $0.01 decline in gasoline prices, it increases annual consumer buying power by $1 billion. As a result, the ~$0.75 decline in gasoline prices since its 2018 high could result in an additional $75 billion in annual spending power for the consumer.

- **Accommodative monetary policy:** While the Federal Reserve has raised its benchmark rate nine times in the past three years, because it came from essentially zero, the real Fed funds rate (Fed funds rate minus inflation) remains highly accommodative. In fact, the real Fed funds rate just crossed into positive territory at the end of 2018 for the first time since March 2008 **(Chart 3)**. We do not expect the Fed to abandon their goal of normalizing monetary policy, but we do expect them to maintain a slightly more dovish tone, be flexible and may even take a pause with their tightening cycle if economic conditions warrant it in 2019. The Fed funds futures market had previously seen the potential (in the middle 2018) of three to four rate hikes in 2019, but after the volatility in 4Q18 and muted inflation pressures, that has been reduced to one or two hikes in 2019 at the most.

Chart 2: Consumer in Strong Position

Footnotes: Data is monthly and as of December 31, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

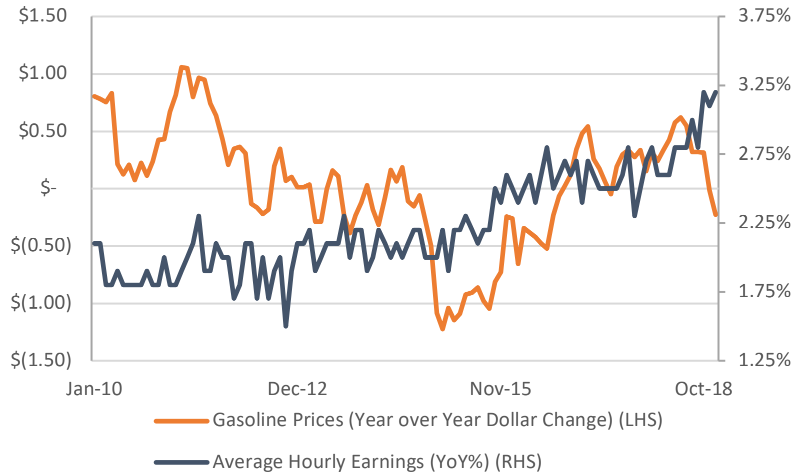


Chart 3: Real Fed Funds Rate Accommodative

Footnotes: Data is monthly and as of December 31, 2018. Using core PCE YoY.
Sources: Bloomberg Finance LP, Verdence Capital Advisors.

	Real Fed Funds Rate at Start of Recession
1973	4.15%
1980	5.76%
1981	6.71%
1990	3.93%
2001	3.23%
2007	1.92%
Current	0.62%

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

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com
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- **Manufacturing expanding:** Manufacturing has slowed in recent months because of moderating global growth and disruptions due to ongoing "trade wars." However, the Index and many of its underlying components remain solidly in expansion territory. When looking at the past 11 recessions, the ISM Index has peaked, on average, roughly two years before the economy enters a recession. Therefore, using history as a guide, if the Index peaked in September 2018 (at the highest level since 2004), the next recession may not occur until 2020. In addition, while some slowing in the industry is expected as the labor market tightens, global growth remains uncertain and trade wars continue to disrupt supply chains, manufacturers remain confident in the outlook for manufacturing. According to the National Association of Manufacturers, the percentage of those surveyed are the most confident about the future in manufacturing in at least the past six years. **(Chart 4)**

- **Capex spending still has room to run.** With small business optimism at the highest level since 2004 and technology investment needed to deal with labor shortages, we expect capex spending to continue in 2019. U.S. companies have brought back over $600 billion worth of cash from overseas due to tax repatriation and current estimates expect that to slow in 2019 (to ~$350 billion). **(Chart 5)**. However, that is nearly $1 trillion worth of money coming back to the U.S. in 2018 and 2019 which is ~5% of nominal GDP and should help to boost capex spending.

- **Global stimulus ahead?** Outside of the U.S., economic growth disappointed in 2018. Germany posted its first contraction in quarterly GDP since 1Q15 while China GDP has slowed to the weakest pace since the Great Recession (1Q09). To stem the slowdown in growth, the People's Bank of China has cut its reserve rate requirement, rolled out programs to get banks to lend more and flirted with the idea of tax cuts or more infrastructure spending. While China walks a fine line between maintaining the stability of their currency and stimulating growth, we believe they have ample tools that can be used to fuel growth. The timing of any additional stimulus is difficult to predict as announcing aggressive stimulus measures may harm China's bargaining power while negotiating with the U.S. on trade. Europe has less appetite for fiscal stimulus due to its debt limitations and politics, but we do not rule it out in select, less leveraged countries (e.g. Germany) and at a minimum we may see a softer tone from the ECB to boost sentiment.

Chart 4: Manufacturing Outlook Remains Strong

Footnotes: Data as of December 20, 2018.

Source: NAM Manufacturers, Verdence Capital Advisors.

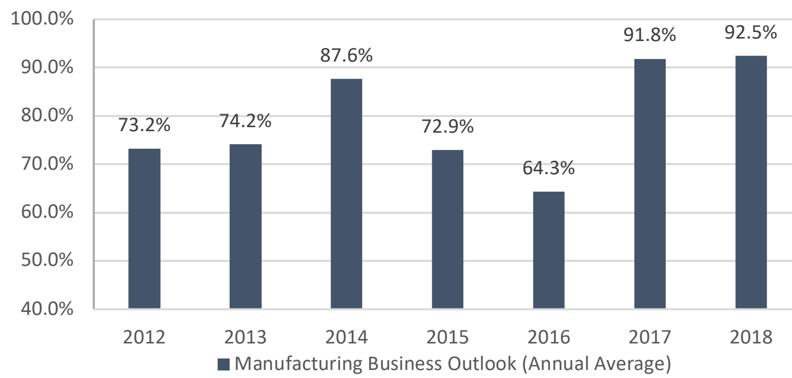
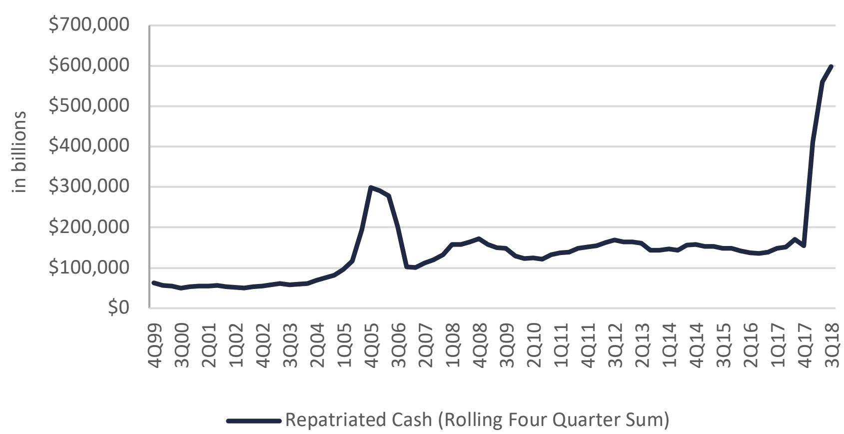


Chart 5: Money Flowing Back to the U.S.

Footnotes: Data as of 3Q18.

Source: Federal Reserve, Verdence Capital Advisors.



Theme 2: Do Not Fear Yield Curve Yet! But be Flexible with Duration

Despite moderately lower long-term yields in 4Q18, the long-term upward trajectory for yields is still in place. **(Chart 6)**. While there is a lot of noise around the recent narrowing of the yield curve (difference in yield a client earns across short and long-term maturities), the yield curve is acting exactly as you would expect three years into a Fed tightening cycle. The Fed is raising short term rates while the rise in long-term yields has slowed as future growth comes into question. The difference between the 10-year Treasury yield and the Fed funds rate has fallen to the lowest level seen since before the "Great Recession." However, it is important to note that the yield curve has inverted on ten different occasions since the early 1970's and only six of them preceded a recession. **(Chart 7)**. In addition, yields are being driven by unprecedented factors including near zero interest rates globally and a Fed balance sheet that is more than the size of Germany's economy. Over the next 12 months, as the Fed raises short term rates, the yield curve (difference between 10YR and short-term rates) should remain narrow and may even invert. However, history tells us that the yield curve can remain flat for extended periods of time and if it does invert and it is preceded by a recession, that recession is ~12 months away from when the yield curve moves consistently into negative territory. Given our base case economic scenario we would recommend the following in fixed income:

- **Short duration but be flexible:** Duration is how sensitive a particular bond's price is to changes in interest rates. Short term bonds offer less interest rate sensitivity (or duration risk) than long-term bonds. Since the difference between the yield investors earn across most maturities in the Treasury market offers little disparity, it does not warrant investors taking on significant duration risk. We recommend investors focus on short term bonds as rates should move gradually higher, but we may see the potential to gradually increase our maturity focus over the coming year. As the economic cycle matures, investors may benefit from having exposure in some intermediate to long-term bonds as future growth fears may result in long-term yields declining.

Chart 6: Long-term Upward Trajectory in Place

Footnotes: Data is as of January 15, 2019.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

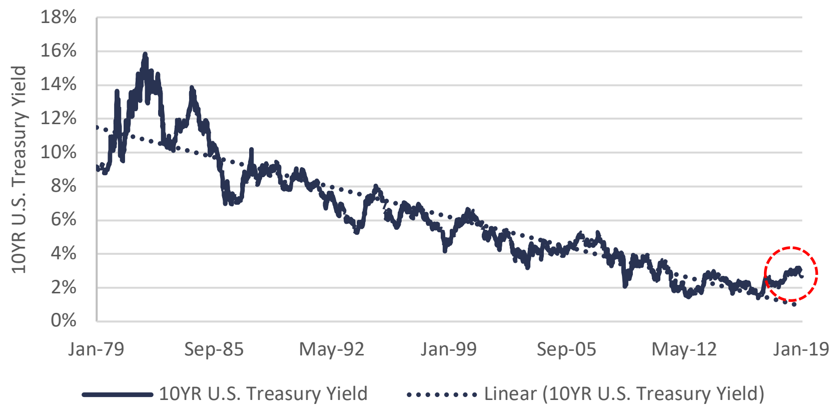
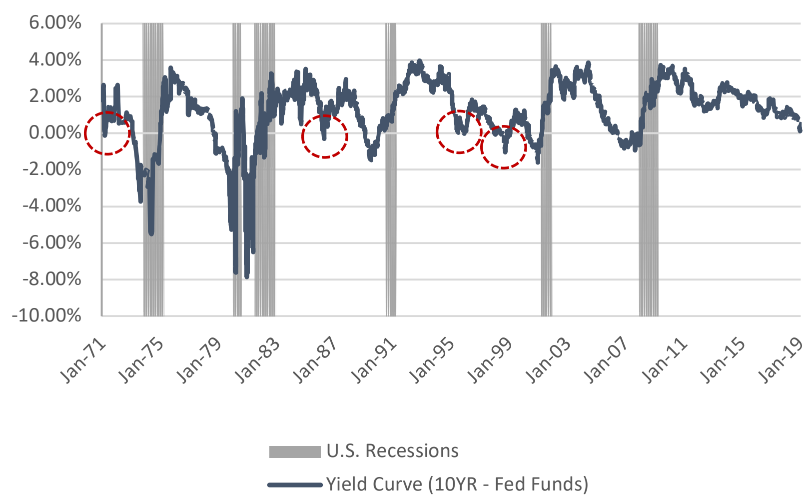


Chart 7: Not all Inverted Yield Curves Lead to Recession

Footnotes: Data is as of January 15, 2019.

Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Credit — Cheap but not cheap enough yet!** The corporate bond market suffered in 2018, especially higher risk credit. High yield declined for only the second year over the past 10 years and high yield spreads (the extra yield that investors demand to own high yield debt over Treasuries) rose to the highest level in two years. **(Chart 8)**. Credit fears, the bear market in crude oil and the volatility in equities hampered the overall credit market. As a result, high yield issuance was nonexistent in 4Q and 2018 was the slowest year for high yield issuance since 2009. While valuations have become more attractive for high yield and leveraged loans, we do not believe they are attractive enough, yet! We will monitor valuations closely and take advantage of opportunities if there is a dislocation between valuations and our economic outlook but at this late stage in the economic cycle, investors will want to focus on quality within the corporate debt market (e.g. Investment Grade over High Yield). We will also continue to look for unique credit opportunities in the private equity space which may look more attractive than traditional credit at this time. Lastly, we recommend emerging market bonds. Valuations for EM bonds are attractive and we do not expect widespread defaults in the emerging market sovereign space.

Chart 8: Credit Not Attractive Yet!

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

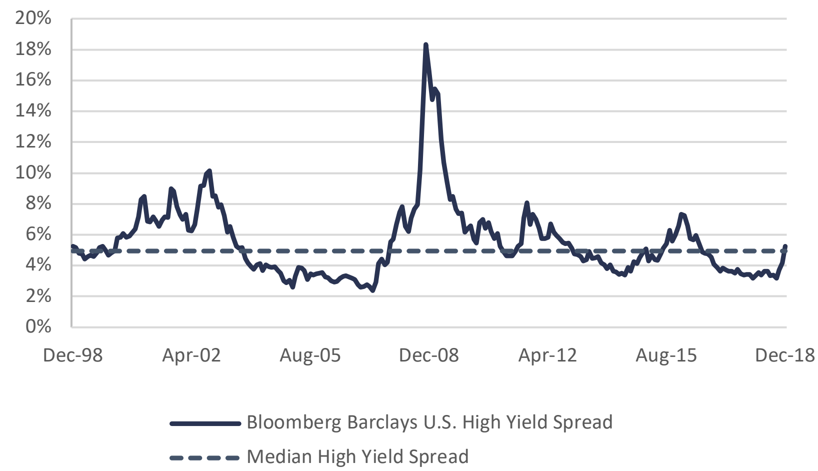
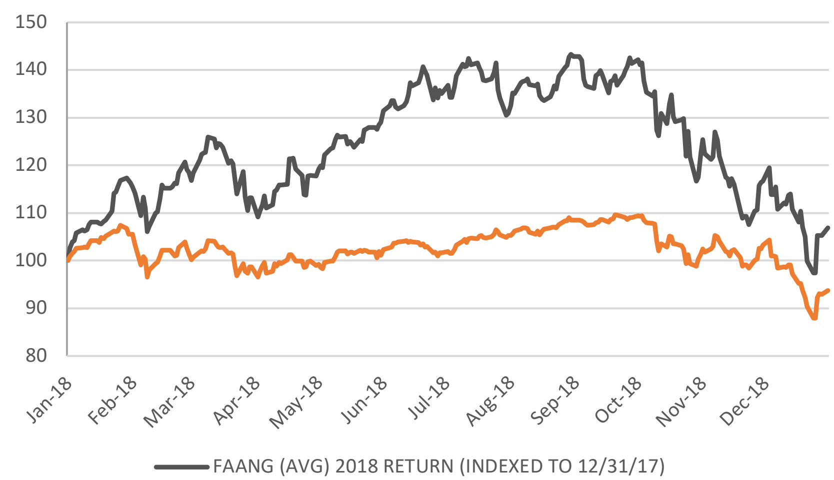


Chart 9: Momentum Mindset Fades in 2H18

Footnotes: Data as of December 31, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



Theme 3: After a Short Break; The Bull Should Persevere

After a tumultuous year for equity investors, the biggest question looming is if the nearly 20% decline in Sept-Dec 2018 (-19.78%) marked the end of the current bull market. Our short answer is no! All the economic indicators that we have outlined above suggest a recession is not imminent and while earnings growth will likely slow along with the expected economic growth in 2019, there is still room for the record long bull market to continue. If you look at the six different scenarios since the 1960s where the S&P 500 encountered a pullback of 15% or more that did not coincide with a recession, each one of those instances proved to be a buying opportunity. In fact, the median rebound in the S&P 500 in those six instances one year later was nearly 30%.

The one positive takeaway from last year is that the near bear market correction washed out some of the dislocations and made select momentum driven investments fair valued. For example, as seen in **Chart 9**, the FAANG stocks (i.e. Facebook, Apple, Amazon, Netflix and Google) were outperforming the S&P 500 by nearly 40% through the middle of 2018. By the end of the year, on average, they were outperforming by less than 15%. When looking at valuations, after the S&P 500 forward price to earnings multiple rose to the highest level since the dotcom bubble, it has since corrected and made the S&P 500 look 25% cheaper than the start of 2018 **(chart 10).**

Given our view that a recession is not imminent, and the bull has room to run we would make the following recommendations for global equities in 2019:

- **Favor value but gradually add in growth:** Our recommendation to favor value over growth for 2018 proved to be too conservative for most of the year. Growth benefitted from improving economic growth, excess liquidity, solid balance sheets, low interest rates but also momentum. Investor euphoria in select stocks (e.g. FAANGs) clouded discipline and select companies saw P/Es trading in "bubble like" territory. **(Chart 10)** Therefore, growth looked historically expensive versus value and we found it irresponsible to chase momentum. However, as equities approached bear market territory the recommendation to favor value over growth proved beneficial as value outperformed growth in 4Q18 for the first quarter in two years. While growth is still expensive versus value on a relative basis, growth valuations (especially in technology) have fallen in the recent equity correction and present an opportunity to gradually add an allocation to an active growth manager. In addition, earnings growth is favorable and looks achievable given our base case economic scenario. However, it is important to note that while we are recommending adding some exposure to growth given its recent correction (over 20% from its 4Q18 peak), we continue to have an overweight to value in our domestic equity allocation. Value is still cheap compared to growth, has an attractive dividend and should outperform in the late stages of the economic cycle.

- **Maintain weighting to small/midcap stocks.** Small and midcap stocks were challenged the most in 2018. After being the bright spot in the U.S. equity market through the first half of 2018, credit fears from widening high yield spreads, historically expensive valuations, collapsing commodity prices, a flat yield curve and growth concerns weighed on the small and midcap space. The price action in the small/midcap space is like what was seen in 2015 and 2016 when crude oil collapsed, China growth fears emerged, and high yield spreads widened to a five-year high. **(Chart 11)**. What is important to note is that when the Russell 2500 bottomed in February 2016, it went on to rally ~40% in the one year

Chart 10: Valuations More Attractive
Footnotes: Data as of January 15, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

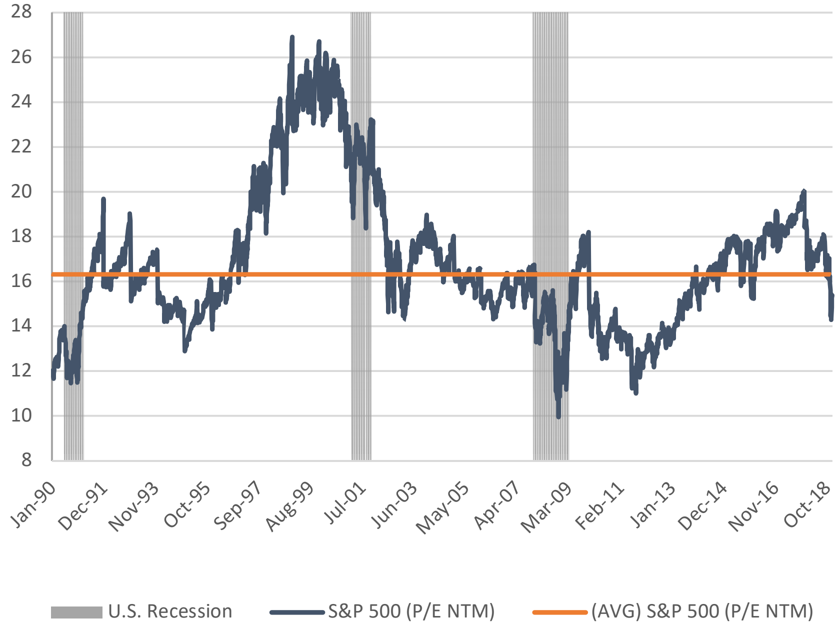
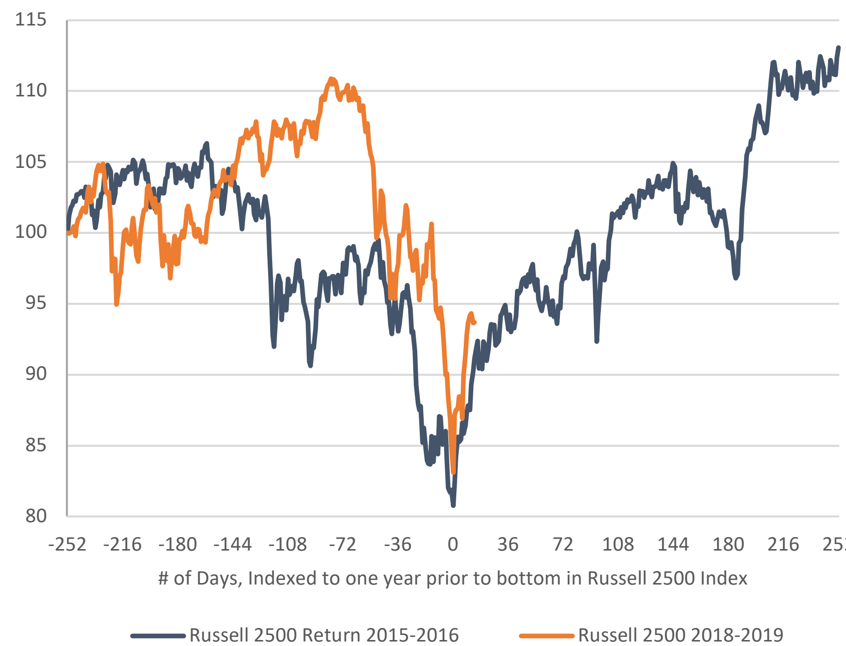


Chart 11: Midcap Stocks in 2015-2016 Pullback
Footnotes: Data is as of January 15, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



later. In addition, when looking at past equity pullbacks of 15% or more that do not occur during a recession, small cap stocks outperform large cap stocks in the one year later.

- **International equities over the U.S.** The U.S. economic picture was far better than its global international counterparts in 2018 and performance in equity markets reflected that. While global equity markets were negative in 2018, the S&P 500 outperformed the MSCI AC World ex U.S. for seventh time in the past 10 years. We expect challenges to remain in international economies in 2019. Europe is still sorting out Brexit, the China/U.S. trade “skirmish” is still unsettled, the Italian government wants to spend more than the EU allows, the ECB is unwinding nontraditional monetary policy and Japan, as of now, is going forward with a scheduled consumption tax hike in 4Q19. However, with many major Indices still in correction or bear market territory they seem to be reflecting the uncertainties surrounding their economies in 2019 **(Chart 12)** and not reflecting some of the positive factors that may arise in 2019. For example, commodity prices are down globally, interest rates are still relatively low, the worst-case scenario seems to be priced in from a trade perspective and a weak Euro should support earnings. It is also important to remember that global growth is expected to slow in 2019, but NOT contract and global trade is slowing but NOT contracting so the current level of pricing in select international markets may be reflecting too pessimistic of an outlook. **(Chart 13)** From a valuation perspective, international equities are at the deepest discount compared to U.S. equities since 2008. In addition, when looking at a variety of factors compared to bonds, international equities look attractive. **(Chart 14)**. At this time, we see the greatest upside in Asia emerging markets as we remain optimistic the U.S. and China will move towards a compromise on their trade “war” and current pricing may not be reflecting a positive outcome or the potential for additional fiscal stimulus.

Chart 12: Equity Indices off 52 Week High

Footnotes: Data as of January 15, 2019.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

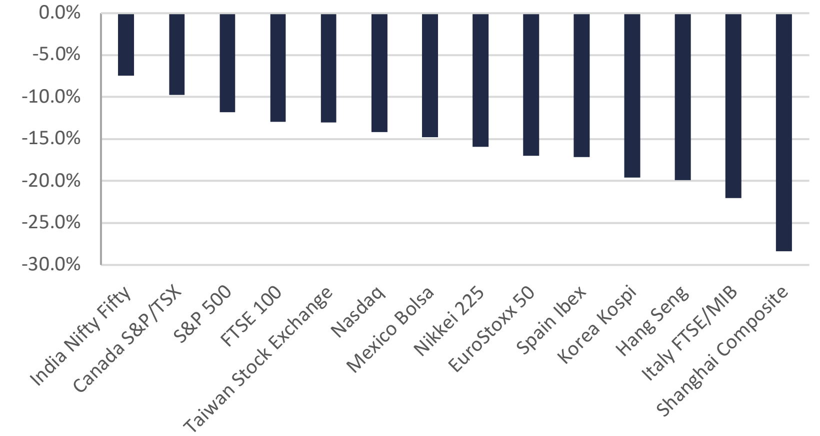


Chart 13: World Trade to Remain Positive

Footnotes: Data as of IMF October Outlook.

Source: IMF, Verdence Capital Advisors.

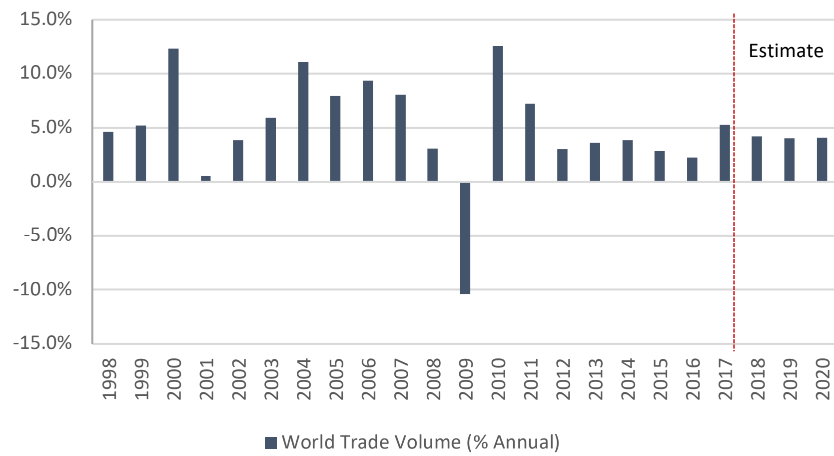


Chart 14: Global Equities Attractive vs. Bonds

Footnotes: Data as of January 15, 2019.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

	Country – Major Stock market	Free Cash Flow Yield	Earnings Yield	Dividend Yield	5YR Govt Yield
G7	U.S.	5.4%	5.6%	2.1%	2.5%
	Canada	1.5%	6.1%	3.3%	1.9%
	Germany	5.0%	8.4%	3.3%	-0.4%
	France	1.5%	6.8%	3.6%	0.0%
	UK	9.2%	6.3%	4.9%	0.9%
	Italy	-4.3%	9.2%	4.1%	1.8%
	Japan	4.4%	7.0%	2.1%	-0.1%
EM Asia	China	10.3%	8.3%	2.6%	2.9%
	Korea	6.6%	9.9%	1.6%	1.9%
	India	-2.8%	4.4%	1.5%	7.4%
	Taiwan	-0.2%	7.9%	4.7%	0.7%
	Indonesia	4.9%	4.9%	2.1%	8.0%

Theme 4:
A Brighter Alternative Year Ahead

For being a non-correlated asset class, many alternatives (from hedge funds to commodities) struggled in 2018 along with global equity markets. Growth uncertainty, tariffs/trade wars, a bear market in commodities, a strong dollar and heightened volatility negatively impacting many portions of the alternative space. However, we believe alternatives will be an important part of an investor's portfolio in 2019. Not only to reduce overall risk in portfolios but also to capitalize on the base case that a recession is not imminent and that trade war fears should fade.

- **Dollar likely peaked in 2018:** The dollar has capitalized on better economic growth relative to the other major economies and interest rate differentials. Global FX investors have allowed those factors to overshadow the weaker fiscal environment and political uncertainty in the US. Treasury debt as a percent of GDP is expected to approach 100% in the next decade while net interest costs will become a larger portion of the U.S. budget. In addition, political uncertainty remains with gridlock in Washington. Therefore, we believe the rally in the dollar will be challenged in 2019.

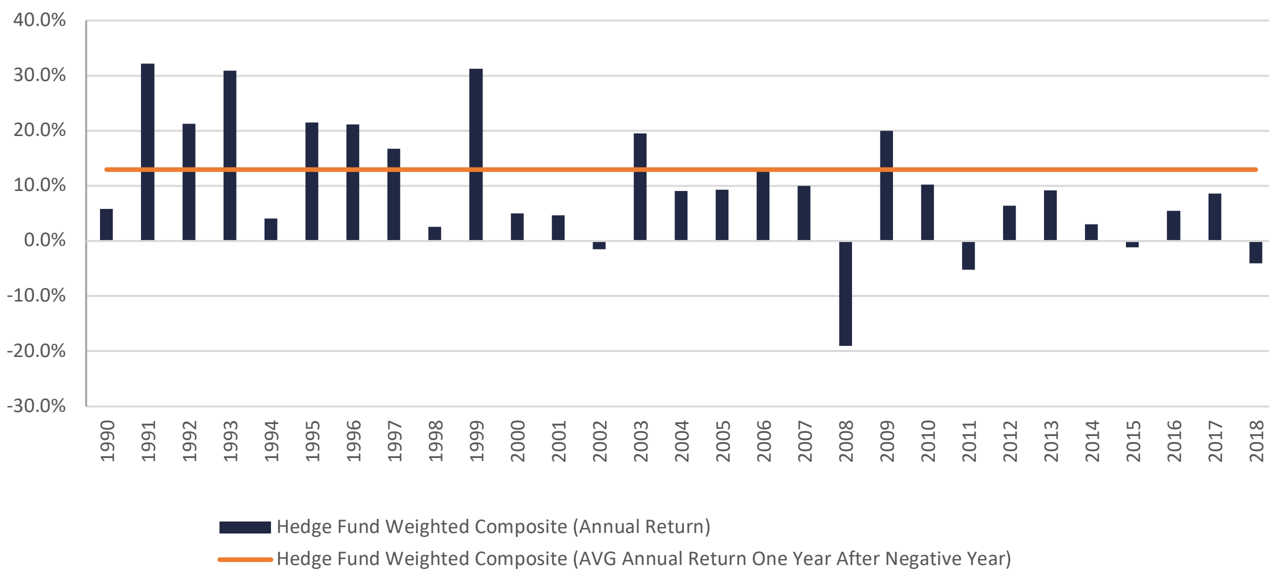
- **Commodities should find relief:** We remain optimistic that progress will be made on the U.S./China trade "war." Any good news on trade between the two largest trading partners should quell the concerns about a global recession. This should help to push commodities higher, especially oil and industrial metals. Oil prices should be supported by OPEC cuts as well as signs that rig counts have peaked (at least at current prices) in the US. Progress on trade, the lack of a global recession and a weak dollar should also support commodities in 2019.

- **Hedge funds come back in favor:** The broad Hedge Fund Weighted Composite Index declined almost as much as the S&P 500 in 2018. Instead of capitalizing on soaring volatility, higher interest rates, slowing global growth, a liquidity squeeze, a sharp reversal of momentum stocks (e.g. FAANGs), deleveraging and fund outflows brought back memories of the 2008 hedge fund destruction. However, it is important to note that hedge funds have never encountered a back to back annual decline. Even in the depths of the Great Recession the Hedge Fund Weighted Composite went on to gain all its losses back in 2009. Since 1990, the median return in the one year after the Hedge Fund Weighted Composite declines, it rallies by ~12%. **(Chart 15).** With momentum and euphoria driven trades slowly phased out of the equity market, the illiquidity crisis that occurred in the small cap space in 4Q18 is unlikely to repeat itself and with leverage levels lowered, we recommend an allocation to hedge funds.

Chart 15: Hedge Funds Have Never Had Back to Back Annual Declines

Footnotes: Data as of December 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

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The Bottom Line:

As we try to navigate through 2019, the factors that drove the volatility in the capital markets in 2018 are far from behind us (e.g. trade, politics, global growth). We do see a better environment for investing in 2019 compared to 2018, but we do not expect it to be a smooth ride and investors should expect a similar type of volatility environment in 2019. While the U.S. expansion has room to run, it is in its late stages and expected to slow. This year it will be crucial for investors to be flexible to make asset allocation shifts that will best serve their long-term investment goals. We will continue to balance underlying fundamentals with valuations to find attractive long-term investment opportunities. Like the start of 2018, we will not chase momentum driven investments that may arise from pricing that is not backed by fundamentals. For example, if an investor had carelessly followed the crowd and added to Bitcoin at the end of 2017, that investor would have seen their bitcoin investment lose ~75% of its value. We will continue to favor quality within the asset class, style and manager selection level and use hedging instruments to mitigate losses as volatility should likely remain heightened.
If you have any questions or feedback please feel free to reach out to your Financial Advisor.

1. *Data for Bloomberg Barclays Aggregate only available from 1977 to present.*

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

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com