# 10-Years with a lot of "Bull"

*Happy 10th Anniversary, Bull Market!*

VERDENCE CAPITAL ADVISORS

*A decade is a long time by most metrics. It is roughly three times as long as the average career of an NFL player, it is longer than the average length of a U.S. marriage and it even spans longer than the legendary sitcom, Seinfeld. For investors, an economic expansion or equity bull market that spans a decade is an anomaly—it's unheard of! But believe it or not, a decade ago in 2Q09, the U.S. economy troughed and began the current historically long economic expansion. This expansion has defied most odds by withstanding the near collapse of the European Union, absorbing countless geopolitical disruptions, experiencing close to record high unemployment and showing resiliency to political tensions and domestic divisiveness. It is even on pace to span more than three times longer than the average U.S. economic expansion.*

*As we celebrate the 10-year anniversary of the end of the worst recession since the Great Depression and move into the 11th year of this economic expansion (begins 3Q19), we want to reflect on how the economy looks now versus 10 years ago and what we see for this impressive expansion as we move forward, both at the economic and asset class level.*

## U.S. Economy – Getting its Second (or third, or fourth) Wind!

Ten years ago, Americans remember the feeling of desperation as the U.S. economy and banking system were dangerously close to collapsing. Economic growth had come to a standstill with nearly every major component of GDP, contracting. Capital expenditures were non-existent **(Chart 1)** and companies were eliminating millions of employees. Newspapers were splattered with headlines like "The American Dream is Over" and "Worst Crisis Since the '30's, With No End in Sight." Consumers, which make up ~70% of GDP, essentially cut off the lifeline of the U.S. economy. Consumption declined on an annual basis for two consecutive years (2008 and 2009), the first back to back decline since the Great Depression.

The housing bubble officially burst and wreaked havoc on the economy and credit markets. New home sales fell to a record low, homeownership plummeted, people abandoned their homes as foreclosures hit a record high **(Chart 2)** and home prices fell into bear market territory. The banking system needed drastic and coordinated intervention as capital remained scarce and fears drove borrowing rates between banks to record highs. The Fed was forced to cut rates to zero and began "printing money."

**Chart 1: Business Spending Collapsed in Great Recession.**

*Footnotes: Data is year over year and as of 4Q18.*

*Source: Bloomberg Finance LP, Verdence Capital Advisors.*

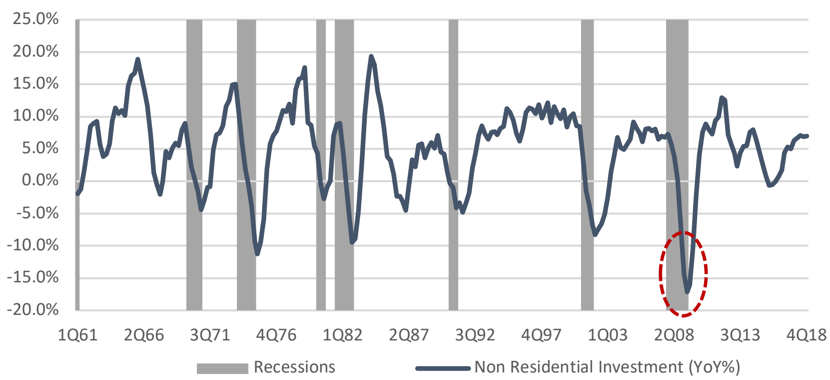
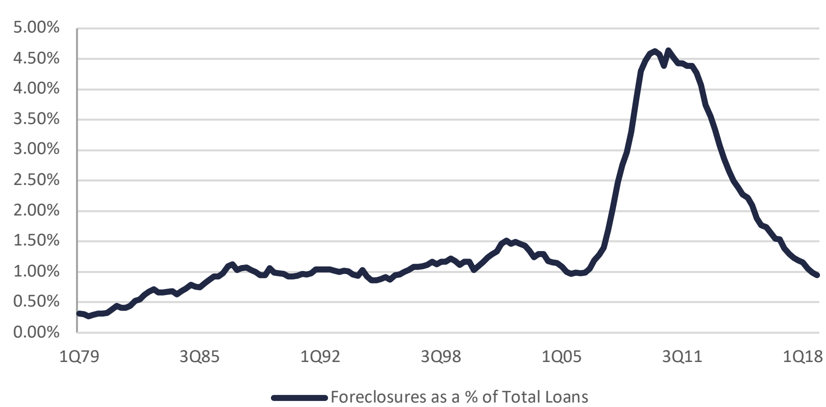



**Chart 2: Foreclosures at a Record High 10 Years Ago**

*Footnotes: Data as of 4Q18.*

*Source: Bloomberg Finance LP, Verdence Capital Advisors*

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This economic expansion has encountered many obstacles along the way and during this 10th year of expansion, optimism on growth is being tested once again. A trade war between the U.S. and China, a slowdown and/or recession in many major global economies and the longest U.S. government shutdown on record has caused the economy to slow and it is looking likely that once we receive 1Q19 GDP, it will show the slowest U.S. quarterly growth in three years. However, we believe the softness will be short lived and this expansion has room to run for the following reasons:

1. **The Fed - A Pause that Refreshes:** The recent slowdown has the FOMC re-evaluating their monetary policy stance. Not only have they essentially wiped out a chance for more rate hikes this year, but odds for the first rate cut since December 2008 have increased. The historically low Fed funds rate looks to remain that way for an extended period. In fact, the real Fed funds rate (Fed funds minus inflation) is nearly 2% below where you typically see it in the one year prior to a recession. **(Chart 3).**

2. **Global Stimulus…Again:** International governments and central banks recently announced much needed stimulus measures at the fiscal and monetary levels. China is cutting taxes, reducing reserve rates for banks and pushing forward infrastructure projects to stem the slowdown that has resulted from trade tensions with the U.S. **(Chart 4).** Europe has slashed growth projections which has offered them the flexibility to reinstate nontraditional monetary policy, and the U.S. is still feeling the positive effects of tax reform.

3. **Consumer is the Powerhouse:** After the Great Recession destroyed consumers, the consumer has been the powerhouse in this expansion. Over the past decade, consumers have seen nearly a $50 trillion increase in net worth (more than two times the size of the U.S. economy), their debt service ratios fall to a record low, jobs return, and confidence surge to near record highs. The consumer should continue to be supported by a solid labor market, rising wages, lower taxes and healthy confidence.

**Chart 3: Monetary Policy Extraordinarily Supportive**

*Footnotes: Data as of March 2019. Real Fed Funds Rate uses core PCE (YOY) as of January 2019.*
*Source: Bloomberg Finance LP, Verdence Capital Advisors.*

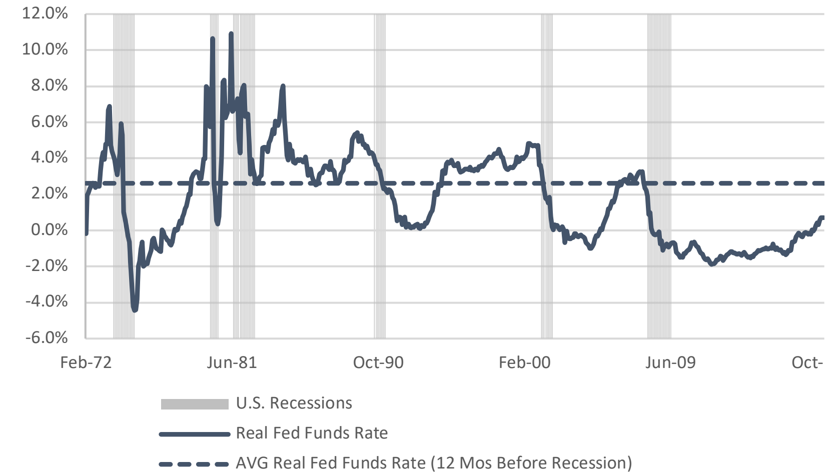
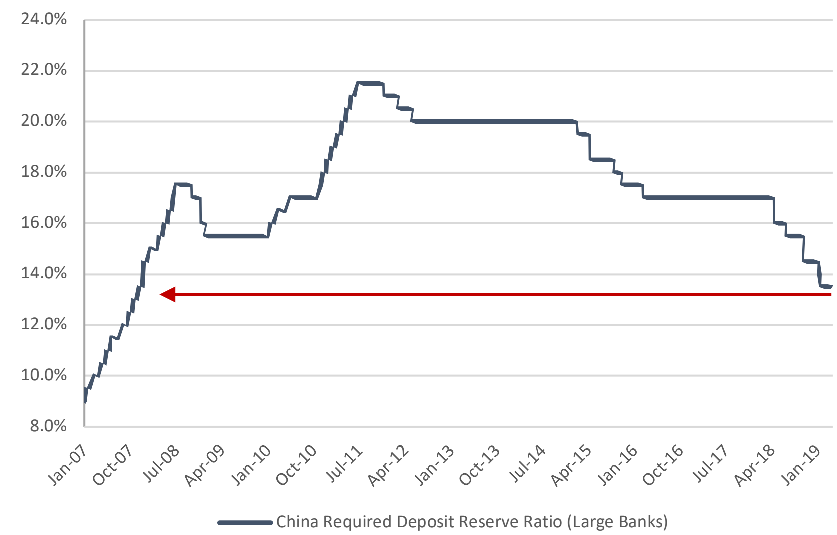



**Chart 4: China Interest Rates Cut to Pre-Great Recession Lows**

*Footnotes: Data as of April 4, 2019.*
*Source: Bloomberg Finance LP, Verdence Capital Advisors.*




4. **Will Housing Pull U.S. out of the Recent Slowdown?** While the housing market collapse devastated the U.S. economy 10 years ago, it may be what helps pull the economy out of the recent slowdown. The decline in long term rates has pushed mortgage rates down by ~80 bps, boosting refinancing and homebuyer affordability.

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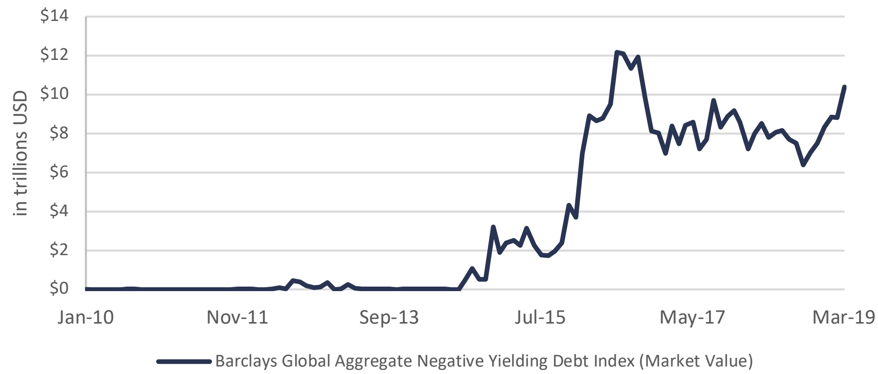
We are not surprised by the recent slowdown in growth, especially given the current global challenges. However, it is important to remember what many Federal Reserve officials have said, that "economic cycles usually don't die of old age." They are usually "killed" by something, whether it is policy error, a credit crisis, excesses in the economy or an economic shock. When we look at the underlying economic data, combined with the reversal in the Fed's stance on monetary policy, we are optimistic this cycle has room to expand into its 11th year, and perhaps even beyond.

**Chart 5: Amount of Negative Yielding Global Debt**

*Footnotes: Data is monthly and as of March 31, 2019.*
*Source: Bloomberg Finance LP, Verdence Capital Advisors.*




## Fixed Income – Stuck in the Fear Phase

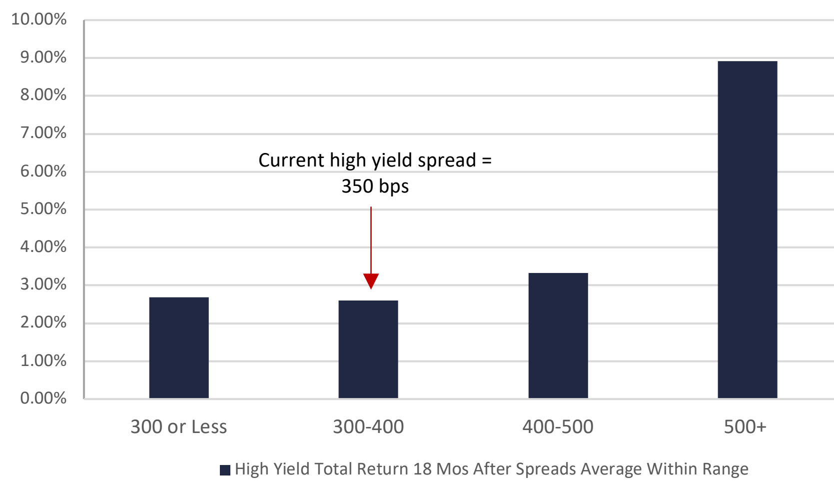
When looking at long term Treasury yields now versus a decade ago, the 10YR U.S. Treasury yield is only ~50 bps above the low it reached during the depths of the Great Recession. This is despite massive "money printing," and a significant widening in the budget deficit. The global correlation in sovereign yields is suppressing Treasury yields as international yields are being driven lower due to rate cuts and a resumption of nontraditional policy in some regions (e.g. Europe). The $10 trillion in negative yielding debt around the world is supporting demand for U.S. Treasuries given interest rate differentials. **(Chart 5)**

While U.S. Treasury yields may remain lower than fundamentals would suggest they should be, chasing expensive investments would go against our investment philosophy at Verdence. Therefore, we would be cautious with fixed income and remain in short to intermediate investments to mitigate interest rate risk.

While lower interest rates may have stemmed fears of defaults in high yield, when spreads are near the current level (350 bps) the future return potential is muted. **(Chart 6).** Instead we would focus on emerging market bonds and income producing private equity as attractive alternatives to high yield and sovereign bonds.

**Chart 6: Spreads Within Current Range Offer Little Return Potential**

*Footnotes: Time period reflects 1998-March 2019. Current spread level is as of April 15, 2019. Returns are 18 months after spreads within specified range.*
*Source: Bloomberg Finance LP, Verdence Capital Adviosors.*



## Global Equities – The Bull Emerges After the Bear Tries to Peak its Head!

A decade ago, the S&P 500 bottomed (March 9, 2009) more than 300% below where it is currently (2,905 as of April 15, 2019). Since then earnings have grown almost 200%, dividends have returned, the pace of capital expenditures has doubled, and balance sheets have been repaired. **(Chart 7).** It was the aggressive actions taken by central banks that pulled the global equity market from the abyss. Now, a decade later and it is the same story! A dovish Federal Reserve helped buoy the S&P 500 to its best first quarter return since 1998 and the MSCI AC World Index saw its best quarterly rebound since 2Q10.

As valuations get more expensive **(Chart 8)** with the U.S. equity market within 1% of its record high, periods of consolidation in the impressive rebound are likely. However, given our base case scenario that the economic expansion has room to run, we will continue to look at periods of weakness as potential buying opportunities and recommend a modest overweight to global equities. Within our global equity exposure, we would recommend the following:

**Chart 7: A Decade Comparison**

| | Average 2009 | Present as of April 15, 2019 |
|---|---|---|
| S&P 500 | 948 | 2905 |
| S&P 500 12 Month Dividend Growth | -7.0% | 6.9% |
| S&P 500 Trailing 12 Month EPS | $53.00 | $152.00 |
| S&P 500 Total Debt to EBITDA | 5.79 | 3.98 |
| S&P 500 (Trailing 12 Months) Capital Expenditure Spending | $48 billion | $84 billion |
| VIX Index (Average Trailing 12 Months) | 31.48 | 16.30 |

*Source: Bloomberg Finance LP, Verdence Capital Advisors.*

- **Neutral on U.S. but Looking for Opportunities:** Given the recent rally, especially in large cap stocks, we are holding a healthy cash position until valuations get more attractive. Currently, we favor the small and midcap space. Small and midcap stocks should benefit from lower interest rates, favorable taxes and a pick up in domestic growth. In addition, while small and midcap stocks were hit the most in 4Q18, their 1Q19 rebound has not been as broad based as in large cap. More than 50% of the companies in the smid cap index are trading in bear market territory compared to 20-30% in the large cap indices. In addition, when looking at how small cap stocks perform versus large cap stocks in the aftermath of a major correction in equities, history shows that if this occurs in a non-recessionary period, small cap stocks outperform large cap stocks. **(Chart 9).**

**Chart 8: Valuations Move Back Above Average**

*Footnotes: Data as of April 5, 2019.*
*Source: Bloomberg Finance LP, Verdence Capital Advisors.*

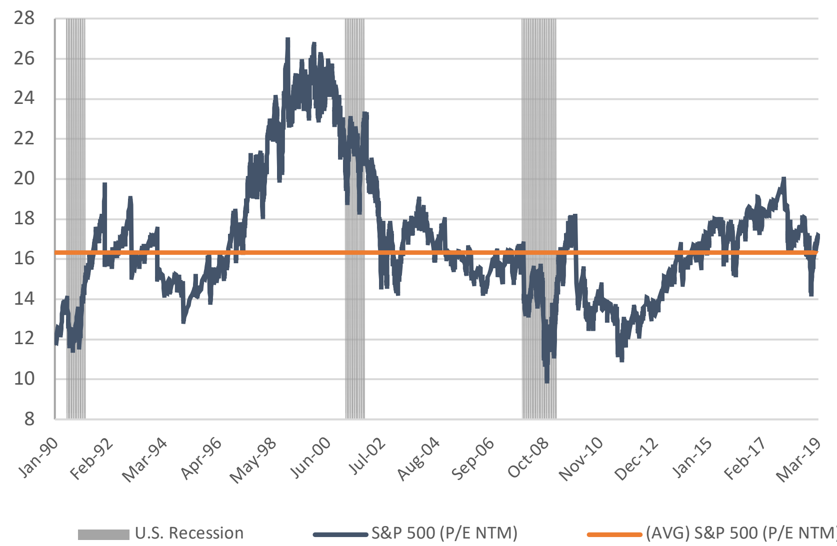



**Chart 9: Small Caps Outperform After 15% Correction in Non Recessionary Period**

*Footnotes: Price Return Only using S&P 500 and Russell 2000. Four occurrences, 1987, 1998, 2010, 2011*
*Source: Bloomberg Finance LP, Verdence Capital Advisors.*



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*Past performance is not indicative of future returns*

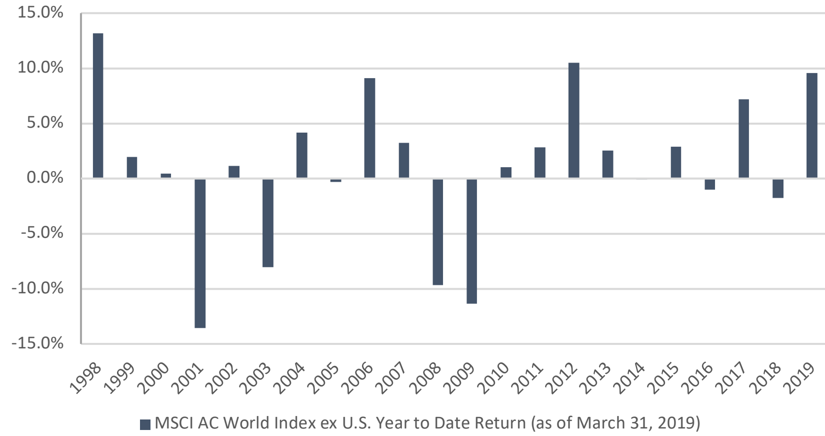
***Discover true independence.***

- **Favor international over U.S. equities**: The MSCI AC World ex U.S. Index is off to its best start to a new year in seven years and second-best start over the past 20 years **(Chart 10).** However, international equities are still lagging the rally in the U.S. as trade and domestic issues weigh on sentiment about economic and earnings growth. Therefore, the MSCI AC World Index ex U.S. remains historically cheap from a pricing perspective versus the U.S. **(Chart 11).** We believe that the underperformance of international equities vs. U.S. equities is already reflecting the recent slowdown in growth and not pricing in the chance for an economic recovery or the favorable shift in monetary and fiscal policy.

**Chart 10: International Equities off to a Solid Start**

*Footnotes: Data as of March 31, 2019.*

*Source: Bloomberg Finance LP, Verdence Capital Advisors.*




## Alternatives—The Lost Decade… For Some

Except for private equity, most alternative investments have disappointed in this economic expansion. The broad commodity index is the only major asset class that is still negative after the depths of the Great Recession and the broad hedge fund composite has posted meager bond-like returns**. (Chart 12).** However, despite the disappointing economic data in 1Q19, we have seen these alternatives start to recover. Commodities have been supported by optimism of a trade deal between the U.S. and China (metals), a change of heart by the Federal Reserve (gold) and OPEC production cuts (oil). Hedge funds posted their best quarter in a decade (since 3Q09) during the first quarter as fund flows returned and opportunities arose after the near equity bear market in 4Q18.

**Chart 11: International Equities Historically Cheap Compared to U.S. Equities**

*Footnotes: Data is as of April 15, 2019.*

*Source: Bloomberg Finance LP, Verdence Capital Advisors.*

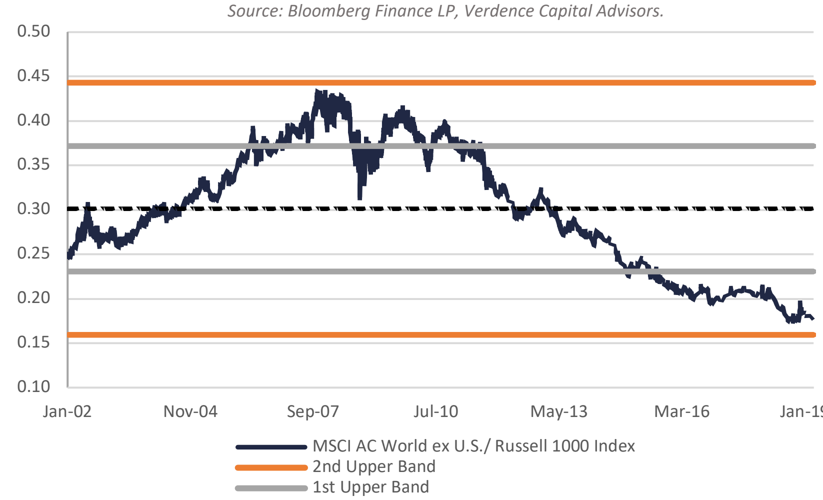
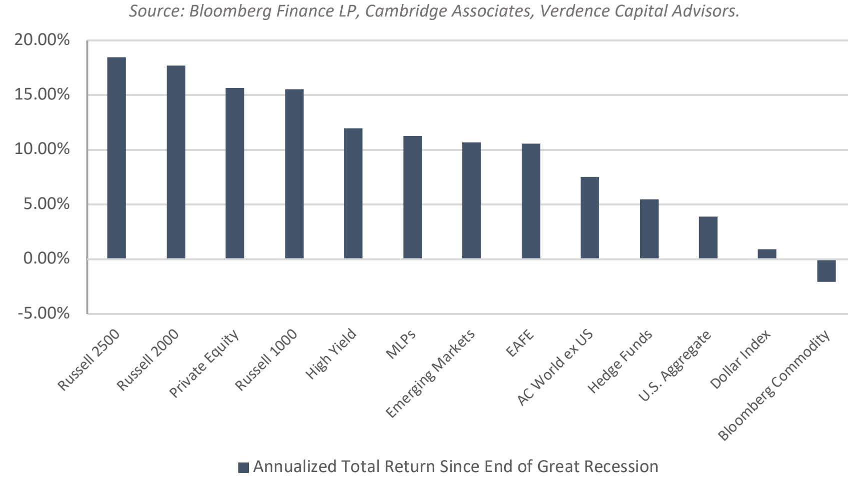



**Chart 12: Asset Class Performance Since End of Great Recession**

*Footnotes: Data is from March 9, 2009 to March 31, 2019. Private equity returns are lagged so data reflects 3/09 - 9/18 and is annualized.*

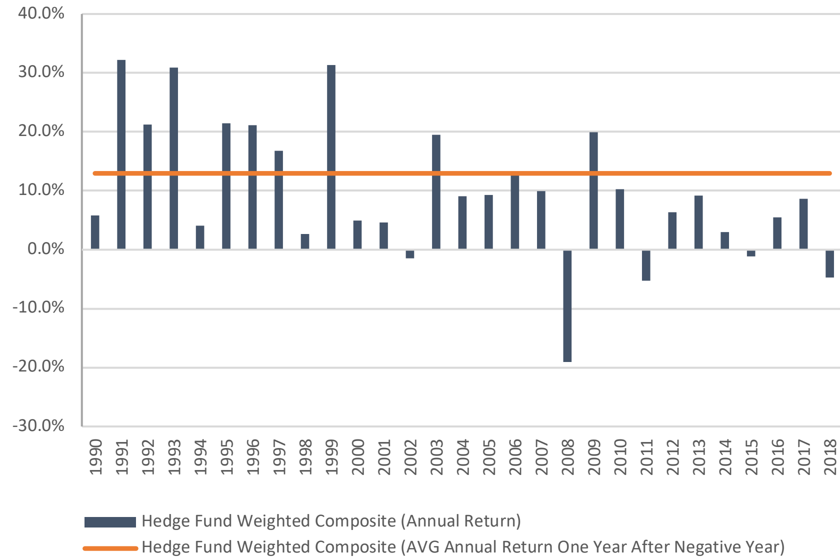
*Source: Bloomberg Finance LP, Cambridge Associates, Verdence Capital Advisors.*



We continue to favor a healthy allocation to alternatives to capitalize on the expectation of the continued economic expansion, a bottoming and recovery in global growth and optimism on further trade agreements (which should support commodities). In addition, hedge funds should benefit from strong fundamentals, the likelihood of volatility as we move into the 11th year of this expansion and fund inflows as investors look for bond alternatives for diversification. History also supports hedge funds as there has never been a time that hedge funds posted back-to-back negative annual returns. In fact, in the year after a negative annual return the Hedge Fund Weighted Composite has returned, on average ~13%. **(Chart 13).** We continue to look for attractive private equity opportunities for long term investors. With the recent rally in the public market, valuations are attractive for private equity and coverage ratios are strong, especially given the expectation of an extended period of low interest rates.

**Chart 13: Hedge Funds Have Never Had Back to Back Annual Declines**

*Footnotes: Data as of December 2018. Time period is 1990-2018.*
*Source: Bloomberg Finance LP, Verdence Capital Advisors.*




## The Bottom Line:

We remain confident that despite the underlying fundamentals for the economy slowing in recent months, they remain intact and warrant an extension of the current record expansion. However, the impressive rebound we have seen year-to-date in the face of weaker global economic data reminds us that complacency still exists, volatility should remain heightened and periods of consolidation are likely. As always, we will not chase momentum driven investments as we have seen the damage it can create for client returns when investor sentiment shifts (e.g. FAANG stocks in 2018). Instead we will focus on a client's long-term objective and balance underlying fundamentals with valuations. We will be patient and assess all market conditions, including the underlying economic environment before making changes. We will continue to favor active management, especially as the cycle matures and bottom up analysis is crucial. In addition, we will use hedging instruments to mitigate losses as volatility is likely to remain elevated.

If you have any questions or feedback, please feel free to reach out to your financial advisor.

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