

Weekly Capital Market Comments

Friday, December 14, 2018

We remain cautious regarding broader market valuations, despite the recent pullback in US equities. We are over 10 years into the longest bull market since the Great Depression and come July '19 the current economic expansion will be the longest since the end of WWII. While recent economic data remains robust, we believe the front-end of the economy has already begun to turn, which is leading a broader global slowdown.

Equity markets remain fragile, and volatility remains heightened, driven by continued geopolitical risk, international trade tensions, slowing forward earnings, uncertain inflation prospects and tightening financial conditions. The S&P has recently consolidated about 10%, with the NASDAQ down over 12%; only to modestly recover following perceived dovish comments from the Federal Reserve. Current forward P/Es of roughly 15.5x, are down about 2 turns since the recent equity market sell-off began. We do not believe equity volatility has ended.

At the same time, diversified bond indices remain challenged, down anywhere between 2.0-3.5% depending on duration and credit, with longer duration corporates/governments down 5-8% YTD. While the Fed has tempered its views on neutrality, we still expect 2-3 more hikes over the next 12 months. Fixed income markets have already consolidated and have begun to benefit from the equity market dislocation. While inflation trends may be moderating, duration risk may persist in the near-term. Credit spreads are pricing in risk (widening), suggesting credit should be fully underwritten commensurate with late-cycle fundamentals in mind. Debt, in some form (corporate credit/gov't deficits), will be the culprit of any further/future market weakness or economic anxiety. However, while a back-up in short-term rates is expected, we anticipate interest rates and inflation prospects to reverse through '19. This will ultimately pass along any significant credit disruption into the next cycle. Further, if rates were to back-up meaningfully, we suggest to investors bolt-on duration when/if the 10yr reaches 3.5%, locking in attractive, risk-adjusted total returns.

In this phase of the capital market cycle, we continue favor value over growth and look to protect principal against near-term rate volatility. This said, the US may still prove to be the beneficiary of both global equity and debt capital flows given our relative economic strength and solid monetary foundation. (Chris Pike, CFA 12/14/18).

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