

Q3 Market Commentary

The Kevlar Market

Q3 headlines were dominated by a variety of geopolitical firestorms including US-China trade tensions, currency crises in Turkey and Argentina, and European anxieties over a showdown between the EU and Italy. While nearly every other stock market in the world traded lower, U.S. markets marched higher...extending what was already one of the most protracted valuation and performance gaps in history.

Consumer confidence, historically low unemployment, and strong corporate earnings drove the S&P 500 to record highs, especially in the technology and consumer discretionary sectors. Much of this success also came from tax reform, fiscal stimulus and corporate share buy-backs (tax-cut-fueled stock repurchases that tend to make corporate profits appear better than they are).

In response to the healthy U.S. economy and higher inflation expectations, 10-year US treasury yields rose above 3.0% during the quarter. The Federal Reserve (Fed) raised its target for the federal funds rate as anticipated to a range of 2.00%-2.25% at the September FOMC meeting. With inflation edging slightly above their 2% target, the market seems to expect additional rate increases in December 2018 and 2019. ■

U.S. vs. Global Stock Market Performance in 2018



Note: US stock market strongly rebounded in Q3 even as global trade war fears and a strong USD pushed stocks lower around the world.

Five Things You Should Know about Q3

1. Trade Strains

Trade war rhetoric continues to put downward pressure on international stocks, bonds, and US sectors with export exposure.

2. Dollar Strength

Global asset classes dance to the tune of a strong US dollar (USD), which has risen +4.3% year to date, a stronger USD has put downward pressure on non-US equities and commodities.

3. Emerging markets worst performers

EM remains steeply discounted relative to US equities as markets price in a one-sided impact from US tariffs.

4. Commodities mixed

Commodities have been weighed down by a strong USD. Oil, although flat for most of the quarter, rebounded in September as prices hit a four-year high. Strong demand, tightening supply, and OPEC adherence to 2017 production quotas drove these higher prices. Countries dependent on oil imports, such as India, suffered as a result.

5. Global Growth drivers peaking

Q3 economic growth remained strong, with central-bank headwinds increasing. One-time US, tax stimulus will soon run its course.

Asset Class ETF Total Returns: Q3 2018

Tech Stocks (XLK)	8.8%
S&P 500 (SPY)	7.7%
Oil (USO)	3.1%
Investment Grade Bonds (VCLT)	1.6%
USD Index (UUP)	1.3%
International Stocks (VEU)	0.9%
European Stocks (VGK)	0.5%
Real Estate (VNQ)	0.5%
Aggregate Bond Index (AGG)	-0.1%
US Treasuries (IEF)	-0.7%
US Inflation-Linked Bonds (TIP)	-0.9%
Emerging Market Stocks (EEM)	-0.9%
Emerging Market Bonds (EMB)	-1.7%
Gold (GLD)	-5.0%
Agricultural Commodities (DBA)	-6.2%



Buckling Up for the Late-Cycle

US stock market performance in the last quarter was a picture of optimism bordering on euphoria. The Petri dish incubating the market's recent enthusiasm included strong Q3 earnings growth, multi-decade highs in consumer confidence, unemployment at 50-year lows, and record US stock ownership. Citing continued and prospective U.S. economic strength, the Fed continued its steady (albeit measured) rate hiking pace. Most market pundits assume that risks of US recession lie many years away, with most remaining exceedingly bullish for the foreseeable future. But if everything is so seemingly perfect, why did stocks suddenly gap down last week? Our answer: This is classic late-cycle market action.

Understanding the Late-Cycle

As Mark Twain said, "History doesn't repeat itself, but it often rhymes", so it is with the business cycle and its corresponding impact on various markets' risk and return.

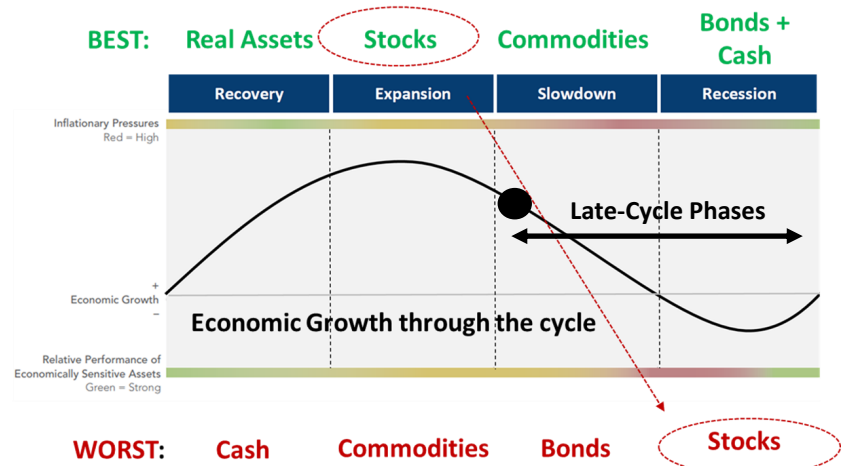
We believe we are in the "slowdown" phase following a very long "expansion" phase—the longest expansion since the 60's. Classic hallmarks of slowdown phases include: rising volatility (✓), declining bond prices (✓), a strong economy with peak margins (✓), and high investor confidence levels (✓).

Post WW II US Stock Market Peaks & Subsequent Returns

Start (Peak)	Duration (Months)	S&P 500 return
May 29, 1946	36	-30%
August 2, 1956	15	-22%
December 12, 1961	6	-28%
February 9, 1966	8	-22%
November 29, 1968	18	-36%
January 11, 1973	21	-48%
November 28, 1980	20	-27%
August 25, 1987	3	-34%
July 16, 1990	3	-20%
March 27, 2000	31	-49%
October 9, 2007	17	-57%

Source: Seeking Alpha

The Business Cycle & Asset Performance Rotation



The economy tends to be its strongest towards the end of an expansion. Then, with little slack in the economy (e.g. low unemployment), continued economic strength threatens inflation (i.e. economic overheating). The Fed rule book for dealing with inflation is to gradually slow the economy by "tightening liquidity" (e.g. raising interest rates).

Eventually markets over-extrapolate the prosperity of late-expansion too fast and too far into the future. These expectations in turn over-inflate stock prices. By the time the Fed finally manages to slow things down, markets are typically caught overly optimistic, causing stock prices to adjust and fall in response. As a negative wealth effect ensues - slowing economic activity even more— this eventually triggers a recession.

Now, the specifics of what will eventually cause the current cycle to rotate into recession will undoubtedly be different from past cycles. Despite knowing a recession will eventually come, most market participants will ultimately be surprised when the stock market—not economists or pundits—predict its arrival by falling in advance. History shows that the stock market re-prices for an earnings deterioration well before conditions actually deteriorate (often 12-18 months before).

Because most investors are heavily overweight U.S. stocks, our recommendation is to prepare now while the US economy remains quite strong. The tailwinds behind this current strength are steadily fading or reversing. The most notable driver of the current earning bonanza were the tax cuts paired with deficit spending. Those benefits are now peak-



ing and will disappear by the end of 2019.

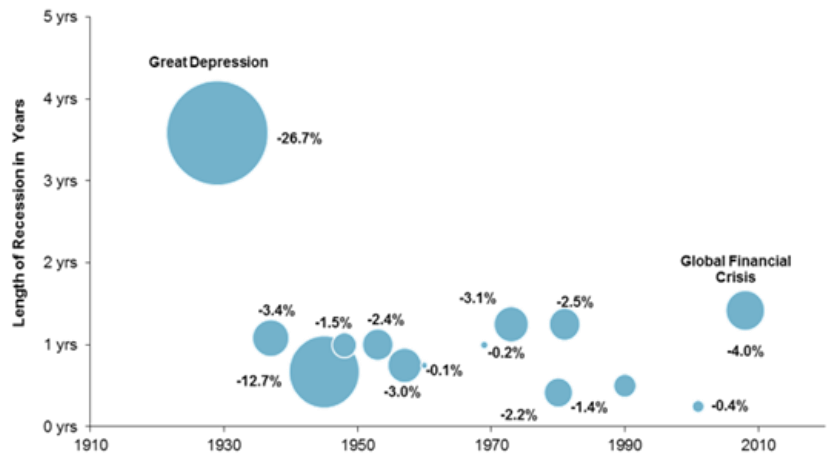
As the one-time tax stimulus disappears, the U.S. Treasury will continue issuing record amounts of debt (roughly \$400B in 2019) to fund it. Concurrently the Fed's rule book (i.e. full employment and stable inflation) compels it to continue to raise interest rates and tighten liquidity.

In total, 2019 will require nearly \$1 Trillion from new Treasury investors (since the Fed ended its rolling bond purchases). That means Treasuries will soak up money that investors previously spent on other things--like stocks. This, in a nutshell, is how "tightening liquidity" hurts prices in the late-cycle...by reducing the number of dollars flowing into assets.

Meanwhile, various other market risks persist or have even become worse. Tariffs, once a threat, are now a reality. The Kavanaugh hearings have divided Washington and voters to an even greater degree (see below); plus, with the midterm elections pending, there is a very real chance we could see a change of control in Congress. History shows that markets don't like political and policy uncertainty. This will undoubtedly make combatting the next slow-down with policy even more difficult to coordinate.

We've highlighted these pessimistic factors because the general market seems to be ignoring them. That doesn't mean that all is doom and gloom in the "late cycle". While

Length and Severity of Recessions since World War II



these later stages of the business cycle provide plenty of drama, they serve up the very best investment opportunities. The key is to be prepared in advance, both from a portfolio and (more importantly) from an emotional perspective. ■

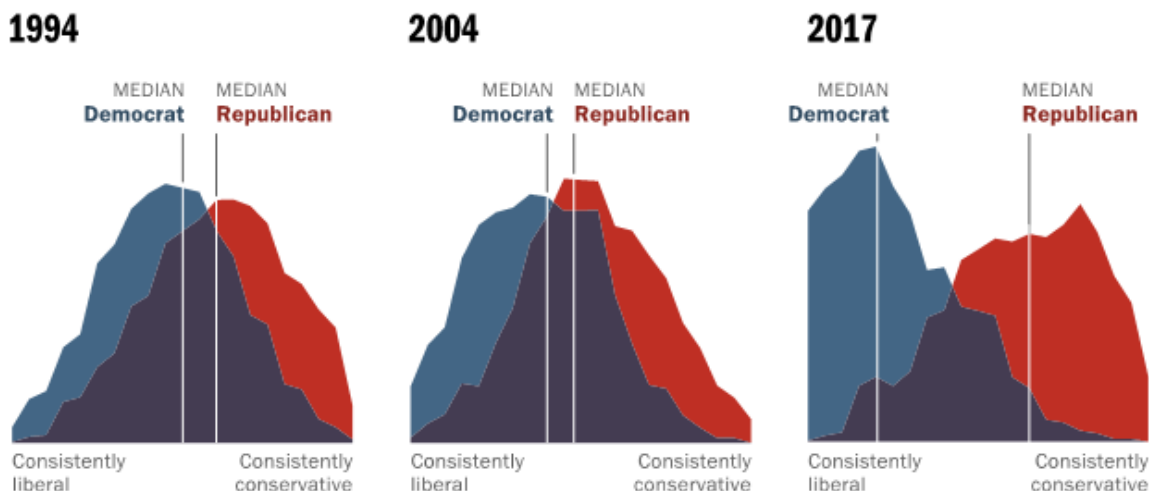
Current Tactical Positioning

Our seasonal adjustments are as follows:

- 1) Underweight stocks and credit
- 2) Overweight US defensive sectors
- 3) Underweight bonds
- 4) Underweight overall model risk

Democrats and Republicans more ideologically divided than in the past

Distribution of Democrats and Republicans on a 10-item scale of political values



Source: Pew Research Center, Epsilon Theory



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