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BCA 3Q 2018 Review and Outlook

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Summary Outlook

- Everyone is waiting for the inevitable downturn in the U.S. economy – but it's still further away than most expect. The business cycle doesn't appear to be in the final innings.
- While the economy can take additional interest rate hikes in 2019, bond prices will likely come under even more pressure as investors are overly optimistic about inflation.
- Two things have accounted for U.S. stocks outperforming international: a stronger dollar and the powerful rally in U.S. technology firms. Near-term these trends are intact, but we don't recommend abandoning international investments.
- Some areas of lending and private equity are getting too crowded; we are striving to avoid those.

Q3 Review

	Total Return	
Index	2018 YTD	Q3 2018
S&P 500	10.6%	7.7%
Russell 1000 Growth	17.1%	9.2%
Russell 1000 Value	3.9%	5.7%
Russell Midcap	7.5%	5.0%
Russell Small Cap	11.5%	3.6%
MSCI EAFE (International)	-1.0%	1.4%
MSCI Europe	-1.9%	0.8%
MSCI Emerging Markets	-7.4%	-0.9%
MSCI Japan	1.9%	3.8%
US Aggregate Bond	-1.6%	0.0%
Long Term Treasury Bonds	-5.9%	-3.0%
High Yield Bonds	2.6%	2.4%
Gold	-8.6%	-4.6%
Crude Oil	21.2%	-1.2%

Source: Factset Research

Note: Int'l market returns reported in U.S. Dollars, not local currency

The S&P 500 Index returned 7.7% in Q3, the best quarter since Q4 2013. The strong gains came at an unusual time in the presidential cycle and were likely due to the tax cuts. The Nasdaq Composite trailed the S&P 500 slightly in Q3 but is still leading by over 7.5% for the year.

Despite a pullback in technology shares at the end of the quarter, the Russell Growth Index outpaced Value again. "Deep Value" strategies had a particularly hard time. Most likely this represents investors throwing in the towel; the last time value investing was so questioned as a strategy was during the late 90's technology boom, after which value went on a half-decade run of outperformance.

As leadership in the stock market narrowed, large cap stocks outpaced small cap stocks by nearly 5%, a sharp reversal from earlier in the year. In U.S. dollar terms, the EAFE (our international benchmark) gained 1.4%, while Emerging Markets dropped a percent.

Gold was the worst asset class in the table. In commodities, oil was relatively strong, although there is a notable divergence between U.S. and international oil prices due to transport constraints. The equal-weighted commodity index, Reuters-CRB, dropped -4.3%.

Except for higher yielding and floating rate securities, fixed income performed poorly in Q3. Hurt by a stronger U.S. dollar, the Bloomberg Barclays Global Aggregate lost 0.7% in Q3. But even in local currencies, returns were poor, with the Euro-Aggregate, Asian-Pacific Aggregate, and Sterling Aggregate Bond indexes all losing ground.

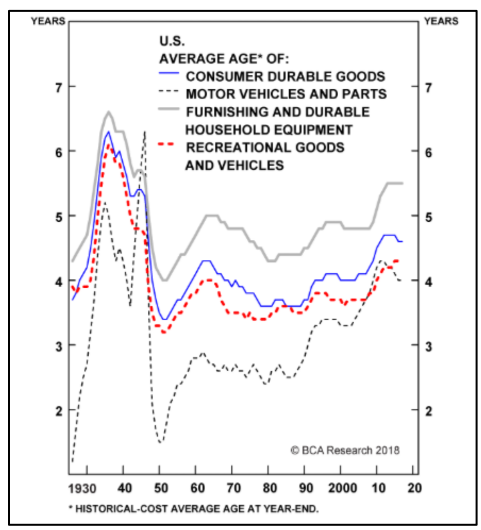
U.S. Economy

U.S. economic growth clearly picked up in the most recent quarter, with real GDP growth coming in at nearly 4% annualized. The large tax cut for consumers and businesses bolstered confidence and spurred a surge in both consumer spending and business investment. Additionally, growth was temporarily boosted by orders for exports surging ahead of potential tariffs on U.S. goods. Assuming growth moderates but remains positive, the economy will soon enter its 11th year of expansion. While many fear we are "due" for recession, presently we don't see the drivers for a downturn.

Source: BCA Research

Why do we think U.S. growth will moderate but remain intact? Several positive factors currently support demand growth: the remaining effects of fiscal stimulus, stronger credit growth as banks seek to lend, and a falling savings rate as consumers are more confident. Businesses plan to continue spending to support their growth (see chart at left).

While the current expansion has been long, it has not been strong, averaging less than 2.5% annual growth. That means unless imbalances have been built up in the system, or the Fed makes a policy mistake, the economy can proceed along – there is no calendar date for recession. Unlike a decade ago, mortgage lending has been conservative. The Urban Institute's Housing Credit Availability Index, which measures the percentage of housing loans that are likely to default over the next 90 days, remains near all-time lows. Banks continue to report very low loan delinquencies. Lastly, we still see sources of pent-up demand, and a consumer that can reduce savings levels built up during the crisis. For example (see chart at right), the average age of houses, cars and other consumer durables has reached multi-year highs.



Source: BCA Research

International Economies

Overseas economies have been less robust than the U.S., with developed countries performing much better than emerging markets. Some emerging market economies with large dollar denominated debts have come under pressure, especially Turkey, Argentina and Brazil. Overall, despite the current narrative, the global economy remains in generally good shape going into Q4.

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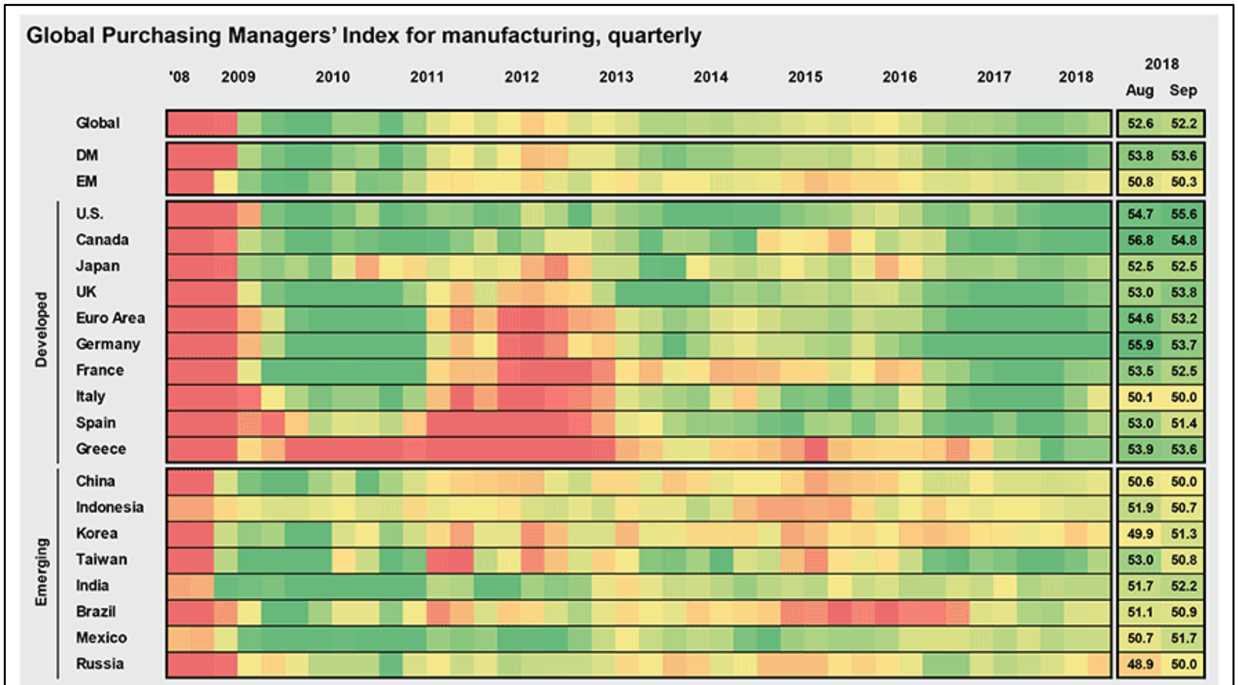
U.S. policy has effectively slowed the global economy, with rising U.S. interest rates, a higher dollar and growing trade skirmishes all adding to the pressure. Yet, international economies, like our own, can have setbacks within a rising trend. The biggest near-term threat to European growth is the Italian budget, which is currently in violation of the E.U. rules. The Italian government's decision here has created a political spat with the rest of the Eurozone. We think this issue is relatively minor and will be resolved in the coming months. PMI data (a measure of economic activity) for September show most major developed and emerging market economies are solidly expanding (see chart below).



Source: Markit, J.P. Morgan Asset Management.

The single largest issue in the global economy is the Trump administration's aggressive use of tariff threats in its efforts to reorder global trade. The progress of these negotiations is mixed, and we don't know how it will turn out. On the positive side, the U.S. has reached an agreement to renegotiate NAFTA (now called USMCA) which actually changed very little and won't create significant disruption. The U.S. and European Union currently have a "time out" on trade threats while they negotiate. In contrast, there is no immediate resolution in sight with China. However, Trump and Xi have agreed to meet, but recent press reports on Chinese hacking of U.S. servers has created further controversy. We still think the most likely outcome is a negotiated settlement with China after the U.S. midterm elections.

The Fed, Inflation and Interest Rates

In the second week of October, stocks dropped sharply, finally reacting to rising bond yields and the Fed's signaling of a continued rate hike campaign. It's difficult to tell, however, if the selloff was a reaction to fear of rising inflationary pressure and the rate hikes necessary to suppress it, or if it was simply a periodic selloff after too much market complacency.

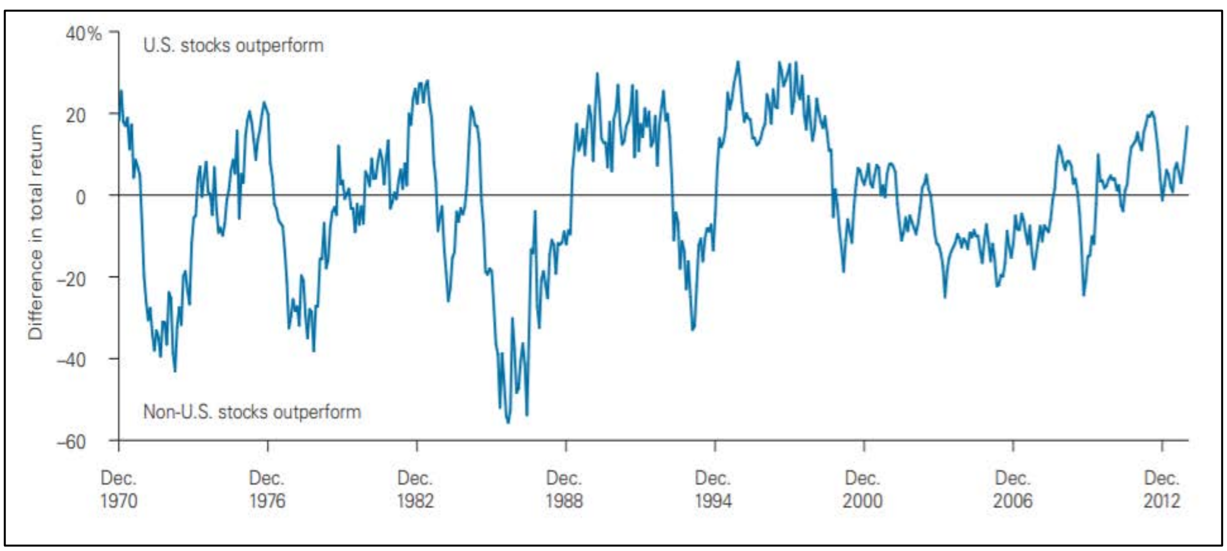
A look at the data and the Fed's (probable) motivation could help inform the answer. In August, the consumer price index was up 2.7% year-over-year while the core index, which excludes food and energy, rose 2.2%. This difference reflects a big surge in oil prices with the price of a barrel of West Texas Intermediate Crude rising from roughly $48 in August 2017 to $68 a year later. Energy prices are volatile, and excluding them from the trend makes sense. We believe inflation is not out of control, and wages have not turned sharply higher.

Turning to the Fed, Chairman Powell is telling us he is just trying to get to neutral, not to brake the economy significantly. The Fed wants to "normalize" policy because it fears easy money often fuels asset bubbles. It is also clear that labor markets continue to tighten and fiscal policy is (perhaps inappropriately) expansionary. The Fed wants to have ammunition to fight future crises by raising rates now. The Fed's September decision to raise the federal funds rate by a quarter point wasn't a surprise The Fed is most likely angling for a long-term equilibrium range of between 2.75% and 3.00% by the middle of 2019, then to wait and see. We think the economy is well-positioned to handle that.

Financial Market Outlook

In a rising rate environment and a growing economy, relative valuations still favor stocks over bonds. Within the bond market, this environment also should favor taking some credit risk in areas like high-yield rather than duration risk in very long-term, interest-rate-sensitive bonds. However, if interest rates do gradually rise in the year ahead, this positioning will have to be continually monitored as bonds approach more normal valuations.

The strength of the U.S. dollar has been a headwind for international investing. This is true both directly through the currency conversion, as well as the fear that countries will have trouble paying for oil (typically priced in dollars) and interest on their dollar debt. Although it doesn't feel like it, the U.S. market takes turns leading global stock performance. The chart below shows a trailing one year performance differentials between the U.S. and international stocks. In the long-run it's a coin flip.



Source: Vanguard

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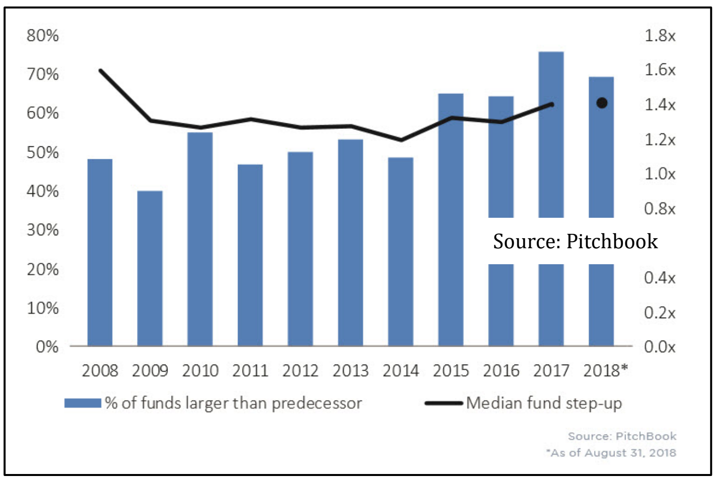
As stimulus fades, moderating U.S. growth and rising trade deficits from cheaper imports should eventually cause the dollar to fall, amplifying the return on international equities. Despite some hiccups this year, economic growth should generally recover in both developed and emerging economies over the next few years, boosting corporate earnings. Finally, broad valuation measures suggest that international stocks are simply cheaper, both relative to U.S. stocks and relative to their own long-term history. Consequently, while international stocks have been disappointing so far this year, we don't think investors should give up on the diversification and return potential they offer.

Lending and Private Equity

After the 2008 financial crisis, major banks pulled back their lending significantly, creating opportunities in lending, "regulatory relief" and private debt strategies. Berman Capital has and continues to take advantage of these opportunities. However, the artificially low interest rate environment has pushed investors to take more risk to capture higher yields and returns. This has worried us, and especially in areas such as "direct lending" (loans made directly from non-bank groups to companies, typically at high rates), because so much capital has come to the space. It is also well-known that private equity companies are making deals at relatively high valuations and with increasingly covenant-lite terms. It's worth noting that historically, cov-lite loans performed better than full covenant loans, since only better borrowers got them.



That said, there are signs that private equity fundraising, which fuels private debt demand, is slowing, as the chart at right shows. While deals are being done at high valuations, the environment remains strong for corporate cash flow, and debt service payment coverage is strong.

There is a lot of variability in the quality of investment managers in this space, and we favor sticking with well-established managers with strong credit research teams. That should go a long way towards avoiding a bad outcome in a market with pockets of overheating.

As always, at Berman Capital we appreciate the opportunity to act as your advisor and to invest on your behalf. If you have any questions, please don't hesitate to contact us.

Important Disclosures: