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MONTHLY UPDATE AND COMMENTARY
SEPTEMBER 2018

Dear Investor,

As we approach the end of the year, there remains uncertainty and open questions even in the face of historic highs within the US equity markets. We sat down with our market strategy partners at Strategas and they provided some very insightful answers to some of those questions. We thought we would share them with you in our monthly update.

**What is your most out-of-consensus view?**
Our most out-of-consensus view remains the possibility that we are in the middle innings of the business cycle rather than late in the game. Our travels to visit clients suggest that very few investors seem willing to consider the potential supply side impacts of the tax cuts passed last December. The conventional wisdom has largely been summed by Chairman Bernanke in his comment that the U.S. faces a Wile E. Coyote moment after the short-term effects of the tax cut are over. This ignores, in our opinion, the potential that companies will use the extra cash for the purpose in which it was intended – namely capital spending. This in turn should lead to a virtuous circle of greater productivity, stronger corporate profits, a pick-up in wages, and still-restrained unit labor costs. If such a happy occurrence should come to pass, we may be more in the fifth inning than the seventh inning of business cycle with obvious implications for interest rates and sector selection.

**What would be the biggest surprise for investors in the final months of the year?**
While there are many potential surprises to choose from, the greatest surprise that has some chance of occurring would be that the Republicans retain control of both the House and Senate, the proverbial Red Wave. Nothing in the polling today suggests that this is likely. Still, it is worth considering to the extent to which it would embolden the Administration to double down on already-expansive fiscal policies. Tax cuts 2.0 would include making the last year's tax reform permanent and introduce other concepts like indexing capital gains to inflation that would boost the after-tax returns for equity investors. A close second would be a pause in Fed tightening. Right now, the market is betting that two hikes in the Fed Funds rate by the end of the year is virtual certainty.

**What is the outlook for corporate profits?**
The bottom-line is in good shape. S&P 500 earnings will be up +22% Y/Y to $160-$162 CY'18 from $132 last year. Said another way, companies will produce 5 quarters of profit in CY'18 at a CY'17 rate. At the prevailing 18x multiple that equates to 540 S&P points.

EPS growth rates will level off next year as the anniversary effect rolls the tax cut into its fifth quarter. Do not expect quarterly earnings growth in the 20% Y/Y range next year. But, do not be overly worried when it's half that rate. We are focused on EBIT (earnings before interest and taxes) growth rates through CY'19 as a substitute for the information traditionally achieved by observing the slope of EPS growth to account for accounting adjustment resulting from last year's corporate tax cut. EBIT is currently running +7.5% over CY'17. Healthy for the later stages of the business cycle. With the U.S. economy, by all appearances, on firm footing, companies are in good shape to evidence continued growth in earnings. With unemployment at secular low levels and wages growth moving toward 3%, companies will be acutely focused on productivity growth and return from incremental investment (capex) in order to maintain their currently high level of profitability. S&P operating margins should finish the year north of 11%. We believe the continued deployment of tax savings - the supply-side effects of fiscal stimulus - particularly into capex and consumer spending should allow S&P 500 EPS to grow faster than nominal GDP next year (CY'19) to $172-$174.

**Will value ever start to outperform? If so, when?**
It's difficult to remember a time when a group of investors was more despondent than value investors are today. As we've noted recently, the valuation gap between Value and Growth is continuing to widen. In what is a persistent theme for us, we believe many of the strong trends currently in place – passive over active and Growth over Value – are a derivative of the fact that interest rates have been kept artificially low by the world's central banks for the last decade. Currently, 35%

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of the companies in the Russell 2000 have not earned a profit in the past 12 months, a level that normally only occurs in the midst of a recession. Low interest rates have created an "everyone gets a trophy" cost of capital that has made it difficult for active investors to beat the indices and for value investors to outperform growth. Increased inflation and a concomitant increase in interest rates and credit spreads will likely change this dynamic. We know not the time or the hour, but we sense that we're getting closer.

**Can you have a bear market in the emerging markets without weakness at home?**
This has come up in nearly every client meeting we've had over recent weeks. Clearly, the backdrop is not preferred, but there are a number of historical examples of pronounced E.M. weakness without the S&P getting hit. 1994 stands out to us given the macro similarities (flattening curve / strong growth) – the S&P spent the year in a sideways range despite a roughly -35% bear market in E.M. from 3Q '94 through 1Q '95 (Mexico was defaulting on the debt and the Peso fell by more than -50% over just a few weeks). Europe was also down about -20% in 1994. The Asian crisis in '97 / '98 is another example, and although the S&P corrected, weakness was short lived and new highs followed. E.M. was also extremely volatile from 2010 to 2015 without much impact on U.S. stocks. At present we're watching domestic credit conditions for evidence of contagion risk (still stable for the most part).

**Why do you believe Goldilocks is dead?**
We could be approaching the "too hot" zone. 4.2% q/q A.R. real GDP with 7.6% nominal in 2Q, a new high in the U.S. PMI at 9+ years into the business cycle, a new high in consumer confidence (Conf Bd), a new high in small business optimism (NFIB), and an unemployment rate staying below 4% reinforce this view. Boston Fed President Rosengren (previous a Fed dove) has turned more hawkish. The same has been true for Fed Governor Lael Brainard. U.S. wages are rising, and once that starts it typically doesn't reverse (ie, there's momentum). Businesses can't find workers, and they seem serious this time (e.g., Fed Beige Book reports). Goldilocks (not too hot or cold) also meant you could hedge stocks with government bonds easily. That hedge worked 1998-2017 (stock price declines were accompanied by bond yield drops), but it was not terribly good before that. Importantly, the stock/bond hedge is not working well now (e.g., Treasury bonds have not protected well against E.M. volatility recently, and did not do a good job hedging the U.S equity volatility earlier in 2018).

Fed Chair Powell noted at Jackson Hole that: "in the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than in inflation … thus, risk-management suggests looking beyond inflation for signs of excesses." The Fed wants rates up, and wants the balance sheet down, and doesn't seem to care if some financial markets break along the way. At least as a first pass. Or put another way, what breaks likely has to get bigger and/or more domestic to get the Fed to pause. The Fed likely won't be unfriendly for the economy – it would be hard to get policy that tight overall, given the U.S. fiscal policy stimulus now. But the FOMC might need to get unfriendly for financial markets first (break something) before they back off.

**Can volatility stay this low?**
Financial markets are assessed on relative performance. This matters because markets now have become accustomed to low interest rates. U.S. equities do not look expensive, for instance, against a sub-3% 10-year Treasury. Low rates make everything work. With the U.S. in a strong patch, however, the economy can probably take higher interest rates for a while. The Fed is taking advantage of this opportunity to normalize, and foreign central banks are also slowly moving in that direction (eg, the ECB taper). It's the financial markets that look vulnerable.

The U.S. economy is unlikely to go from "great" to "terrible" quickly. Economies often are like supertankers, taking time to turn. But going from "improving briskly" to "slowing" is the notable change for risk assets. If there's any good news, recent revisions (up) to the U.S. consumer saving rate suggest there's room for the economy to absorb a moderate financial market hit. But relying on volatility to stay this low looks like a dangerous bet.

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**What will end this business cycle?**

We don't know for sure, but – given the flattening U.S. yield curve – the Fed (eventually) has to be a candidate. This would not be strange in historical context (monetary policy often winds up over-tightening). The FOMC was likely to hike again in Sept. anyway, and no recent data should change that view (E.M. contagion has been minimal to developed markets). It's not to say there are no U.S. weak spots (e.g., flattening U.S. vehicle sales in Aug, choppy housing data), but these are also not enough to change the plan.

We continue to believe the neutral nominal fed funds rate is not too far above 2%, ie, we should be there soon. All in, we see little reason for tight policy with inflation expectations still well anchored. Tight policy would start to be dangerous. We're staying tuned to the Fed's projected path in 2019/20. Right now their "dot" forecasts that far out look high.

**What Is Your Outlook For Trade?**

Our view coming into the year was that shock and awe fiscal policy will dwarf trade concerns and this has largely played out. The US has cut taxes by $200bn this year, increased federal spending by $100bn, and companies are on pace to repatriate $700bn. In sum, $1 trillion of fiscal policy far exceeds the roughly $37bn of new tariffs that will be implemented globally this year. However, over time, the impact of fiscal policy will be less and without some resolution the cost of tariffs (both direct and indirect costs) will increase. The good news is that trade is getting directionally better, but resolution with China will not be easy or come soon. In early July President Trump made a critical decision that the US could not have three trade spats taking place at the same time. The plan called for ending trade fights with existing allies to focus on the real fight – China. As such, the Trump Administration put a plan in place to get Mexico to the table for NAFTA talks immediately after the new President was elected. Those talks have resulted in a bilateral agreement between Mexico and the US and has added pressure for the US and Canada to come to a final agreement. Our expectation is that at some point the US and Canada will reach their final compromises to close the NAFTA deal out. This is positive for industrial companies as the uncertainty over NAFTA and its supply chains has weighed on the sector. At the same time, the US and EU are discussing a possible deal to reduce tariff and non-tariff barriers. We are not really bullish on a new agreement being reached as there are some complicated issues. But the most important takeaway for investors is that with the EU and US at the table, the likelihood of the US imposing tariffs on EU autos goes down. Imposition of auto tariffs on the EU would double the amount of tariffs imposed and lower global growth estimates. This leaves us with China. Trump is not looking for soybean purchases. He wants structural reforms which include the lowering of tariffs to be more in line with other developed countries and an end to the stealing of intellectual property. The equity market has given Trump a long leash because if he achieves these objectives, the policy changes will result in better trade policy and stronger growth. But China is resisting these types of measures as they see the proposed changes as a direct assault on their economic model. In our view China is waiting until after the midterm election to seriously negotiate as they believe Trump will be weakened by the election results. However, cracks are appearing in China which could lead to some negotiation. We are watching China's currency and emerging market stocks relative to US small caps as signposts for how the market is pricing in the possibility of a US-China trade deal.

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