Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
Bruce L. Swanson, PhD
OCTOBER 2018

September Re-Cap

Global equities finished the month modestly higher at +0.2%. Unexpectedly strong U.S. growth numbers (but without growing inflation pressures) allowed U.S. equities to hold their value despite a sharp pick-up in interest rates.

Overseas, more orthodox policy in Turkey; the trilateral agreement to replace NAFTA; investor hopes (including mine) that Europe would avoid a worst-case outcome on Brexit; and the Italian budget stabilized foreign markets. Crude oil rose nearly 5% to late 2014 highs in front of U.S. sanctions against Iran.

U.S. shares also gained 0.2%, with growth and, particularly, larger capitalizations outperforming. The top 200 growth index rose 0.85%, while small-cap-value stocks returned -2.5%. Energy and healthcare sectors led at 2.5%; material and financials (despite higher interest rates) fell 2%.

International Markets

International equities matched U.S. gains, with emerging market shares lagging foreign developed market peers by 1.5%. Slightly different style forces were at work, with large caps outperforming by more than 2%, even more in emerging markets. Value outperformed growth by 2%. Japan led developed markets with a 4% gain as Prime Minister Abe won reelection in a landslide. Italy cut its quarterly loss to 7% with a 2.5% gain on hopes that the coalition government's proposed budget deficit would be no worse than 2%.

"U.S. consumer confidence surged to dot-com era highs."

The U.K. gained 1% after European Union (EU) Chief Negotiator Barnier hinted that a Brexit deal could be concluded by the end of October. France gained 2% after the government promised to cut taxes to create jobs. In contrast, Germany fell 1% on weakening support for the ruling coalition government in front of Bavarian elections and a continued fall in Eurozone confidence, with consumer confidence hitting a one-year low. Emerging markets found some support when Turkey's central bank raised rates more than expected, from 18% to 24%, triggering a 17% gain. Brazil gained 5% as electoral polls showed increasing support for a conservative candidate. Oil price moves contributed to a 9% gain in Russia, but an 8% loss in India.

Economic News

Economic news was balanced, as a further widening in growth between the U.S. and the rest of the world was offset by easing non-China trade tensions. While the Organization for Economic Cooperation and Development's global growth forecasts were marginally downgraded to 3.7% in 2018 and 2019, U.S. consumer confidence surged to dot-com era highs. Institute for Supply Management (ISM) numbers surprised to the upside and consensus numbers for third quarter growth moved up to at least 3.0% - a downshift from Q2, but higher than many expected. The U.S. found agreement with South Korea and Japan, with the trilateral agreement with Canada and Mexico to replace NAFTA providing for trade stability. While demonstrating that the U.S. is willing to compromise on some key issues, China may be a special case, as tensions escalated with President Trump's 10% tariff on an additional $200 billion of Chinese imports kicking in on September 24th (with the rate scheduled to escalate to

25% at year-end absent a trade deal). As expected, China responded with additional tariffs on $60 billion of U.S. imports.

Central Banks and Credit Markets

Despite the lack of a reported inflation pick-up, central bank guidance was more hawkish than expected. No doubt a bit embarrassed to have been seen obsessing about a flattening yield curve given the outlier ISM numbers, the Federal Reserve Board (Fed) not only raised rates as expected in September but guided four additional rate hikes and a 3% target rate by year-end 2019, with at least one additional hike in 2020. Investors listened for a change and priced in two rate hikes for 2019. The European economic outlook was also warmer, as in addition to hopes for a satisfactory Brexit agreement (with accompanying rate hikes), European Central Bank (ECB) President Draghi forecast that inflation would rise to a higher than expected 1.7% for the next three years.

The combination of strong growth in the U.S., hawkish central bank guidance and hopes for more positive European political developments drove rates higher and government bond prices lower. Treasuries posted 1% losses as the curve shifted upwards and steepened, with 3-month rates up 8 basis points and yields for longer dated issues up 15-20 basis points. Similarly, British and German 10-year yields increased 10 basis points and 14 basis points, with the latter moving from 33 basis points to an intra-month peak of 55 basis points. Credit markets liked the combination of inflation-free growth: U.S. corporate bonds outperformed as credit spreads tightened 8 basis points; and high yield did even better with Eurozone issues gaining 0.3% and U.S. peers returning 0.6% as spreads tightened to a post-global financial crisis low. Emerging market debt took top honors as spreads tightened by 35 basis points and both local and dollar-denominated debt gained more than 2.5%. The higher interest rates pressured real estate markets, with US real estate investment trusts (REITs) falling more than 2%.

The dollar fell 1.6% against emerging market currencies and was mixed elsewhere, as safe havens weakened (Swiss franc -1.3% and Japanese yen -2.3%). The Canadian dollar gained 1% on the new trade deal. Commodities gained 2-4% depending on the index as crude oil rose 5% on Iran sanction-related-supply concerns and the reprieve from recent dollar strength; gold fell nearly 1% as risk appetite rebounded.

October Market Developments and Portfolio Positioning

The first two weeks in October have seen world equity markets decline more than 6%. As expected, Treasuries have proven to be no safe haven, with longer term bonds losing more than 2%. We had identified the worst valuation froth to reside in the smaller cap growthier names: the Russell 2000 has fallen double digits in the past six weeks (versus -5% for the broader market); Russell 2000 growth has fallen more than 12%. Cash/treasury bills have also proven to be the clear winner from a year-to-date return perspective, to say nothing of risk, versus global equities (-2%), U.S. bonds (-2%), non-U.S. bonds (-3%), high-yield bonds (-1%), municipal bonds (-1%) and REITs (-5%).

Our base case has been that:

- U.S. stocks were overvalued 30%, with bubble-like valuations in some smaller tech names;
- foreign stocks are much more attractive, but only fairly valued in an absolute sense;
- global growth (outside of China) would maintain above trend levels given still low levels of interest rates (net of inflation); and
- the Treasury yield curve would steepen as inflation drove through 2% and the Fed found itself behind the curve.

From a global equity perspective, my conclusion was that the valuation (and performance gap) between U.S. and foreign markets would close with positive returns abroad and modestly negative returns in the U.S. (as opposed to a massive spike up in foreign stocks).

While U.S. stocks have in fact fallen, to my surprise the “gap” has only increased, with foreign stocks trailing domestic peers by an additional 1% thus far in October. While disappointing news on the Italian budget did not help, the bigger issue may be that of global growth uncertainties, particularly with respect to the timing of the next U.S. recession and an eventual recovery in China. This is important, as (is often the case) the most attractively valued names are not always the safest.

The other area of interest to reconsider is my inflation outlook and the likely Fed policy response. The market has delivered the outcomes I expected in terms of interest rates, future expected Fed rate hikes and inflation hitting the Fed’s 2% target earlier than expected. The surprise has been that the acceleration in inflation has stalled out despite a remarkably strong labor market. I need to confirm and/or revise my outlook in this important area, particularly as it interacts with the outlook for economic growth.

We will not be standing still while re-examining the macro-outlook, as an active tactically driven investment approach must act when valuations change. We are likely to maintain domestic equities at or near the bottom of our allowed range, but replace some large cap exposure with some smaller cap names that have been unfairly penalized. In addition, we will modestly increase foreign exposure, and emerging markets within that, to a small overweight. At the same time, if the equity investor mindset has changed from “how high can it go” to “where is the bottom,” one must remember that parts of the U.S. equity market have no valuation support: the broad Russell 2000 index is trading at record high debt levels, record high revenue multiples and with a record high (36%) share of firms reporting losses. Consider the possibility that the process of "closing of the gap" (between domestic and foreign equities) may not be as benign has I have envisioned. Could the last few months be simply the beginning of a global equity downturn where the U.S. market falls last, but falls the most?

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Sentinel Trust

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com