

SIGNATURE **FD**

MARKETS SAG TO START 2018

SPRING 2018



OVERVIEW

We began [last quarter's newsletter](#) with a list of data points describing how unusually global markets behaved in 2017—relentless moves higher with virtually no volatility. We observed that entering 2017 investors had modest expectations, but by the end of the year the mood had shifted closer to exuberant. January saw an acceleration of this upside bias, but by February the trend had shifted. As markets are prone to do when most investors shift to a common viewpoint, the markets move opposite of what is expected. By the end of March, the eight-quarter streak of positive results for U.S. equity indexes was broken and volatility had increased materially.

When markets make a quick turn, we are often asked, “what caused the change?” It is human nature to assign cause to every situation, but sometimes this exercise adds a level of precision to markets that just doesn't exist. At their core, markets are an aggregation of a nearly infinite number of inputs and individual investor views. Over the short run they move on investor emotion. Of course, the normal litany of issues has been used to explain the recent correction: trade wars and tariffs, White House drama, geopolitical risk, equity valuations, rising interest rates, and concern over the pace of global growth. However, the same basic set of news stories existed in 2017 and—as we know—the investor experience last year was much different.

Throughout the rest of this newsletter we will provide our views on the fundamental backdrop, the areas of opportunity and risk we are monitoring, and how we have positioned client portfolios. But the overriding theme will be that the investor experience in 2018 is actually much more consistent with history, and the outlier was 2017.

During the first quarter of 2018, broad indexes in the U.S. suffered small losses. Smaller companies, as well as technology and consumer discretionary stocks, held up the best with telecom, consumer staples, and energy stocks lagging. Outside of the U.S., markets were mixed with emerging markets and Eurozone stocks performing among the best. Interest rates surged higher early in the quarter before easing back partially, but still closed the quarter higher by about 0.33% on the 10-year treasury. Before shifting to more specific details, the table below shows quarterly and recent 12-month performance of various broad benchmarks.

| | 1st Quarter | 52 Weeks |
|---|-------------|----------|
| S&P 500 | -0.76 | 13.99 |
| Dow Jones Industrial Average | -1.96 | 19.39 |
| MSCI EAFE (Developed International) | -1.53 | 14.80 |
| MSCI EM (Emerging Markets) | 1.42 | 24.93 |
| Bloomberg Commodity Index | -0.40 | 3.71 |
| Barclays Global Aggregate Bond Index (Global Bonds) | 1.36 | 6.97 |
| Barclays U.S. Aggregate Bond Index (Taxable Bonds) | -1.46 | 1.20 |
| Barclays Municipal 5 Yr Index (Tax-Free Bonds) | -0.57 | 0.65 |
| HFRI Fund of Funds Composite Index | 0.91 | 6.22 |

THE START OF SOMETHING MORE SERIOUS?

All bear markets start with a correction, but all corrections don't turn into bear markets. (Note: investors have traditionally set the threshold of a correction at 10% and a bear market at 20%.) Even during the current bull market that has seen the S&P 500 increase by 300%, there have been five declines of more than 10%. These were mostly clustered around the Euro crisis in 2011 and the oil price declines in 2015-16. However, both market declines stopped short of bear territory. How does one know when to prepare for something worse?

At SignatureFD, we manage money for clients that have multi-decade time horizons. Therefore, we do not believe it is productive to try and time the frequent twists and turns of the market. To capture these moves, investors need to be right twice—selling before much of the decline—and then getting back invested before the recovery. For taxable investors this would often come with the recognition of capital gains which would further erode the principal available to invest. Simply put, going through this exercise repeatedly could leave investors with less wealth than a simple buy-and-hold strategy. History tells us that corrections are just part of the investing experience, occurring roughly once per year on average. Bottom line: investors should be prepared for the normal process of corrections, and manage these risks with a diversified portfolio rather than trying to time such events.

Since World War II, the more damaging bear markets tend to happen every seven years and last for a more sustained period, often several quarters. Long-term investors can be rewarded in attempting to avoid some of the losses that occur during these more serious setbacks. What is unique to bear markets is that they almost always occur during periods of economic recession. Thus, it is critical to assess the economic backdrop as part of the exercise of managing portfolio risk around major declines. Simply put, it is the presence of both market volatility *and* economic contraction that signal the likelihood of major market losses.

Of course, determining in advance when economic recessions are likely to occur is not a simple task. Opportunities and risks are always present, and differentiating when these variables are likely to trigger a true economic downturn never happens the same way twice. Compounding this challenge, the market acts as a leading warning sign for economic contractions. This makes sense as equity

prices are the collective wisdom of all investors and provide information about the future, not just the present. Our approach is to combine analysis of the markets with the underlying fundamental backdrop to determine when the weight of the evidence leads to a conclusion that a true economic event is likely. Below we will touch on several current observations about the market but provide mitigating reasons that they may not be signaling that a more serious downturn is imminent. In preview, we remain constructive on markets though we recognize that risks are rising.

OBSERVATION: The current bull market is nine years old. In less than a year it will be the longest bull market on record. Does this mean we are due for a pause?

MITIGATING FACTOR: Markets and economies don't follow calendar cycles. The current bull market has gone on longer than normal and has seen equity prices rise substantially, but the economic performance has been more muted. Because the recovery has been so lackluster, it is possible that it has more time before the eventual downturn occurs.

OBSERVATION: The Trump administration has taken a dangerous turn by implementing tariffs on steel and aluminum and seems to be going after China. Won't this lead to a trade war?

MITIGATING FACTOR: Global trade is a key component of expanding global wealth. Since World War II this has been a powerful force, creating huge amounts of wealth and lifting billions of people out of poverty. We are a long way from seeing a reversal of these multi-decade trends. The changes in trade policy thus far are limited in scope and we believe part of a negotiating process. China would be hurt worse than most by a full-blown trade war and we suspect that the White House is pushing for negotiations to appease the political base.

OBSERVATION: Elections can trigger uncertainty around economic policy and history shows that market returns during a mid-term election year are often the worst of the four-year cycle.

MITIGATING FACTOR: Again, while no two years are the same, volatility in mid-term election years has tended to rise. On average, the market has seen 18% declines in midterm election years; but when taking out periods of recession, losses have been between 7% and 20%. The pattern has shown weakness through the summer, with a strong rally in the fourth quarter. Moreover, since World War II, there has not been a loss in the S&P 500 in the 12 months following the midterm election.

OBSERVATION: Stocks are trading at very high levels, especially in the U.S. Based on metrics including multiples of earnings, the CAPE ratio, book value, and sales, these valuation metrics are higher than past averages.

MITIGATING FACTOR: This is true. By many measures, the U.S. equity markets have valuations in the top 20% of their historic norms. In some cases (e.g.: price to sales and price to median earnings) these are at or approaching highs only seen in 1929 or 2000. However, valuations in and of themselves are not useful in predicting near-term market performance. Specifically, over a one- or two-year period, valuations have almost no predictive power in explaining market performance. However, over periods of 10 years or more, valuations can explain much of the return. Elevated valuations are a long-term risk, but in the short run our portfolio decisions are likely to be driven more by economic fundamentals.

OBSERVATION: Interest rates are rising and there is a lot of discussion about the threat of inflation. Won't the market struggle if these trends continue?

MITIGATING FACTOR: The relationship between interest rates and the equity market is complex. Over the past fifteen years, stocks have tended to do well when rates are rising. However, in the 1970's and 80's, stocks reacted very negatively to spikes in rates and inflation surprises. Rates rose quickly and early this year, and fears of wage inflation set off the initial market decline. However, rates are lifting off historically low levels, and a process of normalization in rates and inflation can be good if it happens at a measured pace. If growth is strong and productivity improves, then rates and inflation can trend up to their historical averages without creating major stress on equity markets. This is currently our base case.

OBSERVATION: The so-called FANG (Facebook, Amazon, Netflix, Google) stocks have driven the market in recent years. With these stocks coming under increased scrutiny and the stocks declining, does that signal an end to the bull market?

MITIGATING FACTOR: The FANG stocks have outpaced the broader markets in recent years rising between 90% and 375% compared to the 33% rise in the S&P 500. These stocks have all fallen more than the S&P 500 over the past month. This doesn't mean the market must decline. Healthy markets show a tendency for sectors to rotate in and out of style. As it specifically relates to technology, even with the highly visible companies now lagging, the broader growth and tech sectors have held up okay. This shows an underlying resiliency that other companies are making up for the weakness in FANG.

OBSERVATION: Since the market peaked in late January, volatility has surged higher. Doesn't this rising volatility mean that stocks are likely to go down?

MITIGATING FACTOR: As we discussed earlier in this newsletter, the extremely low levels of volatility experienced in 2017 is the historic outlier. Yes, volatility has staged a comeback, but as of the end of the quarter, the VIX (market's so-called fear gauge) has averaged 20 since late January. This is right on the historic average. Moreover, in the late stages of an economic and market cycle, it is not unusual to see volatility gradually rise, even before the eventual market peak.



THE MARKET IS CURRENTLY FORECASTING ONLY TWO RATE INCREASES FROM NOW THROUGH YEAR-END 2019.

In summary, we believe that sustained and significant bear markets are almost always associated with a recession. At present, the fundamental data can't support this as our base case. Individual investors with long time horizons are thus, over time, rewarded for staying in the equity markets unless they can adequately anticipate a true economic downturn. But with risks rising, we will remain vigilant in watching all incoming data and will adjust our portfolios if we see evidence that fundamentals start deteriorating.

OUTLOOK AND PORTFOLIO POSITIONING

Our portfolios have been rewarded for our generally positive outlook over the past few years. The economic data remains solid with unemployment in all major global regions trending toward multi-decade low levels. Manufacturing indexes remain near their cyclical highs in the U.S., Europe, and Japan, in what is the strongest period of synchronized growth since the late 1990's. The positive environment is feeding into earnings, which are being reflected in upgraded revisions at the fastest pace in 30 years. All of this is even before the follow-through from tax cuts and fiscal stimulus that is likely being under appreciated by markets. Inflation and interest rates are trending higher, but thus far, financial conditions have stayed supportive of growth and the Federal Reserve would likely back off rate increases at the first hint of slowdown.

But this may be as good as it gets. Recent manufacturing data in the U.S. dipped slightly, though historically that turn has happened up to three years before outright recession. Economies outside the U.S. have also shown some slippage in recent reports and data out of China shows moderating growth after peaks in early 2017. Therefore, we would characterize economies as being near a cyclical peak with risks rising. This environment could exist for some time, and we don't see it as a time to rapidly shift course to a more defensive posture. That said, we do not expect to get more aggressive in portfolio allocations in the current environment. In fact, our investment team has been spending most of our time refreshing our list of ideas for a negative market environment. With valuations high and the longer-term risk/reward for buy-and-hold strategies potentially less appealing than recent years, we appreciate that preserving capital whenever the recessionary bear market arrives will be critical for many investors.

At present, our portfolios remain underweight to core fixed income with a bias toward higher yielding, shorter-term holdings. On the equity side we are overweight in cyclical themes, especially energy, industrials, and financials. These themes position portfolios well for a modest rise in inflation, ongoing economic expansion, and continued increases in energy prices. Globally, portfolio construction remains largely in line with the broad global benchmarks, and we continue to hold exposure to all the major regions including Europe, Japan, and emerging markets. As always, portfolios are managed for unique client needs around tax constraints, cash flows, and risk tolerance. We are always happy to answer questions about your specific portfolio construction. Thank you for your ongoing confidence in our team at SignatureFD.

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