NEAM VANTAGE POINT

Outlook

FOURTH QUARTER 2018

EQUITY REVIEW

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Notable Occurrences: Equity Market Top Ten

Piecing together data from 2018 creates an interesting mosaic. What can the details of the past year tell us about where we may be headed?

4Q 2018 REVIEW

Turmoil characterized the equity market in the final quarter of 2018 with the S&P 500 index price falling almost 14%. Shortly after being heralded as the longest bull market ever, with Apple and Amazon eclipsing $1 trillion market capitalizations, the U.S. market fell swiftly over the next three months. More hawkish Federal Reserve policy and tighter financial conditions propelled the market lower with liquidity slowly exiting the global financial system. Likewise, the trade war remained front and center given its determinant role for corporate earnings growth. Fears of recession ensued, and volatility reached a frenetic crescendo with December's 9% price slide ranking second only to the early 1930s.[1] The back-end loaded nature of the weakness felt even more unnerving with the S&P stopping just shy of a bear market, defined as a 20% peak-to-trough decline, by Christmas Eve.

For many pundits, the fundamental backdrop ostensibly argued for higher stock prices in 2018 versus the surprise outcome. The economy paced greater than 3% growth, and corporate profits approached their highest levels in eight years. Additionally, the Federal Reserve seemed in control of monetary policy and interest rates as its new Chairman, Jerome Powell, took the reins. However, Chairman Powell effectively spooked the market with his more hawkish October commentary stating that the Federal Funds rate stood a "long way from neutral." This change in tone challenged the favorable underpinning to equity valuations from a more gradualist Federal Reserve. Powell's subsequent comments suggesting that the Federal Reserve balance sheet reduction would be on "autopilot" further soured equity sentiment. Investors feared the Fed was too detached from the eventual feedback loop between market volatility and the real economy and that this inflexibility would lead to a policy mistake. The script for the final quarter of 2018 deviated from consensus views in large part due to this more restrictive policy narrative.

Trade tension also influenced the wild end to 2018 as the stalemate between the U.S. and China continued to mire the global outlook. Tensions grew between the superpowers upon the arrest of the chief financial officer of Huawei, the Chinese maker of telecommunications and smartphones which had been labeled a national security

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threat. Economic momentum in China slowed further, evidenced by weakening industrial production and retail sales figures. Negative announcements from Micron and Federal Express, prompted by tariffs and trade uncertainty, exposed that the U.S. economy is not entirely immune. Trade policy remained a storm cloud on the horizon as the quarter came to a close.

2018 REVIEW

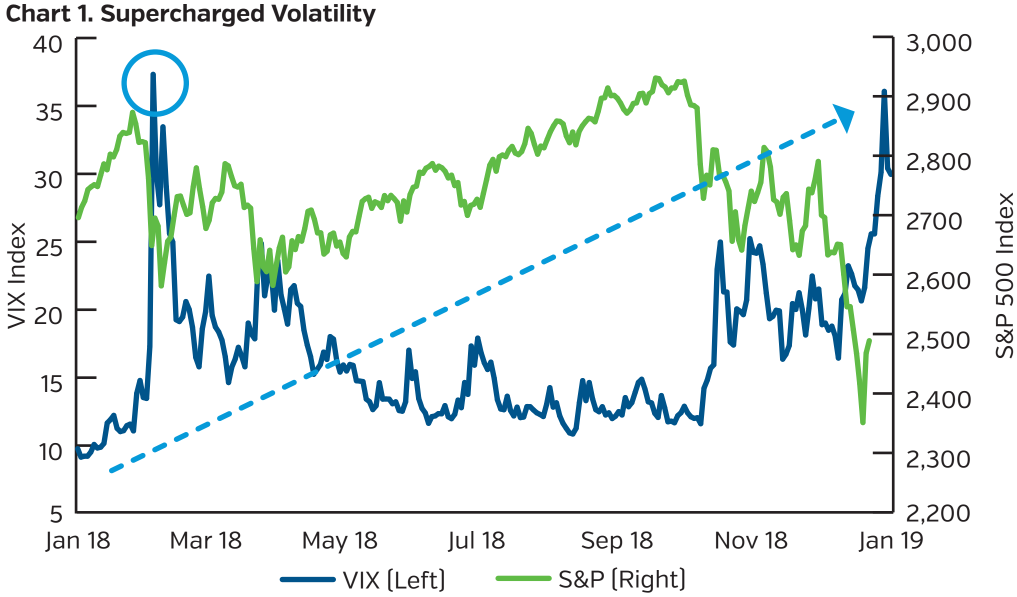
Reflecting upon the entire year, euphoria characterized the start of 2018 with sentiment surging behind a marked acceleration in upward earnings revisions and prospects for synchronized global growth. Shortly after, inflation fears rose as wage inflation looked poised to rise. Correspondingly, higher bond yields reversed the new market highs. The spring months ushered in dollar and oil price gains against a flattening yield curve backdrop. Meanwhile trade sanctions brewed further uncertainty, not yet readily evident in earning trends which continued to beat expectations supported by tax cuts and confident consumers. Emerging market dislocation injected volatility in Q3 as trade tensions intensified and the dollar rose further. As previously described, the final quarter capped off a fairly tumultuous ride.

Besides eventful, the year proved to be unprofitable for many investors as stocks in general posted the worst global annual equity returns in almost a decade. After elation early in the year, volatility wiped out decent year-to-date gains at the end of the Q3, as the S&P limped to a 4% loss for the year. If judged only by this single digit decline, history could conclude that 2018 was a disappointing, yet unremarkable, year. However, volatility compounded itself, providing the largest annual rise in volatility since 2008 as tracked by the Chicago Board Options Exchange S&P 500 Volatility Index ("VIX"). In this regard, the year was more remarkable than it looked.

With a nod to David Letterman, and in an effort to have some fun, this issue will review ten of the most notable happenings in 2018 from our eyes. In no particular order, we present NEAM's top ten occurrences for 2018:

1. Largest one day spike in 28-year history of the VIX: The market recorded the largest one day spike in volatility as measured by the VIX in February (Chart 1). On this day, the VIX crested over 37 - just shy of a four-fold increase relative to the cycle lows reached in early November 2017. In totality, the volatility index ***more than doubled*** for the year.

Chart 1. Supercharged Volatility

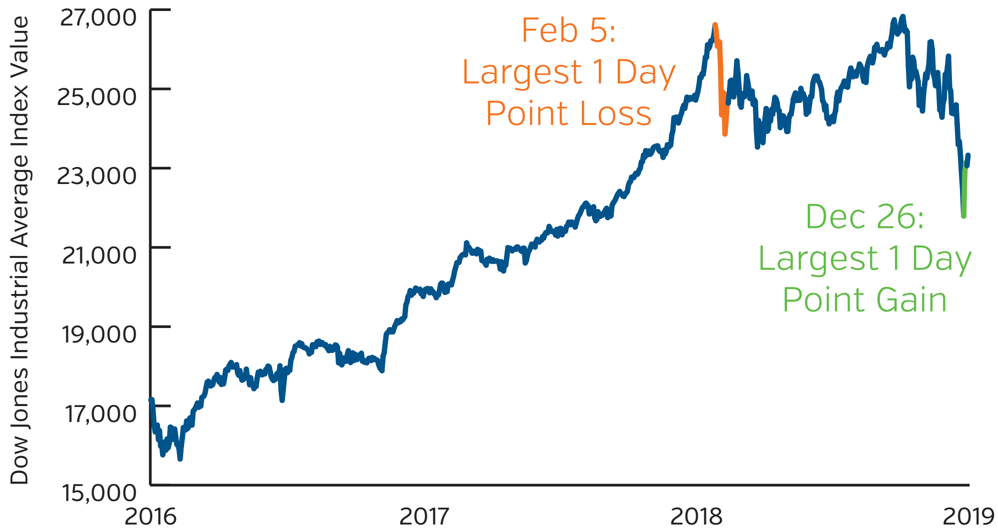


Source: Bloomberg, NEAM

2. First 1,000+ point gain for the Dow Jones Industrial Average: In December, the Dow notched its first ever ***daily*** gain of this magnitude. Given the higher base, the swing amounts to a smaller scale in percentage terms (ranks near bottom of top ten largest one day % gains on closing price basis). While it may not hold as much significance as in the past on this basis, the achievement is momentous for its speed. For context, the Dow jumped 1,000 points for the first time on a ***monthly*** basis almost two decades ago in April 1999.[2] This further evidences the compounding effect of volatility, to the upside and the downside.

3. Largest daily point drop on record for the Dow Jones Industrial Average: Reached in February, the Dow plunged as much as 1,500 points before closing off its intraday lows to record the largest daily point loss. Comparatively, this surpasses the sharp point movements in 2008 but ranks behind that turbulent period in percentage terms. Of note, the biggest daily point gain ***and*** biggest daily point loss occurred in the same year (Chart 2), an infrequent distinction last earned in 2008.

Chart 2. Largest Point Gain/Loss in Same Year



Source: Bloomberg, NEAM

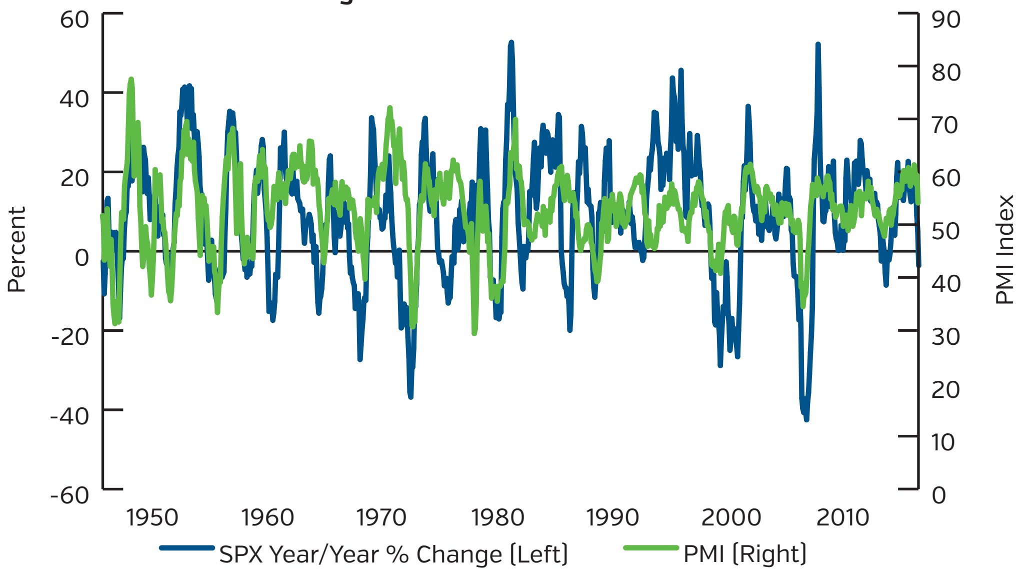
4. First $1 trillion market capitalization U.S. Company: Apple reached $1 trillion market capitalization in October, marking the first time a publicly traded American corporation achieved this milestone. To dimension the enormity of this feat, this magnitude approaches 5% of America's Gross Domestic Product and dwarfs the estimated budget deficit for the U.S. as of fiscal year-end (September 2018).[3,4] This invites debate of whether an extreme was reached and augured a broader market top, or if the large installed base supported Apple's stock price irrespective of the market cycle. While the jury is still out, the recent price action favors the former as this threshold subsequently proved to be a high water mark.

5. Largest fund outflows on record: According to data compiled by Bank of America Merrill Lynch, record global equity outflows, totaling approximately $84 billion, occurred over the last six weeks of the year, paralleling the extremes seen on a comparable basis in 2008.[5] Flows, often used as a measure of sentiment, mirrored the sharp upturn in fear inherent in the rising volatility index.

6. Second longest economic expansion faces skepticism: As the year ended, the current business expansion clocked itself at 114 months approximately six months shy of achieving first place historically. All good things must come to an end, however, and concerns had already surfaced around potential peak earnings. Given its anticipatory nature, the stock market began to discount this deceleration, best illustrated by the relationship between the

Philadelphia Manufacturing Index (PMI) and the year-over-year change in the S&P 500 (Chart 3). When reported in early January, the December PMI displayed the largest decline since 2008 confirming the market's suspicion of a slowdown.

Chart 3. S&P 500 Price Change vs. PMI

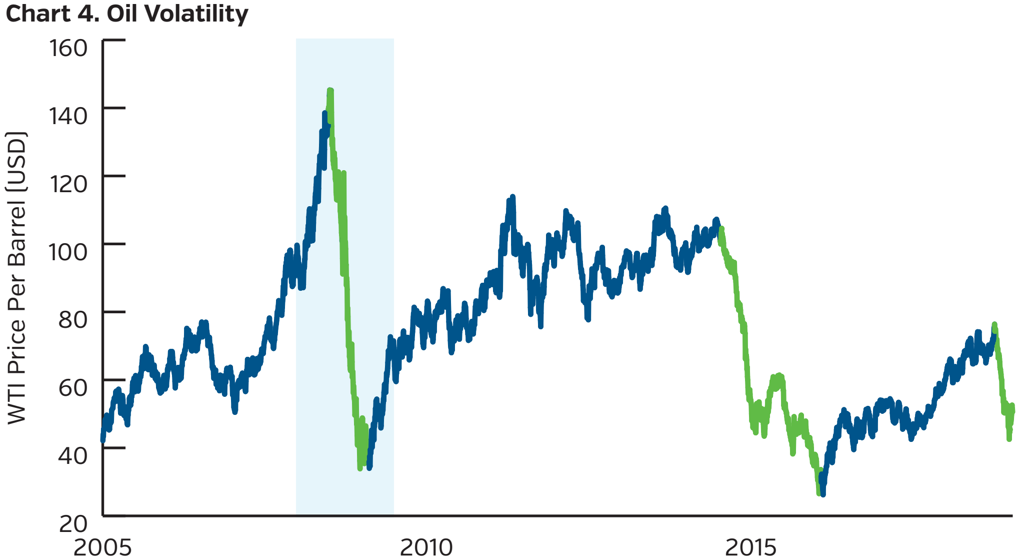


Source: Bloomberg, NEAM

7. High yield investors blinked: In the height of the dislocation around Christmas, the ICE Bank of America U.S. Cash Pay High Yield index briefly generated ~8% effective yield, a level previously seen in early 2016 when the last global growth scare occurred. Spreads widened over 200 bps from recent tights at this same disruptive point. As a leading indicator for equities due to the more levered nature of this cohort, this heretofore resilient asset class embodied the lower risk tolerance evident in falling equity prices.

8. Fastest velocity for oil price reset in the last decade: In 2018, the commodity complex suffered losses. For oil, the speed of its contraction was especially acute as West Texas Intermediate (WTI) dropped by almost half in ***just two months***. This compares to the pattern seen in 2014 and 2008 when the monthly compression averaged closer to 10% and 16% respectively (Chart 4). The swiftness of this descent could not help but destabilize broader market sentiment and penalize energy related equities.

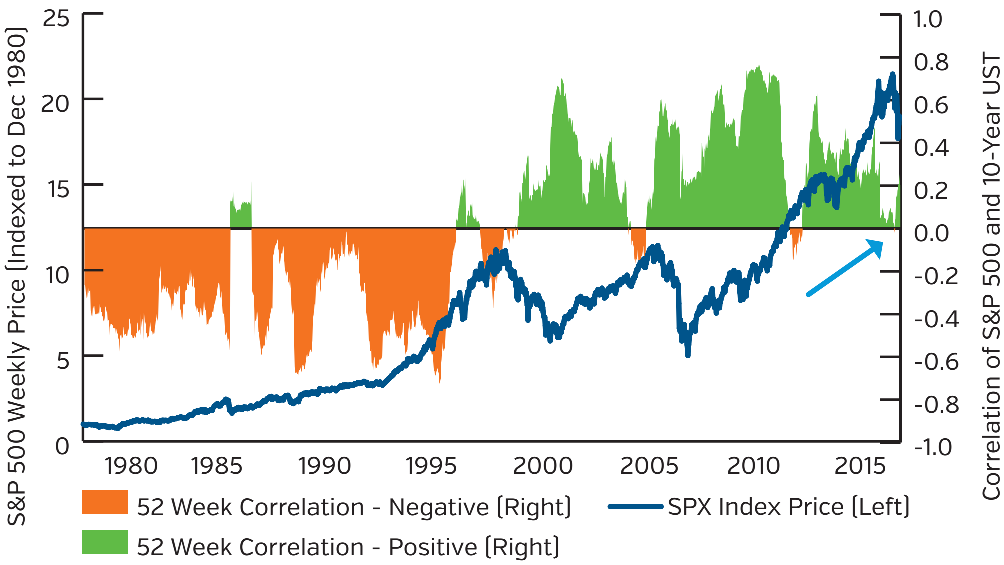
Chart 4. Oil Volatility



Source: Bloomberg, NEAM

9. First near-reversal in positive correlation between stocks and bonds since 2014: Conventional wisdom posits that stocks and bond prices are negatively correlated – as risk rises, there is a flight to quality into bonds sending prices up/yields down while equity investors become risk adverse and prices fall. Over the long run, however, inflation, real interest rates, unemployment and growth can lead to similar effects on stock and bond returns, inducing a positive correlation, as shown in Chart 5. Having dominated for close to two decades, this positive relationship flirted with reversal in late 2018 as volatility reset for both asset classes (almost imperceptible to the eye in Chart 5 – highlighted by arrow). Inflection points historically portend weak prospective returns as the previous reversals preceded equity market corrections.[6]

Chart 5. Stock Bond Correlation



Source: Bloomberg, NEAM

10. China's economic rebalancing = slower growth: The trade skirmish is undoubtedly straining the Chinese economy and negatively impacting global equities. Internal reform efforts and China's weak domestic property market further hinder China's economic growth. Vacancy rates are estimated to be as high as 20% for the 65 million apartments in Chinese cities according to Gan Li, a professor at Southwestern University of Finance and Economics in Chengdu. This is problematic since housing and related industries account for one fifth to one third of China's economic growth.[7] Likewise, property accounts for the largest source of wealth for households so positive residual value remains critical to any consumption-led economic vision. With one in five empty dwellings, the trajectory may be lengthy.

CONCLUSION

Our "Top Ten" paints a mosaic that the regime may indeed be changing. The hallmarks of a late cycle backdrop - unemployment near a record low, consumer confidence extremely high, rising core inflation, widening credit spreads, and the yield curve nearing inversion – abound. Fundamentals have likely peaked and are characteristically weakening. While decelerating growth can still be supportive of equities, these market inflection points often breed volatility. The nature of the surprises discussed gives testament to this variability.

Market valuation and sentiment increasingly discount some level of fundamental slowdown, yet the probability of a recession is higher now than it was a few years ago. Business cycle uncertainty compounds the difficulty for investors in the short run given the variance of the resulting corporate earnings stream. Additionally, as policy emphasis shifts away from monetary, the tighter liquidity likely ushers in lower prospective returns. While the lower index price level favors better return potential than what was witnessed in 2018, there remains debate over whether 2019 will offer levels proximate to the long-term average of ~10% for U.S stocks.[8] NEAM's base case incorporates returns below this average accompanied by elevated levels of volatility. Resolution of the trade dispute remains a key factor shaping the range of outcomes.

Against this mosaic, within our active portfolios, our positioning is still focused on defensive elements that we believe will accrue benefits over a full market cycle. That said, volatility also offers opportunities for fundamental stock picking to drive alpha. Since it is virtually impossible to time the market, we continue our focus on risk adjusted returns, but we note that the tradeoff between risk and reward is markedly more balanced as we enter the new year.

ENDNOTES

[1] Bloomberg, Sarah Ponczek, Elena Popina and Vildana Hajric, "Whiff of Extinction Blows in Bull Market That Outlived Them All," dated December 26, 2018.

[2] Katie Little, Yahoo Finance, "Why the Dow's 1,000 Point Gain This Month isn't as Impressive as it Used to be."

[3] Calculated using current dollar GDP of $20.66 trillion as of 3Q data from Bureau of Economic Analysis.

[4] Investopedia, "At $1 trillion, Apple is Bigger Than These Things," dated August 2, 2018.

[5] Michael Hartnett, Bank America Merrill Lynch, "The Flow Show," dated January 3, 2019.

[6] Bloomberg, Gina Martin Adams, "Watch Bond Correlations for Stocks," dated October 8, 2018.

[7] New York Times, Alexandra Stevenson and Cao Li, "Empty Homes and Protests: China's Property Market Strains the World," dated December 30, 2018.

[8] NEAM analysis calculated since 1926 on nominal basis using Global Financial Database.

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