Perspectives

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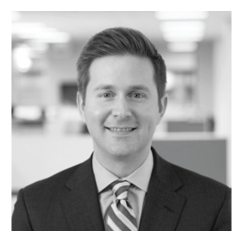
2019 Market Preview: U.S. Equities

THE PRO-GROWTH NARRATIVE FIZZLES OUT

U.S. equity markets were turbulent in 2018 as investors dealt with a variety of concerns including slowing global growth, tighter financial conditions, and growing trade tensions.

The year began with high investor expectations fueled by pro-growth fiscal policies such as tax cuts and deregulation, but the market's reaction to these measures ultimately proved short-lived. The steady upward trend in equities over 2017 continued into 2018 with a strong January start; however, the market's positive sentiment quickly changed to a concern that inflation, interest rates, and wage growth could rise faster than expected. In this environment, U.S. equities experienced their first significant pullback since February 2016 with the S&P 500 falling by 10% over the span of just nine trading days. This pullback ended the S&P 500's record tying 15-month streak of positive returns originally set in 1960, but the correction was ultimately short in duration and equities quickly rebounded. Against the backdrop of record stock buybacks and increased market volatility, equities subsequently produced new all-time highs. The S&P 500 hit an all-time closing high on September 20th and the Russell 2000 hit an all-time closing high on August 31st. For most of 2018, growth continued its longstanding outperformance of value with sectors such as technology, healthcare, and consumer discretionary outpacing the market. FAANG stocks continued their multi-year lead as growth and momentum factors were rewarded. By August and September, Apple and Amazon each had achieved the milestone of reaching one trillion in market value. Trade tensions with China, which began in March, steadily escalated throughout the year with the U.S. imposing increasingly higher tariffs and China responding with their own sets of retaliatory tariffs. Small-cap stocks, which saw the greatest benefit from tax reform, were rewarded in this environment given that smaller companies were relatively shielded from the effects of tariffs. This helped small-cap to outperform their large and mid-cap peers over the bulk of 2018, however, the trend quickly reversed course in October. The fourth quarter saw a sharp rotation away from growth and momentum towards defensive, dividend paying, and lower-volatility stocks. Small-cap, growth styles, and cyclical sectors such as industrials, energy, and materials led

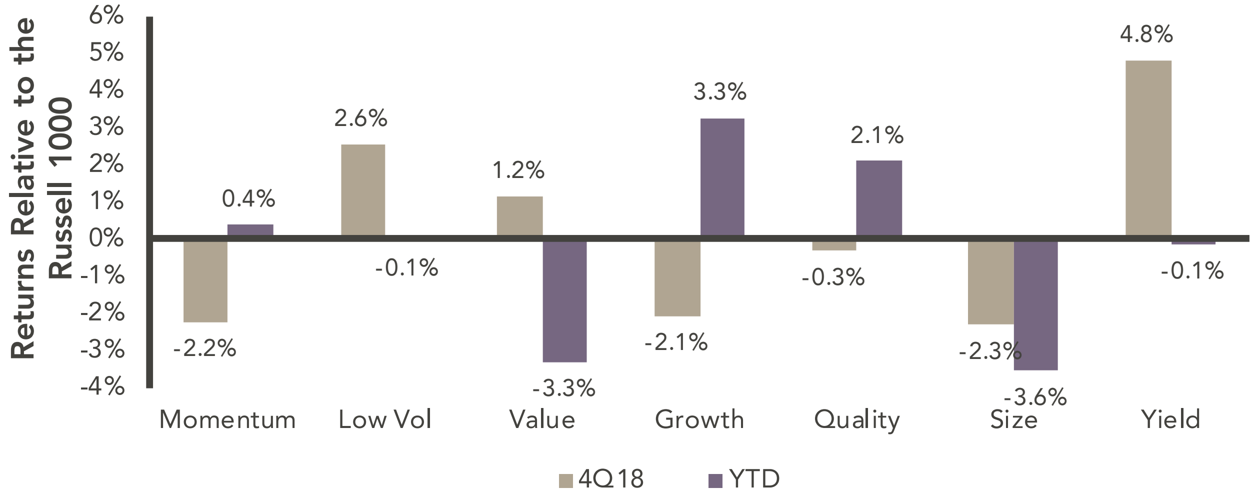
Samantha T. Grant, CFA, CAIA
Senior Research Analyst, U.S. Equities



Rob Britenbach, CIPM
Research Analyst, U.S. Equities

the way down. December saw further records set, but this time to the downside, with the S&P 500 recording its worst December monthly performance since 1931, the Russell 2000 logging its worst December monthly performance over its 40-year history, and many sectors solidly in bear market territory.

Exhibit 1: Russell Factor Performance Reverses in the 4th Quarter

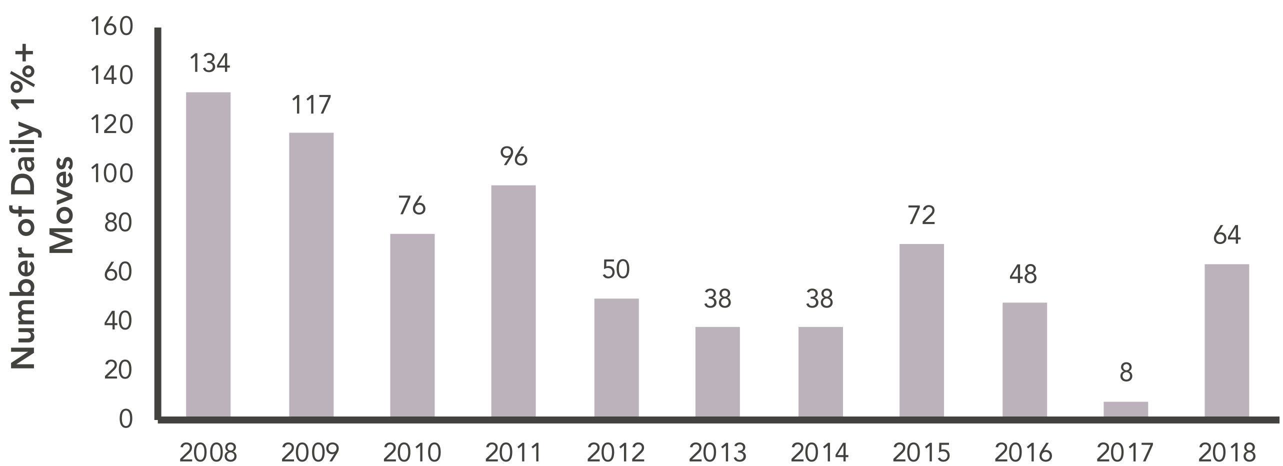


Source: Bloomberg as of December 31, 2018

THE RETURN OF VOLATILITY: Market volatility returns and is likely to persist

For much of the 10-year bull market, a subdued level of market volatility was present. While the low volatility theme peaked in 2017 with only eight 1%+ moves in the S&P 500, volatility returned to more normalized levels in 2018 with 64 1%+ moves. Volatility is expected to remain elevated as the macro themes that came into focus over 2018 have yet to be resolved. Investors have no shortage of issues to contend with in 2019 and ultimately, the direction equity markets take over 2019 will depend on how these same themes play out. The effects of tightening monetary conditions and waning fiscal policy measures continues. The pace of future Fed rate hikes, if a trade deal materializes with China, and whether a recession emerges will serve as key macro catalysts to watch. While economic and corporate earnings growth are set to slow in 2019, their outlook remains positive albeit at lower levels than seen in 2018.

Exhibit 2: Normalization of Volatility in 2018 with most S&P 500 1%+ moves YTD since 2015



Source: Bloomberg as of December 31, 2018

IS THIS BULL MARKET OVER?: All good things must come to an end

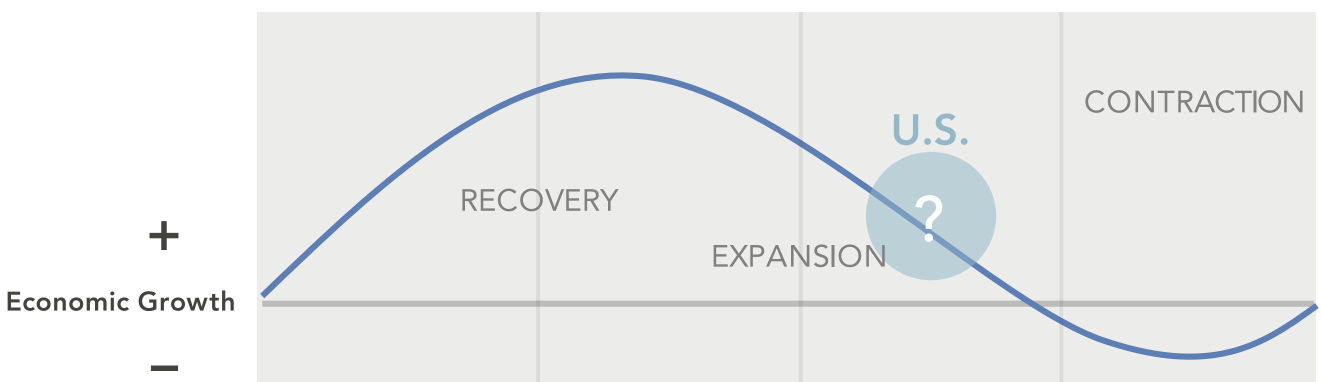
Where have we been? Where are we now? Where might we be going?

In 2018, the S&P 500 index declined 4.4%, marking the first negative calendar year since 2008. Despite the decline, the market hit many milestones, most notably becoming the longest bull market ever in August and reaching a record high of 2,930 in September. If September 20th, 2018 is not the market peak (which seems increasingly unlikely given the current volatile environment), the bull is still maturing. And while bull markets do not die of old age, the current bull market seemed "old" from the very start. Lower than average GDP and productivity growth coupled with nonexistent wage growth overshadowed stellar market returns of +300% cumulative and +10% annualized since the market bottom in 2009, outpacing the 8% annualized that investors expect from equities.

Today, low interest rate and corporate tax reform policies that supported the post-Global Financial Crisis recovery are fading while global growth is slowing, credit is tightening, wages are increasing, and earnings are softening. From an equities perspective, corporate profits, business confidence, and consumer confidence are at or near cyclical highs, making downside risks ever more probable. As a result, the United States is most likely entering or in the late phase of the market cycle.

Exhibit 3: Business Cycle Can Influence Sector Returns

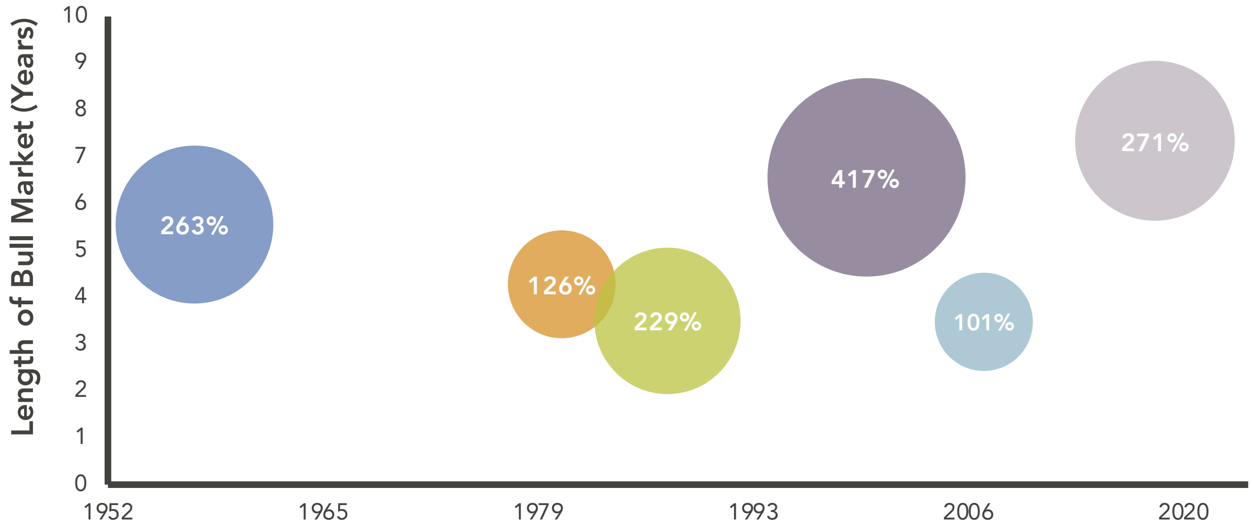
Cycle Phase	Early	Mid	Late	Recession
	▪ Consumer Discretionary ▪ Industrials ▪ Technology ▪ Financials	▪ Industrials ▪ Technology ▪ Financials	▪ Financials ▪ Energy ▪ Materials ▪ Consumer Staples ▪ Health Care	▪ Consumer Staples ▪ Health Care ▪ Telecoms ▪ Utilities



Source: Fidelity Investments; edits by Marquette Associates

There is no specific time period on how long the late market cycle phase can or will last. On average, late market cycles last anywhere from a year to 18 months with bull markets ending a few quarters before a recession begins.[1] Consequently, as we progress through the economic cycle, we would expect volatility to continue in 2019. Defensive sectors like Health Care and Consumer Staples typically outperform other sectors in late cycle environments. In addition, we expect the price investors pay for stocks to become even more important as macro tailwinds abate and companies work to differentiate themselves from peers.

Exhibit 4: Length of Bull Market Run vs. Percent Change in Each Bull Market



Source: Bloomberg as of December 31, 2018

Given the sheer difficulty of predicting bear markets and recessions, we will review the last three recessions and compare them to the environment today. Starting with the most recent, the recession associated with the Global Financial Crisis officially began in December 2007 and ended in June 2009. The associated bear market began in October 2007 and ended in March 2009. Rising interest rates and commodities prices exposed financial imbalances that led to a 55% decline in the S&P 500. We doubt the next recession would be as severe as the Global Financial Crisis since many of those excesses have been corrected (i.e. bank balance sheets) or are non-existent (i.e. excessive mortgage debt by consumers). The depths of the Global Financial Crisis are second only to the Great Depression and has been followed by the longest and one of the highest returning bull markets ever.

The second recession started in March 2001 and ended in November 2001, making this recession both short and shallow. The associated bear market decline of 49% began in March 2000 and ended in October 2002. There were numerous events that contributed to this recession: the severe decline of high valuation Technology stocks, a spike in oil prices, and the September 11th, 2001 attack.

Declining growth, increasing rates, and the threat of war in the Persian Gulf precipitated the last recession, which started in July 1990 and ended in March 1991. The associated bear market sell-off of 20% started in July 1990 and ended in October 1990.

Most likely, the next slowdown will be some combination of the 1990 and 2001 recessions since excessive financial imbalances have been kept in check by regulation over this cycle. Some of the precursors to both recessions already exist today: a hawkish Fed, slowing growth, and high relative valuations in Technology and Internet-related stocks. Even though a recession could be on the horizon, economists have found that the severity of the recession critically influences the magnitude of the recovery. That is, a deep recession tends to be followed by a strong recovery, but a mild recession tends to be followed by a mild recovery.[2] In addition, the St. Louis Fed found that recessions that follow long expansions tend to be of shorter duration and to have smaller-than-average declines in output and payroll employment.[3]

So where are we now and where are we going? While equity markets flirted with the bear (The S&P 500 index came within 0.50% of an official bear market on December 24th) in the fourth quarter of 2018, the U.S. economy is still healthy. Typical bear market indicators include high equity market valuations, rising unemployment and inflation, falling factory activity, and, infamously, the inversion of the yield curve. Most of the indicators in Exhibit 5 are softening, but not alarming.[4] For instance, the Purchasing Managers Index softened in 2018, but is still above the trouble level of 50. The spread between the two and ten-year Treasury, which is the metric used for yield curve inversion, has declined over this cycle, but has not breached the zero threshold for inversion. We acknowledge that the next three years will probably be more difficult than the last three years, but recession risk still seems quite low given the indicators below.

Exhibit 5: Equity Market Leading Indicators Table

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Valuations	12.6	18.0	14.7	12.7	13.8	16.7	17.2	17.4	18.9	20.0	15.4
Unemployment Rate	7.3	9.9	9.3	8.5	7.9	6.7	5.6	5.0	4.7	4.1	3.9
Inflation	1.8	1.8	0.8	2.2	1.9	1.7	1.6	2.1	2.2	1.8	1.9
PMI	34.5	55.8	56.6	53.0	49.8	55.9	54.7	48.4	54.3	59.3	54.1
10 Yr minus 2 Yr Treasury Yield	1.6	2.7	2.7	1.7	1.5	2.6	1.6	1.3	1.3	0.6	0.2

Source: Bloomberg as of December 31, 2018

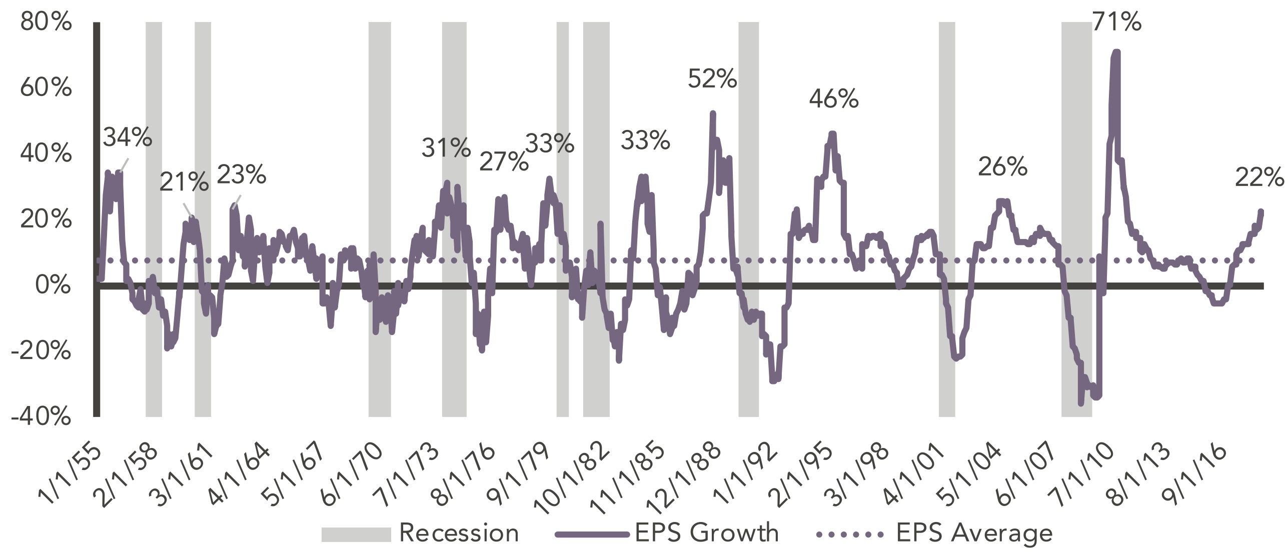
THERE ARE TWO SIDES TO EVERY COIN: There is no reward without risk

We have more trepidation about 2019 than we had last year. At the end of 2017, we were optimistic that global growth synchronization and fiscally-generated earnings growth would support extended domestic equity valuations to propel the market higher. We were about 75% correct given performance through the third quarter. Unfortunately, the fourth quarter was a different story, and by the end of 2018, there were new policy and geopolitical risks that have implications for 2019 U.S. equity performance. The most apparent is rising interest rates. Rising rates have been a factor in five of the last seven recessions and yield curve inversions. The yield curve inverts when the spread between the 2-year and 10-year Treasury bonds becomes negative; short-term interest rates are higher than long-term interest rates when the yield curve inverts. However, inversions do not necessarily mean that a bear market is imminent. Recessions can occur, on average, in as little as 8 months and as many as 22 months after the yield curve invests. Equities usually produce negative returns in the short-term after the yield inverts. However, over the long-term, equities revert to producing positive returns.

The next looming risk is U.S. trade negotiations with the rest of the world. USMCA, the new NAFTA, still needs to be approved by Congress; it is not clear if the U.S. and China will de-escalate trade tensions after the 90-day truce expires on March 1st; and the U.S. still needs to negotiate Brexit if and when it occurs. There is no doubt that cyclical sectors like Energy, Materials, and Industrials have been negatively affected by a slowdown in global growth and escalating trade tensions.

Earnings have also lost their 2018 luster. Pre-tax reform earnings were growing at a healthy and normal high single-digit rate to lower teens rate. Tax reform added an additional 10%–15% to earnings growth. This temporary boost will fade in 2019 simultaneously as wages and interest rates are increasing, which will pressure margins going forward. Earnings are expected to return to their high single digit historical averages in 2019; earnings most likely peaked in the second quarter of 2018. According to Bloomberg, in the past 25 years, two profit peaks occurred right before economic recessions, in 1999 and 2006. The other three happened in 1993, 2004 and 2009, with stocks falling in the following six months. However, in each case, earnings continued to slowly grow, which supported a 12% market gain over the next two years. Earnings growth turned negative in 2015 with the decline in oil prices and no bear market or recession followed. While earnings growth is an important component of the overall fundamental landscape, lower earnings growth does not necessarily lead to a bear market or a recession.

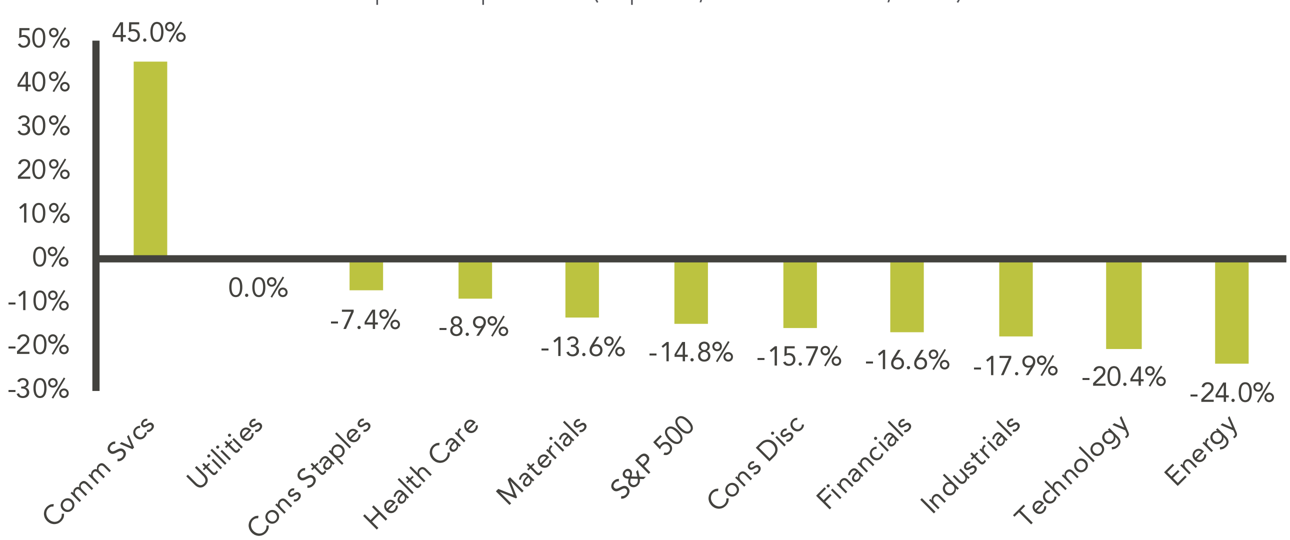
Exhibit 6: Have We Reached an Earnings Peak?



Source: Bloomberg as of December 31, 2018

Lastly, valuations corrected in 2018 along with the market despite strong earnings growth. High valuation, high growth Technology and internet-related stocks were especially hard hit and given their growing importance in market indices, overall market valuations look much more attractive. The FAANG stocks and their derivations were down on average 23% due to lower growth expectations. While FAANG's downward descent seems stark, their outperformance over the rest of the market was just as stark. While the market reassesses the outlook for these stocks, performance for the group could get worse before it gets better.

Exhibit 7: Forward P/E Multiple Compression (Sept. 20, 2018 – Dec. 31, 2018)



Source: Bloomberg as of December 31, 2018
Note: the Telecommunication Services sector became the Communications Services sector on September 21, 2018, hence the increase in forward P/E ratio.

Things are not all doom and gloom; there are always opportunities to outperform the broader market. The first opportunity would be the falling divergence between growth and value. The annual spread between growth and value closed by almost 10% to under 4% year-over-year. We highlighted that growth was becoming increasingly risky as valuations rose and the fourth quarter performance of the FAANG stocks proved that out. Reasonably-priced companies that can offer growth in a slower environment should do well.

Even though the large cap S&P 500 index did not enter correction territory, the small cap Russell 2000 index did. The Russell 2000 fell 20.2% in the fourth quarter and 11.0% for the year. Valuations declined even more. At the start of 2018, small cap indices were the most highly valued across all domestic equities, but at the start of 2019 small-cap stocks look the most attractive. The current landscape provides potential upside support for small-cap stocks since they are more domestically-focused and somewhat immune from trade disputes and strong currency moves in the dollar.

CONCLUDING REMARKS

Last year, we identified interest rate policy as the main risk for the year and it was. The market corrected after Fed Chair Powell, who is more hawkish than his predecessor, was confirmed and the market corrected again after the September and December rate hikes. We continue to believe that monetary policy normalization through the Fed Funds rate and the reduction of the Fed's balance sheet will continue to stoke volatility.

Global trade risks are the largest risk facing domestic equity markets. There is no doubt that trade tensions with China weighed on the overall market as the year progressed. Cyclical sectors like industrials, materials, and energy have been the most affected. If the U.S. and China, the two largest economies in the world, are involved in a significant trade dispute, then that can only be a drag on equity returns. If the U.S. and China resolve their trade dispute it can only be a positive for equity returns and global growth.

At this point, U.S. equity markets are pricing in negative growth (rather than a slowdown in growth), and that helps explain the negative returns in the fourth quarter. Unemployment and interest rates remain low, corporate earnings are still growing though at a slower rate, and valuations are below historical averages. While there are strong positive examples that could support and sustain future positive returns, only time will tell if this long economic cycle is coming to a close.

KEY TAKEAWAYS

1. **Large-Cap**: The U.S. dollar's rise and trade tensions in 2019 were huge headwinds to performance in 2018. While it is unlikely that the dollar would have such strong performance in the new year, the trade risk has not abated. We expect to see continued volatility in internationally-focused, cyclical sectors.
2. **Mid-Cap:** Mid-cap stocks should avoid most of the fallout from trade and should continue to see M&A activity increase given the large cash balances of multi-national companies who may prefer to buy growth domestically.
3. **Small-Cap:** 2018's market decline was especially painful for small-cap stocks and resulted in a relative P/E valuation discount, compared to large-cap stocks, not seen since 2002. This implies a potentially better risk/reward trade-off for small-cap stocks going forward, however, small-caps have a greater sensitivity to rising interest rates.

[1] Minaya, Jose and Nick, Brian, "Late Cycle signals and implications," Nuveen, 2018. https://www.nuveen.com/late-cycle-investing-late-cycle-signals-and-implications
[2] See Friedman (1964) or Balke and Wynne (1996).
[3] Kliesen, Kevin L. "The 2001 Recession: How Was It Different and What Developments May Have Caused It?," Federal Reserve Bank of St. Louis Review, September/October 2003, pp. 23-38. https://doi.org/10.20955/r.85.23-38
[4] The equity market leading indicators table displays various metrics used to signal the health of the economy. Metrics above their 20-year average, above the neutral rate, or trending negatively, will be represented by yellower and redder colors while metrics below their 20-year average, below the neutral rate, or trending positively, will be represented by greener colors.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO I BALTIMORE I PHILADELPHIA I ST. LOUIS

PHONE 312-527-5500
WEB marquetteassociates.com

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