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January 7, 2019

FROM THE DESK OF DAN VERU, CHIEF INVESTMENT OFFICER

2019 Outlook

I will give you the good news first – I strongly believe that a year from now stocks will be higher than they are today, potentially gaining 10-20% over the course of 2019. However, the path to higher stock prices will likely be bumpy and very unpredictable. We just completed the worst December since 1931 and 2019 is off to a volatile start as well, but I do believe we are at an inflection point for the following reasons:

1. Investors are viewing recent equity market swings as indicative of a material slow-down or a recession in 2019. Yes, the recent ISM data, a measure of U.S. manufacturing strength, indicates the economy is slowing, but I do not believe we are at the precipice of a recession. Historically, stocks have *not* been a great harbinger of recessions. In fact, since 1946 the S&P 500® has had eight significant corrections ranging between -15.2% to -35.9% that did not result in a recession. The selloff in the fourth quarter, which brought the S&P 500® down -13.5%, seems to be the result of China's slowing economy and a loss of confidence globally, which has been exacerbated by the tariffs imposed by the Trump administration, rather than the onset of a U.S. recession.
2. S&P 500® valuations are very reasonable, dropping from 18.4x at the beginning of the year to 14.5x on December 31st, which is below both the five- and ten-year averages. While earnings growth in 2019 isn't expected to keep up with 2018's growth of 20.2%, the highest since 2010, consensus estimates are forecasting 7.4% earnings growth in 2019, which is still a higher growth rate than 2012, 2013, 2014, 2015, and 2016. The market is confusing slower growth with negative growth. I believe 2019 earnings for the S&P 500® will be higher than 2018 earnings, unless some unforeseen geopolitical event occurs.
3. Trade negotiations between the U.S. and China are ongoing and could result in some sort of a deal that allows both leaders to declare victory. Given that negotiations seem to be moving at a faster rate, I expect we will hear more details on the progress being made. The political stakes have risen for both President Xi Jinping and, especially, for Donald Trump as he prepares for his 2020 re-election campaign. As I've reported previously, a robust economy is critical to the success of his re-election efforts.
4. Economic conditions in China appear to be deteriorating at an accelerating rate. This past October, the Chinese government took the extraordinary move of suspending the release of PMI survey data (a leading indicator of projected economic growth) after several months of weakness to try and hide the bad news. I believe there is a higher probability of a major stimulus plan in 2019 on par with the Shanghai Accord from 2016 that could re-invigorate growth in China and around the world.
5. Many technical indicators are at extreme levels of bearishness, a very good contra-indicator for the direction of stock moves. For example, the Put/Call ratio, which

measures put buying versus call buying, reached levels that had not been reached in several decades, indicating that market participants became overwhelmed with fear. On Friday, December 21st and on Monday December 24th, the Put/Call ratio was at 1.8 to 1, indicating investor sentiment was extremely bearish. Additionally, 52-week lows reached record levels on both the 21st and the 24th (nearly 50% of the S&P traded to a 52-week low on the 24th, one of the highest readings seen over the last decade). These are consistent indicators of a "get me out at any price" capitulative end-of-correction event.

6. Liquidity conditions have tightened, but we are far from an environment of tight money. There is ample liquidity throughout the financial system, but we are coming out of a long period of financial repression where interest rates were at zero (and even negative when adjusting for inflation). At the same time, the Federal Reserve is reversing a policy of quantitative easing (by shrinking its balance sheet). We have a long history of the impact of rising and falling interest rates, but a policy move from quantitative easing to quantitative tightening is new, and there are some questions as to its effects on the markets. Offsetting these tighter liquidity conditions is tax reform, of which we are yet to feel the full effects, and de-regulation. Given mounting evidence of slowing conditions, Federal Reserve Governors and Chairman Powell himself seem to be walking back plans on the number of rate hikes and, perhaps, might slow or stop the pace of quantitative tightening.

I am old enough to remember the 1987 crash, the greatest example of a market sell-off that did not trigger a recession. To be very clear, I am not calling for a 35% sell-off in stocks, but there are some similarities to the current market worth noting. Back in '87, a recently appointed Fed Chairman named Alan Greenspan (appointed August 1987) also raised interest rates perhaps one too many times and something called "portfolio insurance" triggered a huge sell-off in stocks. That correction, and others like it, point out potential weaknesses in our system (and I am sure this correction will have its own autopsy) and negatives of new investment products. I am not going to pile on ETFs–they are simply the enabler of making a quick directional move in a basket of stocks. However, more exotic quant model-driven investment strategies, coupled with fewer restrictions like the market uptick rule, exacerbate swings in both directions. Markets function well when there is a balance between quantitative strategies driven by sophisticated computer models and fundamental investors where human decision making dominates. However, when this balance is not present, the market is subject to much wider swings and volatility, which we are seeing today.

The market correction that started in September seems to be running its course. If history serves us correctly, markets could enjoy a strong short term rally. If we don't get tangible evidence of progress on trade, a more accommodating Federal Reserve, and economic improvement in China, the rally will be short lived. But, given the rising political stakes for the leaders of both countries, I think these events will happen over the course of 2019.

Dan Veru, Chief Investment Officer

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