AUGUSTINE
ASSET MANAGEMENT

April 2018

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# The Weight of Expectations

## MARKET SUMMARY

### Equities

| | |
|---|---|
| S&P 500 | 2,641 |
| Price / Earnings | 21.2x |
| Dividend Yield | 1.9% |

### US Treasury

| | |
|---|---|
| 2 Year Yield | 2.3% |
| 10 Year Yield | 2.7% |
| 30 Year Yield | 3.0% |

### US Corporate Spreads

| | |
|---|---|
| Investment Grade | 1.0% |
| High Yield | 4.1% |

### Volatility

| | |
|---|---|
| CBOE Market Volatility | 20.0 |

### US Economic Figures

| | |
|---|---|
| GDP Growth 4Q17 | 2.9% |
| Unemployment | 4.1% |
| Inflation | 2.1% |
| Fed Funds Rate | 1.75% |
| 3 Month LIBOR | 2.31% |

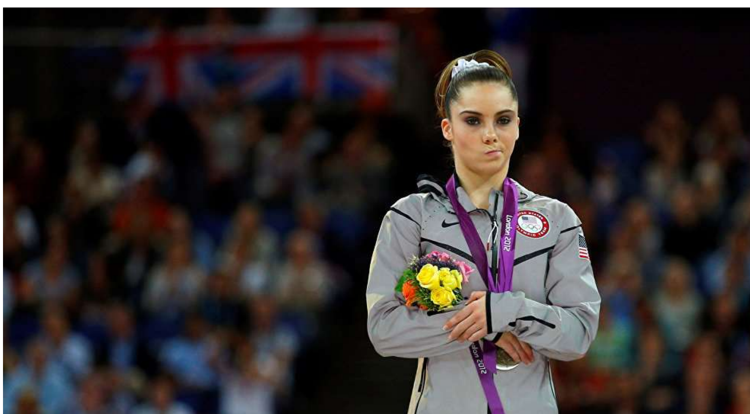
### Commodities

| | |
|---|---|
| Oil (Brent) | $70.27 |
| Natural Gas | $2.73 |
| Copper ($/lb.) | $3.03 |
| Gold ($/oz.) | $1,325 |

### Foreign Exchange

| | | |
|---|---|---|
| Euro | $/€ | 1.23 |
| Japanese Yen | ¥/$ | 106 |
| Chinese Yuan | 元/$ | 6.27 |

Market summary data as of:
March 30, 2018



There's an old investing adage that Mr. Market has an uncanny way of proving accepted wisdom wrong. Particularly at investors' emotional extremes – at the peak of optimism or nadir of despondency – capital markets, time and again, surprise the consensus.

This year's opening quarter adds to that record. Following 2017's strong returns for stocks and absence of even mild set-backs, investors entered this year with a record level of optimism. Surveys conducted by the Conference Board and the University of Michigan had a record proportion of investors expecting stocks to rise through 2018 – a level of bullishness even higher than that seen during the late 90's stock market bubble (see Exhibit 1). Investors acted on that enthusiasm. According to EPFR, investors deployed $102 billion into global equity funds in January, a record suggesting a pervasive "fear of missing out".

Negative returns for stocks (MSCI All Country World in US$ down 1.0% and S&P 500 down 0.8%) and bonds (Bloomberg Barclays US Aggregate down 1.5%) during the first quarter amidst rising volatility caught many by surprise. A global economy that had picked up the pace compared

Exhibit 1: Great Expectations – Record Investor Optimism Entering 2018

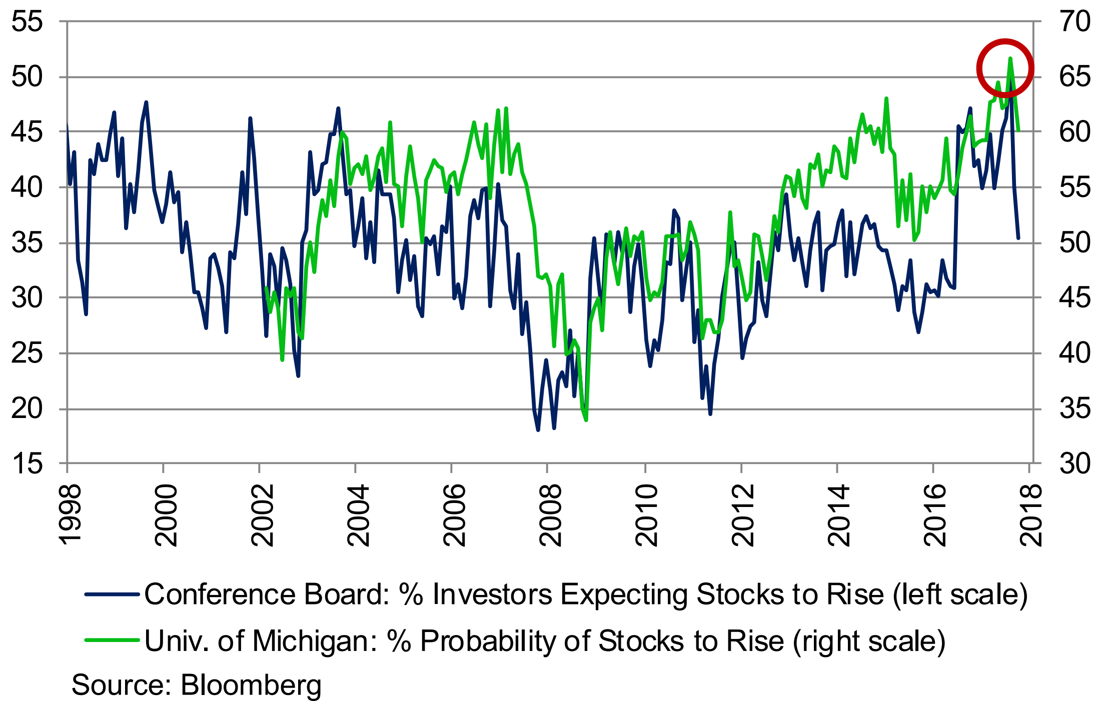
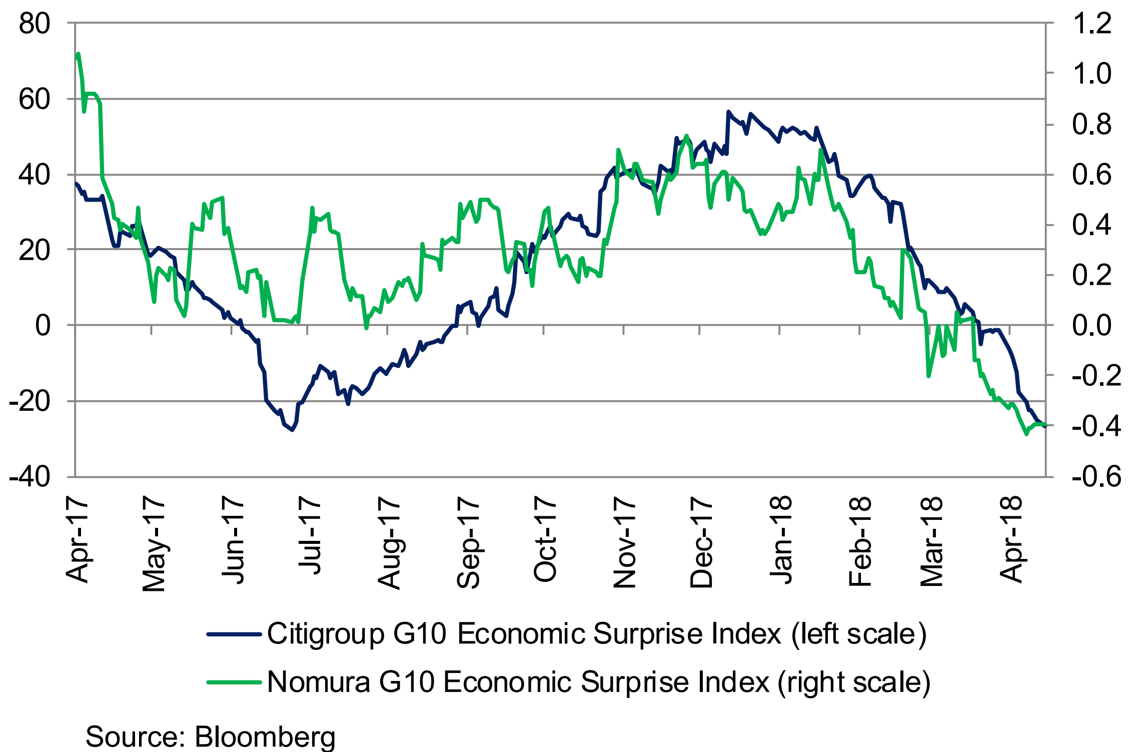



Exhibit 2: Global Economic Data Shifted from Above to Below Expectations



with recent years and lower US corporate tax rates that could add 7% to profit growth this year had provided a positive tone to the fundamentals. Central banks, meanwhile, remained highly supportive with negative real (net of inflation) interest rates.

Yet, such positives can present a challenge in capital markets. Investors tend to over do it by extrapolating that conditions will go from good to great while expecting the market to take on a sustainable "new normal" regarding valuation and risk. Economist Hyman Minsky's Financial Instability Hypothesis described this dynamic. Prosperous times encourage financial speculation, which eventually produces market volatility when conditions don't meet lofty expectations. Minsky's work speaks toward the broader economy and overuse of leverage, but we think it's applicable to the capital markets. The modest pull-back and increased volatility recently seen in stock prices can be seen as a limited-scale "Minsky moment", triggered by softer data on the global economy, a slightly less accommodative stance by the Federal Reserve, and the emergence of trade policy as a risk to the growth outlook.

Economic data among the world's largest economies indicate continued growth, but at a pace below aggressive consensus expectations. To be clear, our outlook and that of the consensus (3.7% in 2018 and 2019) for growth worldwide remains non-recessionary and better than recent years. Markets have, however, needed to adjust to recent data that remained merely good rather than accelerating to great (see Exhibit 2).

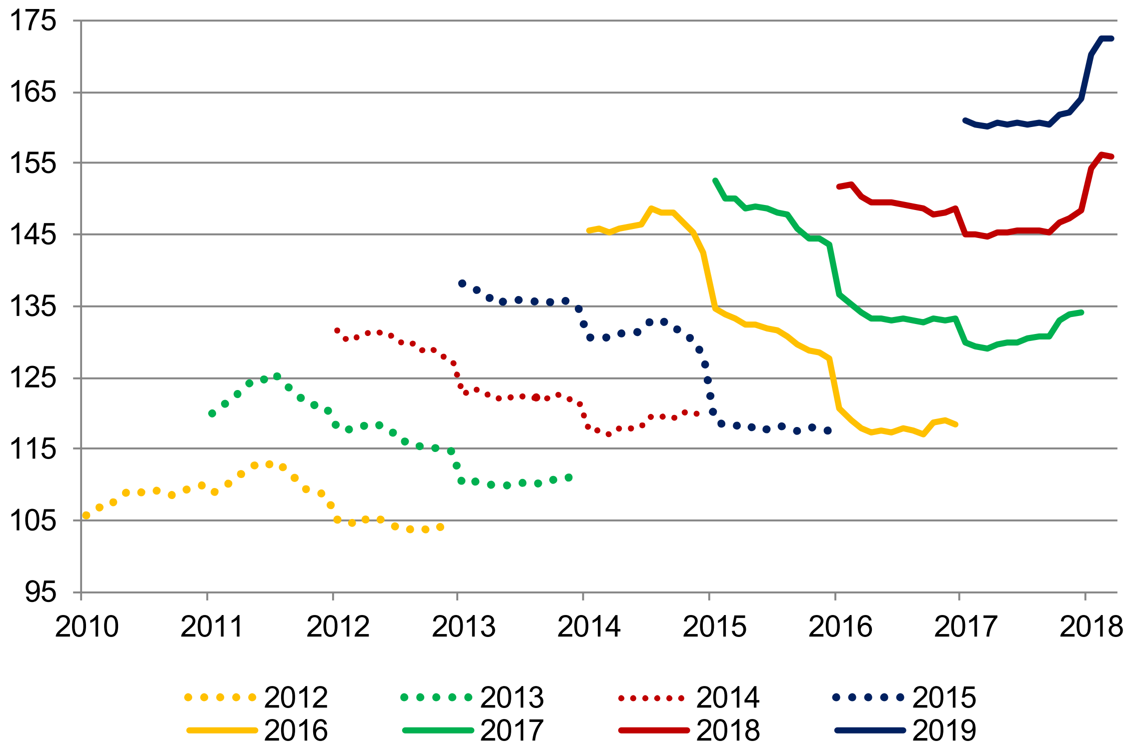
Investors have also had to adjust to a slightly less loose Federal Reserve. Rhetoric from official announcements as well as public comments from individual Fed governors have shifted in recent months. Inflation and the potential that tighter policy may be required have featured more prominently in their discussions, while comments about minimizing financial market instability have become less frequent. The median forecast among Federal Open Market Committee participants for the 2018 and 2019 year-end Federal Funds rates jumped to 2.9% and 3.4% at their March meeting from 2.1% and 2.7% just three months earlier. Investors in the Fed Funds futures market now expect three quarter-point rate hikes this year, up from two expected at the beginning of the year.

Meanwhile, trade policy and protectionist tariffs have replaced changes to the tax code at the top of Trump administration's economic and foreign policy agenda. From an initial foray covering aluminum and steel imports, the US is now contemplating a wider scope of trade penalties. Full blown trade war with a wide range of countries would be mutually detrimental and materially increase the risk of a global recession. We believe, however, that the recent trade-related sabre rattling is an opening gambit to negotiate better terms of trade and reduce chronic abuses. It nonetheless adds uncertainty to the global economic outlook.

Fortunately and more importantly for investors, the outlook for corporate profits remains strong and the probability of recession appears low over the next several quarters. According to Factset, earnings per share for US companies are expected to grow 18.5% this year and 10.5% in 2019 through a combination of better underlying profits, aggressive share buybacks, and lower taxes. Exhibit 3 illustrates how the trajectory of earnings has improved in recent quarters.

Of course these projections are contingent on the economy remaining on a growth path – a reasonable assumption given the absence of conditions that historically have served as accurate indicators of economic risk. Exhibit 4 shows a variety of cyclical factors and

Exhibit 3: S&P 500 Consensus Earnings Per Share Estimates




Source: Bloomberg

Exhibit 4: Cyclical Indictors for the Economy are Positive

| Recession | Credit | Housing | Inflation | Labor | Industry | Yields |
| --- | --- | --- | --- | --- | --- | --- |
| 1973 | ↓ | ↓ | ↓ | ↓ | ↓ | ↓ |
| 1980 | ↓ | ↓ | ↓ | ↓ | ↓ | ↓ |
| 1981 | ↓ | ↓ | ↑ | ↑ | ↓ | ↓ |
| 1990 | ↓ | ↓ | ↓ | ↓ | ↓ | ↓ |
| 2001 | ↓ | → | ↓ | ↓ | ↓ | ↓ |
| 2007 | ↓ | ↓ | ↓ | → | ↓ | ↓ |
| Today | ↑ | ↑ | → | ↑ | ↑ | → |

contrasts current conditions with those at the start of the last six recessions. Today's strength in credit, housing, labor, and industrial markets, which have yet to generate inflation above the Fed's comfort level, suggests a low risk of a cyclical downturn.

Based on the constructive state of the economy and corporate earnings, we view the recent modest pullback in stock prices and widening of corporate bond credit spreads as more of an adjustment in sentiment rather than as a sign of weakening in underlying fundamentals.

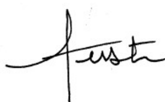
With financial assets trading at historically expensive valuations and investor behavior showing euphoria as we entered 2018, the rebasing of sentiment – and the volatility that such a reset requires – is a normal function of the market. It can, indeed, be viewed as a healthy development insofar as it helps limit wanton speculation. The recent price corrections among consumer-related technology stocks that have rallied to incredibly high valuations and the new wild west of crypto currencies seem like a step away from fundamentally-agnostic, momentum-based speculation toward a degree of rationality.

We appreciate your trust in our management of your capital and would welcome further discussion of our outlook and the strategy reflected in your portfolio. Please contact us with any questions.

With best regards,

Jeffrey E. Bernardo, CFA    Gregory M. Estes, CFA    Steven M. Herbert, CFA

Neil J. Sullivan, CFA    Frederick M. Blum



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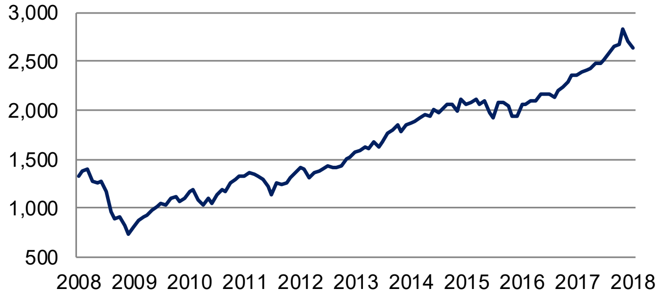
Chart 1: S&P 500 Index
3,000
2,500
2,000
1,500
1,000
500
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

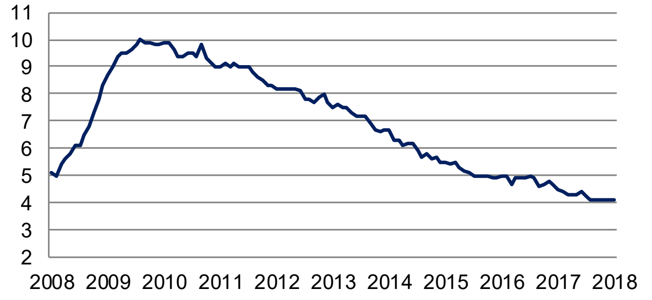
Chart 6: US Unemployment Rate %
11 10 9 8 7 6 5 4 3 2
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

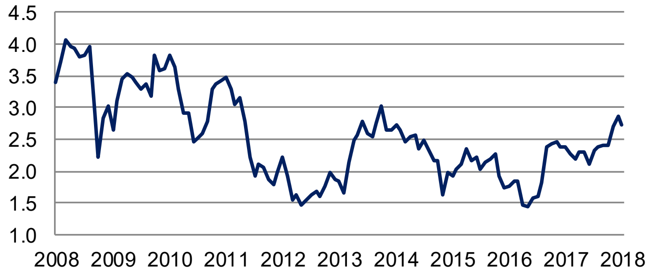
Chart 2: US Treasury 10 Year Yield %
4.5 4.0 3.5 3.0 2.5 2.0 1.5 1.0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

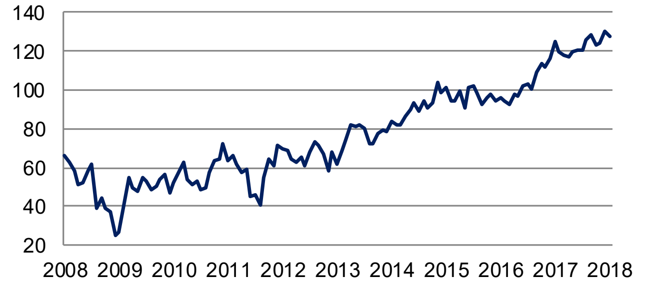
Chart 7: US Consumer Confidence Index
140 120 100 80 60 40 20
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

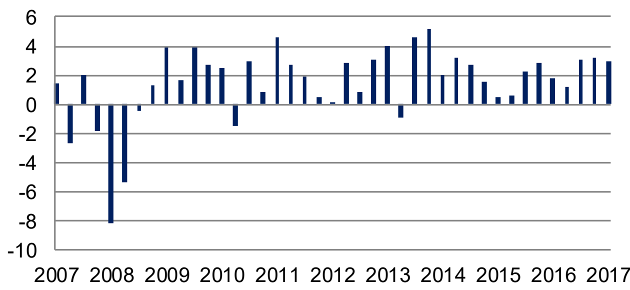
Chart 3: US Annualized GDP Growth %
6 4 2 0 -2 -4 -6 -8 -10
2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017

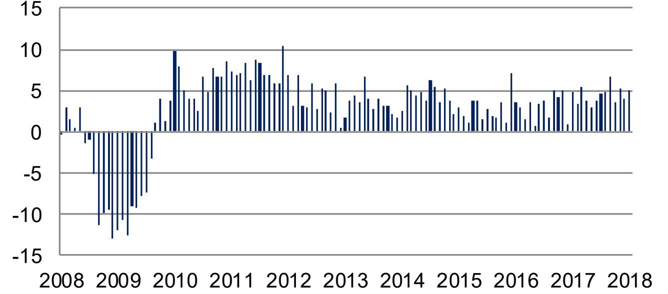
Chart 8: US Retail Sales Growth %
15 10 5 0 -5 -10 -15
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

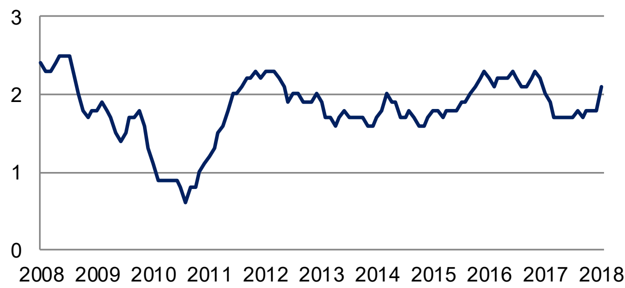
Chart 4: US Core Consumer Price Index %
3 2 1 0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

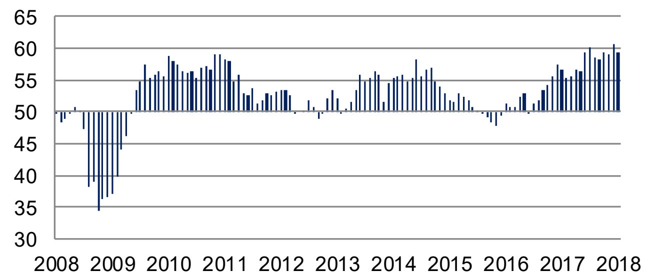
Chart 9: US ISM Manufacturing Index
65 60 55 50 45 40 35 30
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

Chart 5: Trade-Weighted US Dollar Index
105 100 95 90 85 80 75 70
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

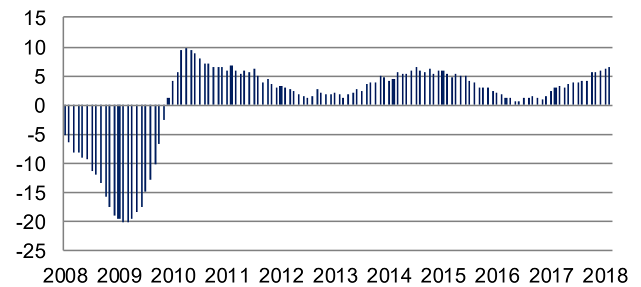
Chart 10: Conference Board Leading Index
15 10 5 0 -5 -10 -15 -20 -25
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018