AUGUSTINE
ASSET MANAGEMENT

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MARKET SUMMARY

Equities

S&P 500	2,507
Price / Earnings	17.1x
Dividend Yield	2.1%
MSCI AC World	555.66
Price / Earnings	14.9x
Dividend Yield	2.8%

US Treasury

2 Year Yield	2.5%
10 Year Yield	2.7%
30 Year Yield	3.0%

US Corporate Spreads

Investment Grade	1.5%
High Yield	5.7%

Equity Volatility

CBOE SPX Volatility	25.4

US Economic Figures

GDP Growth 3Q18	3.4%
Unemployment	3.9%
Inflation	2.2%
Fed Funds Rate (mid)	2.4%
3 Month LIBOR	2.8%

Commodities

Oil (Brent)	$53.17
Natural Gas	$2.94
Copper ($/lb.)	$2.63
Gold ($/oz.)	$1,282

Foreign Exchange

Euro	$/€	1.15
Japanese Yen	¥/$	110
Chinese Yuan	元/$	6.87

Market summary data as of:
December 31, 2018

Reversions

Capital markets have entered a tumultuous time. Market volatility has risen in the last three months, capped by a sharp correction in December that brought returns for nearly all risk asset classes to a loss for 2018. Over the quarter, US equities (S&P 500) fell 13.5% and global equities (MSCI All Country World) fell 12.8% as investors rushed out of stocks. Meanwhile, the US bond market (Bloomberg Barclays US Aggregate) rose 1.6% as investors sought perceived safety in long-term government securities. The rapid shift from optimism to pessimism turned prior gains in stocks and losses in bonds on their respective heads. In the end, US equities (-4.4%) and global equities (-9.4%) delivered negative returns while US bonds were flat (0.0%) for 2018.

Concerns with tightening monetary policy (discussed in our last letter *Taking the Punchbowl*), escalating trade tensions, and festering government dysfunction have proven toxic to investor sentiment. The trifecta of growth-inhibiting factors led some to believe that an imminent economic recession is highly likely despite the momentum that had produced average growth of 3.3% in the US and 3.6% globally in the year to date.

Are these concerns and the market's reaction justified? While no one can give a definitive answer, we believe the magnitude

of the recent drop in stock prices and widening of credit spreads overstates the risks to the economy and the corporate profit cycle. Should an improved tenor and less confusion regarding monetary policy, trade negotiations, and governance present, investor sentiment could take a step back from the brink of recession expectation, and asset prices could stage some form of recovery.

Monetary Policy: He said what?

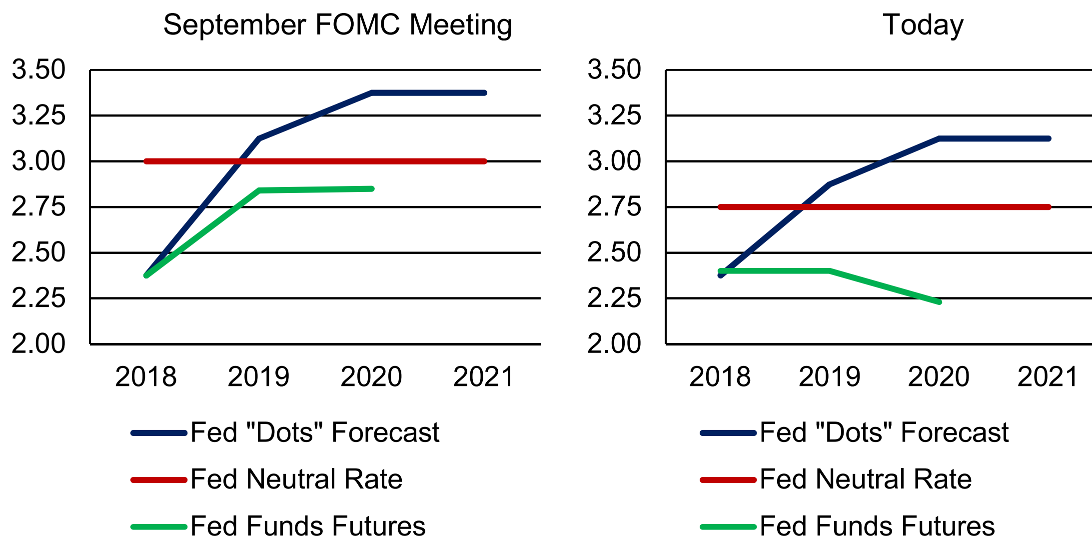
The Fed remains on its program of reverting to a more normal policy stance. While the run rate of $50 billion in balance-sheet-reducing bond maturities and a steady pace of increases to short-term rates were well communicated, confusion erupted during the quarter regarding the extent to which the Fed would tighten and whether financial market conditions still affect their decisions.

An October statement by Chairman Powell that rates were "a far way from neutral", a further hike in the Fed funds target rate in December, and a press conference in which Powell appeared both unconcerned with market volatility and rigid regarding the pace of its liquidity-draining balance sheet reduction ("on autopilot", in his words) contributed to a sense that the Fed might be more hawkish than previously believed. The "Fed put" which had helped asset returns and volatility for many years suddenly appeared to be off the table, triggering a sharp fall in stocks prices and widening of credit spreads.

In early January, the Fed, through statements by its chairman and various committee members, calmed market fears. Powell indicated that monetary policy was instead “not on a preset course" and that the Fed is prepared to alter its tightening path "significantly" if necessary. He clarified, "we will be patient (with raising rates) as we watch to see how the economy evolves…and will be prepared to adjust policy quickly and flexibly and to use all our tools to support the economy should that be appropriate."

Markets have reacted positively in recent days to the Fed's dovish shift in forecasted rates and rhetoric and now expect a less aggressive pace of interest rate increases, as seen in the implied forward rates from Fed funds futures (see Exhibit 1).

Exhibit 1: Markets Now Expect the Fed to Pause its Rate Increases



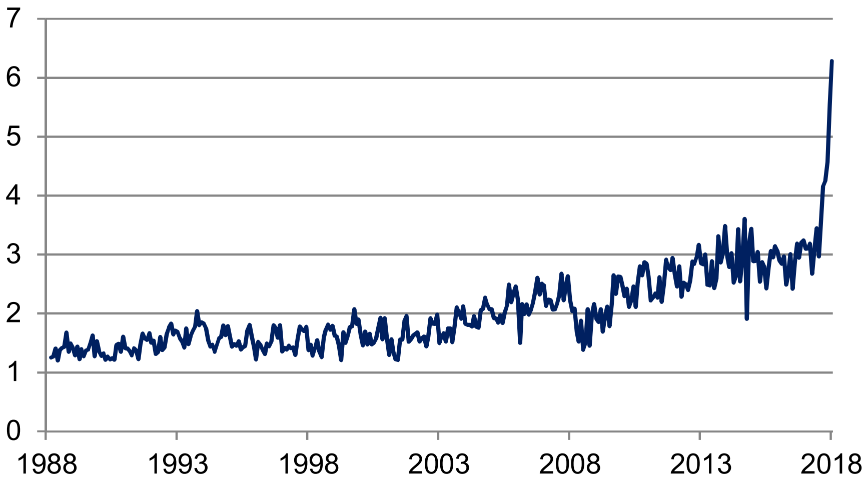
Trade Policy: He said what?!

We've highlighted in prior commentary trade policy as a threat to the outlook for global growth. While exports are less than 15% of the US economy, industrial supply chains are global and disruption of trade through punitive tariffs can have an outsized effect. Importantly for investors, corporate earnings are much more exposed to demand and growth throughout the world, particularly in the technology, energy, materials, and industrial sectors.

While negotiations with many trade partners have been constructive, discussions with China have worsened in recent months. Rhetoric has been inconsistent and increasingly bellicose.

> *"It's an incredible deal…If it happens, it goes down as one of the largest deals ever made…What I'll be doing is holding back on tariffs. China will be opening up, China will be getting rid of tariffs. China will be buying massive amounts of products from us."*
>
> President Trump, December 2, 2018, via Twitter
>
> *President Xi and I want this deal to happen, and it probably will. But if not remember ... I am a Tariff Man…It will always be the best way to max out our economic power. We are right now taking in $billions in Tariffs. MAKE AMERICA RICH AGAIN"* (see Exhibit 2).
>
> President Trump, December 5, 2018, via Twitter

Exhibit 2: Monthly US Treasury Customs Net Receipts $ Billions

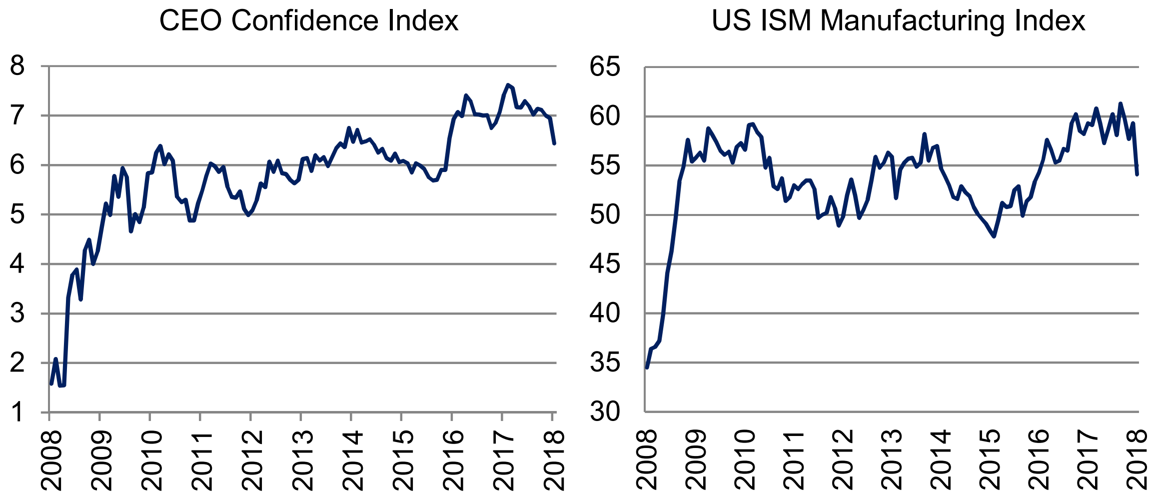


The arrest of Huawei (a Chinese communications technology company) executives in Canada and Poland on suspicion of violating Iran sales restrictions and of state-sponsored espionage have marked an escalation in the world's push-back against China's alleged unfair and illegal industrial practices.

These developments have created an expectation that trade policy and its effect on growth could get worse before getting better. Fed measures of business optimism and capital spending plans began to note trade and tariffs as an issue in early 2018 with respondents citing concerns as offsetting policies favorable to sentiment such as the lower corporate tax rates enacted in late

2017 and less aggressive regulations over the last two years. Recent surveys have shown trade increasingly affecting sentiment, particularly among manufacturing companies (see Exhibit 3).

Exhibit 3: Trade Concerns Affecting Business Confidence

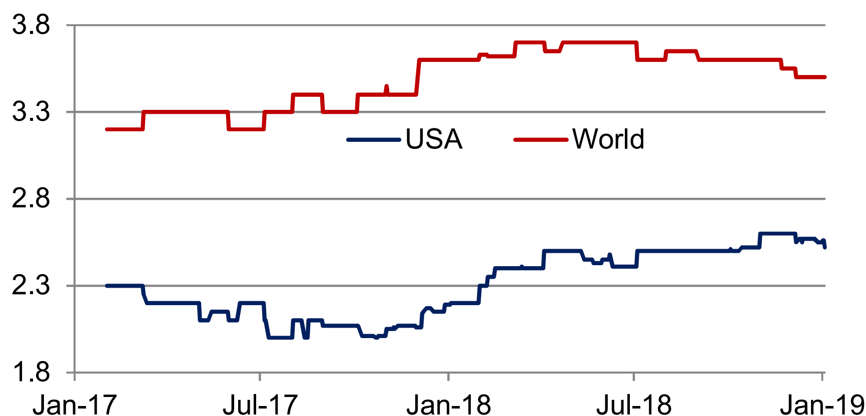


The Economy: Enough momentum…for now.

Global economic activity continues to grow, albeit at a slower pace than recent quarters, despite recent monetary and policy headwinds. Following above-trend domestic growth of 4.2% and 3.4% in the prior two quarters, the closing months of 2018 are estimated by the Atlanta Fed to have grown at 2.8%. Global growth, which averaged 4.2% in the first half, is forecasted by UBS to have grown by 2.7% in the fourth quarter.

The cadence of economic growth is slowing and reverting toward longer-term trend after a period of unusually fast growth. The current expansion is certainly mature. However, we see sufficient momentum going into 2019 that the probability of recession this year remains low and consensus expectations for domestic growth of 2.5% and global growth of 3.5% appear reasonable (see Exhibit 4).

Exhibit 4: Consensus Forecasted 2019 GDP Growth %



Measures that describe the current momentum in economic activity generally support that view (see Exhibit 5). Meanwhile, indicators that monitor for the classic excesses that serve as raw materials for economic downturns – overspending by businesses on fixed assets and by consumers on durable goods and an accelerated pace of borrowing – don't describe an expansion that is about to end under its own weight (see Exhibit 6).

Exhibit 5: Leading Indicators Not Suggesting Recession

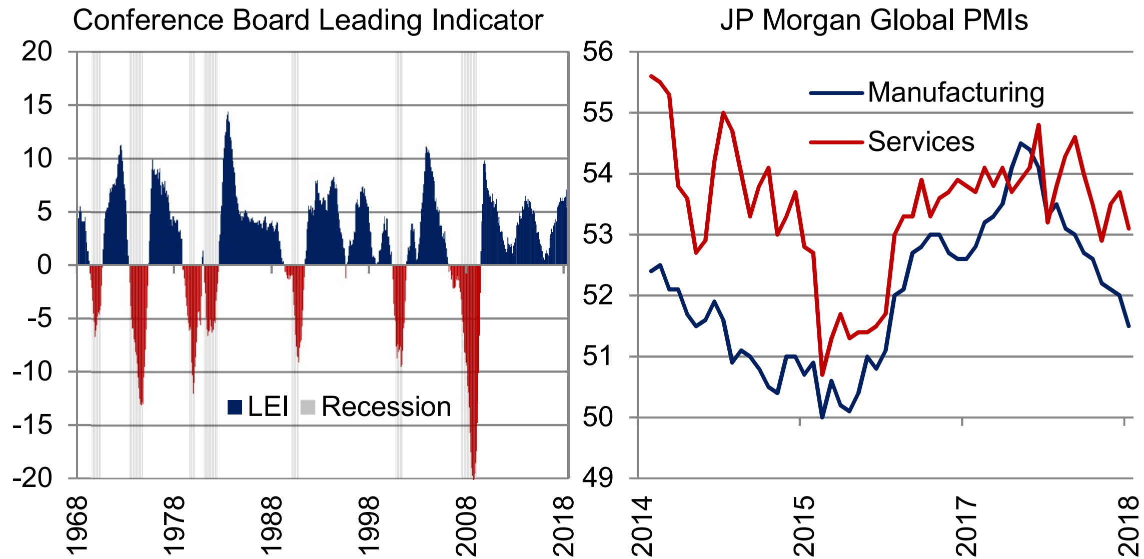
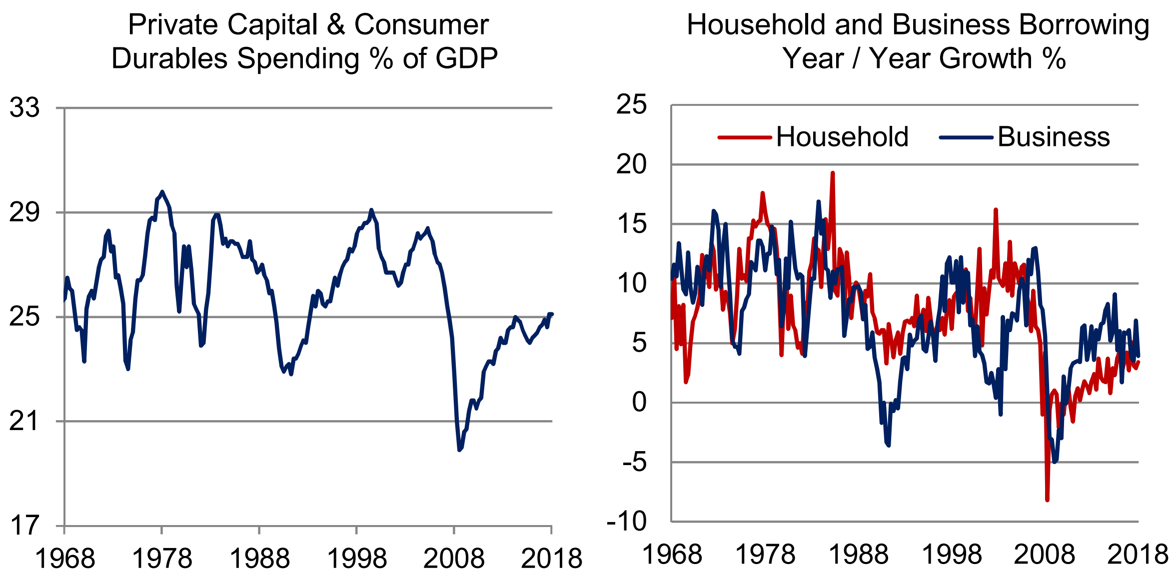


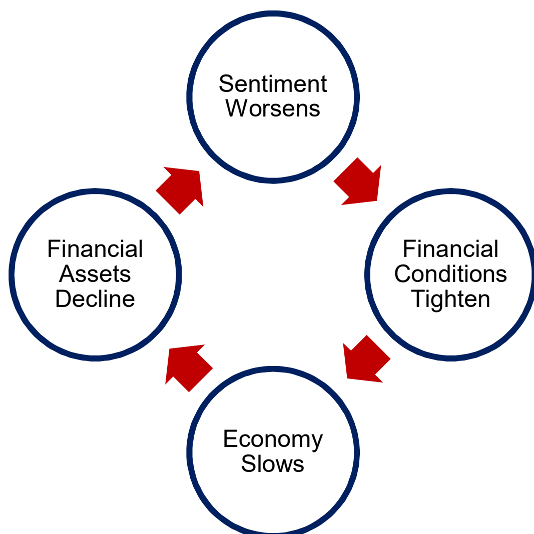
Exhibit 6: Classic "Top of the Cycle" Behaviors Not Evident

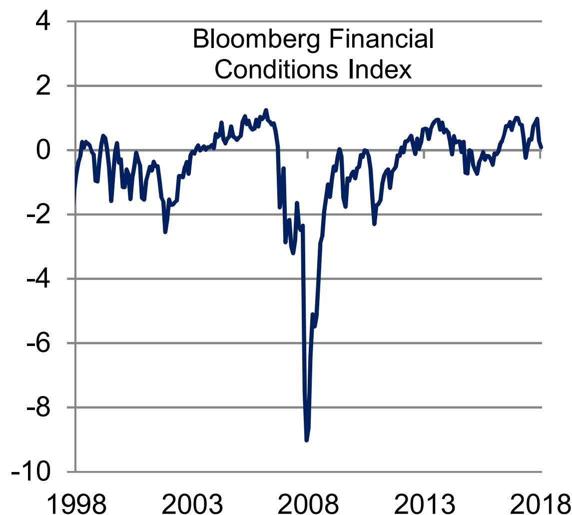


Of course, the outlook for the cycle can change, and risks that we're following include weakening of currently-strong employment, retail sales, and consumer credit trends and the potential for trade concerns and government breakdowns like the current shutdown to further influence sentiment and create a negative feedback loop in which decreased optimism affects financing

markets which, in turn, affects economic activity. That dynamic is not present today but gets closer as policy uncertainty and government dysfunction persist (see Exhibit 7).

Exhibit 7: Risk of a Negative Feedback Loop





Investment Strategy

Based on the likelihood of continued economic expansion and Fed policy that now appears to be taking a “go slow” approach to normalizing, we believe financial asset prices can recover from the fourth quarter correction, particularly if progress toward improved trade ties with China are achieved in coming months.

Higher market volatility, however, is probably here to stay as liquidity continues to be drained from the system through shrinkage of the Fed balance sheet, reduced quantitative easing by foreign central banks, and rising issuance of treasury bonds to fund increased government deficits.

As liquidity conditions revert back from extreme levels, we expect some reversal in the market distortions created by highly supportive monetary policies. Higher, more normal volatility should compress stock market valuation multiples, and the wide performance and valuation premium that speculative stocks have garnered should also revert to historically normal levels.

This process may prove challenging after several years when a stock’s price momentum mattered a lot more than its valuation and cash flow generation. A portfolio of quality stocks selected with a bias toward lower multiples on earnings and cash flow can perform well in this environment while carrying less embedded valuation risk. That means a preference, as we have in client stock portfolios, for value and global diversification (see Exhibits 8 & 9).

In bond portfolios, we continue to see a historically flat yield curve as providing little reward per unit of interest rate risk and remain positioned with a maturity profile shorter than the overall fixed income market. Credit spreads, which widened substantially during the fourth quarter on recession fear, can recover, should such concerns prove to be overblown (see Exhibit 10). As

such, we anticipate that a portfolio of well-vetted corporate securities can perform well in the coming quarters.

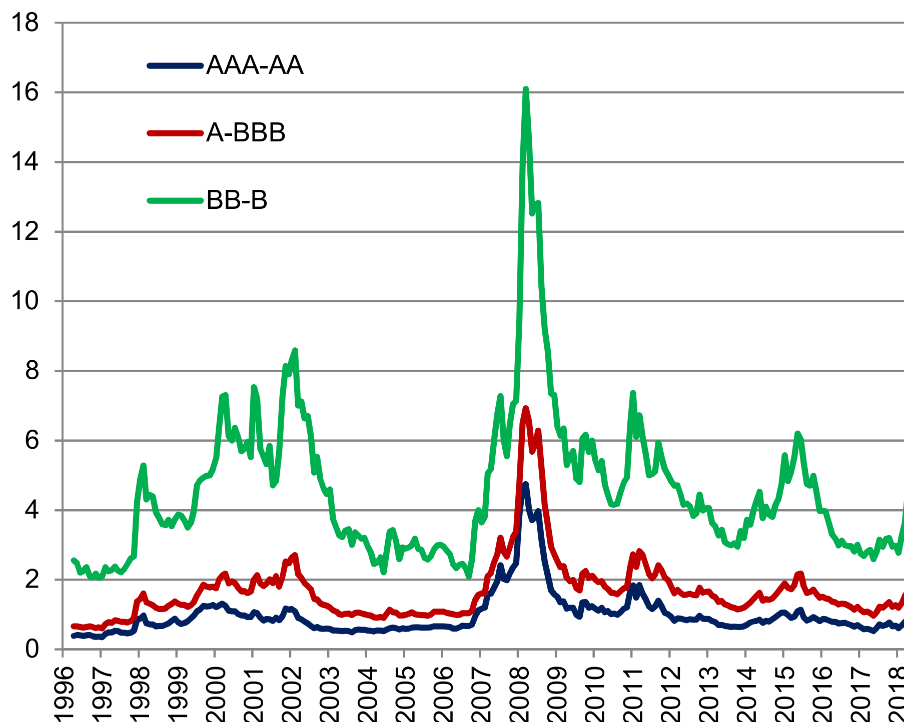
Exhibit 8: Value Stocks are Attractive

	Global Value Stocks			Global Growth Stocks		
	Price/ Earnings	Price/ Cash Flow	Price/ Book	Price/ Earnings	Price/ Cash Flow	Price/ Book
Current	12.0	8.5	1.4	20.0	12.1	3.6
15 Year Average	15.1	9.5	1.6	20.7	12.2	3.0
Premium/Discount	-20%	-10%	-10%	-3%	-1%	18%

Exhibit 9: International Stocks are Attractive

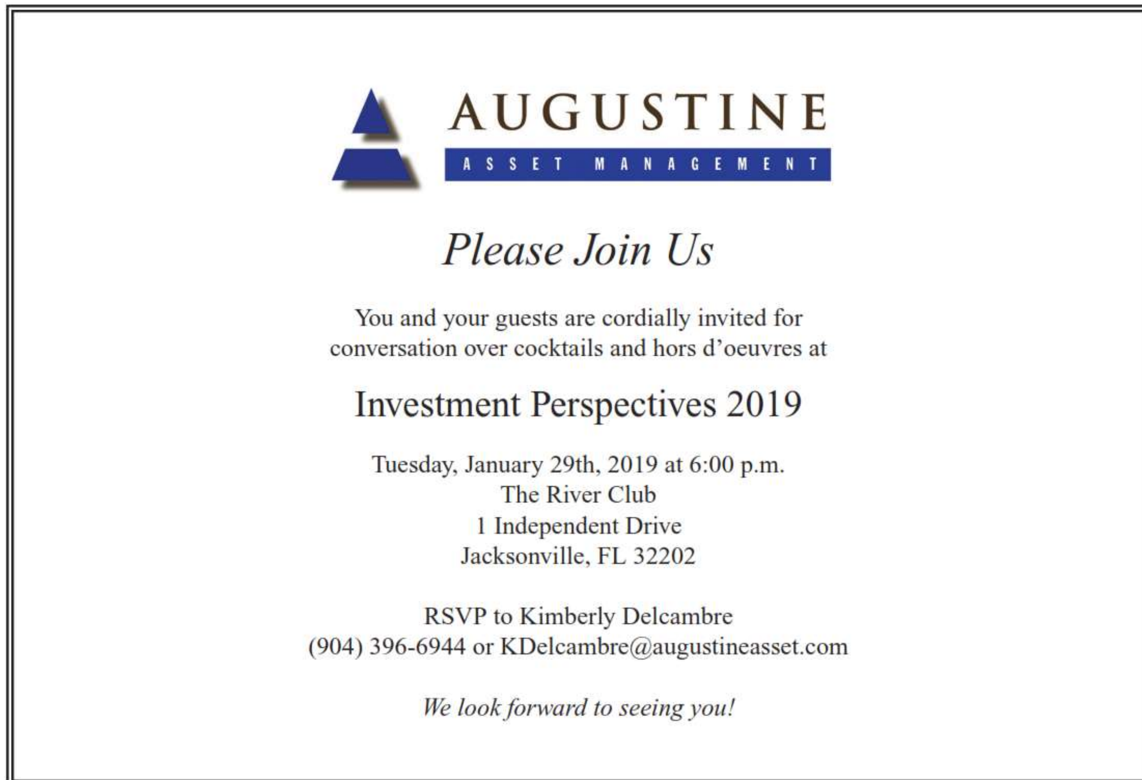
	US Stocks			International Stocks		
	Price/ Earnings	Price/ Cash Flow	Price/ Book	Price/ Earnings	Price/ Cash Flow	Price/ Book
Current	17.3	12.0	3.0	12.9	8.3	1.5
15 Year Average	17.8	10.8	2.6	16.8	8.8	1.7
Premium/Discount	-3%	11%	15%	-23%	-6%	-15%

Exhibit 10: Credit Spreads Reflect Recession Fear



An Invitation

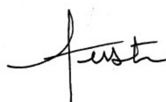
We hope this review of the economy, capital markets, and investment strategy helps inform you of the macroeconomic world we live in and how we've positioned client assets to achieve attractive risk-adjusted returns. We look forward to discussing these topics further at our upcoming *Investment Perspectives* reception. We will be gathering at The River Club (1 Independent Drive, Jacksonville) on Tuesday January 29th at 6:00 pm for cocktails and hors d'oeuvres and a discussion on ways to pursue returns while protecting capital. We would be very pleased if you would join us.



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. We welcome your call or email.

With best regards and wishes for a happy and prosperous 2019,

Jeffrey E. Bernardo CFA   Gregory M. Estes CFA   Steven M. Herbert CFA   Neil J. Sullivan CFA



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