EquityCompass

Investment Commentary

2019 First Quarter Commentary, Review, and Outlook



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"In a dark room you move with tiny steps."

— **Mario Draghi**, *President*, European Central Bank, March 7, 2019

Commentary

For the past 12 months, we have been concerned the U.S. economy, as well as the global economy, would begin to grow at a slower pace more akin to its long-term secular capability. We feared this decelerating growth rate could cause significant angst for the markets and its investors.

A year ago this past March, the Federal Reserve (Fed) announced it was launching a campaign to normalize interest rates higher and terminate the quantitative easing program initiated after the 2008 Financial Crisis. In the same week, President Trump announced he was going to wage war—a trade war—with our neighbors Canada and Mexico. Soon after, the administration turned its sights on China, announcing the first round of tariffs on Chinese imports.

At first, the stock market waved off these body blows. Even as U.S. economic GDP and corporate earnings growth ticked down month after month, quarter after quarter, this record-setting bull market would not buckle. But once December arrived, the trade war punches to the body began to buckle the champ. Then a right cross to the chin was landed by the Fed announcement that more interest rates hikes were forthcoming in 2019. This dropped the bull market to its knee —down 20% from its September all-time high.

Although investors were ready to throw in the towel, this bull market champion pulled itself up, touched gloves, and found new life in its now decade-old legs. The Fed signaled in January it would pause and recalibrate whether or not to raise interest rates in the near future, and the behind-the-scenes negotiations between the U.S. and China suggested a new trade agreement between the economic powerhouses might be in the offing. Investors took cheer and willed the stock market back to life.

While everyone roots for a comeback story, it is important investors pocket their emotions and remain focused on the economic facts. What is unmistakable is the U.S. economy, along with the global economy, continues to slow. U.S. corporate earnings that grew 22% in 2018, made largely possible because of the one-time effect of the Tax Cuts and Jobs Act, are now growing at 4.4%—less than half the rate in 2017, before the change to lower corporate tax rates.

Review

In the first quarter of 2019, stocks staged an impressive bounce back from the fourth quarter of 2018. After being down 11.83% in the fourth quarter of 2018, the Dow Jones Industrial Average (Dow) gained 11.15% in the first quarter of 2019. The S&P 500 Index posted a 13.65% return, and the ever popular NASDAQ Composite advanced 16.81%. The drubbing that stocks took in last year's fourth quarter is now a faint memory.

Small cap stocks performed well but continue to lag their larger brethren. The S&P Small Cap 600 Index gained 11.61%. The somewhat larger S&P Mid Cap 400 Index inched a bit higher plus 14.49%.

The ever-present tug-of-war between value and growth saw growth stocks resuming their market-beating ways. The S&P 500 Citigroup Growth Index was up 14.50% ahead of the S&P 500 Citigroup Value Index which gained 11.47%.

Parsing the internals, Information Technology once again was the standout with a +19.72% return followed by Real Estate +17.27%,

Industrials +17.03%, Energy +16.12%, and Consumer Discretionary +15.60%. Sectors that trailed the broader market included Health Care +6.45%, Financials +8.36%, Materials +10.11%, Utilities +10.56%, Consumer Staples +11.75%, and Telecom Services +13.87%.

Europe posted positive numbers but lagged U.S. stocks. The CAC 40 Index (France) was up 13.10%, DAX Index (Germany) +9.16%, FTSE 100 Index (United Kingdom) +8.19%. Much was the same in Asia. The Kospi Index (South Korea) was up 4.88%, Nikkei 225 Index (Japan) +5.95%, Hang Seng Index (Hong Kong) +12.40%. The best performing major global market index was the Shanghai A Share Index, bouncing back from its 2018 bear market with a 23.97% gain.

Shifting attention to the income side of the ledger, the S&P High Yield Dividend Aristocrat Total Return Index posted +11.86% while the lower volatility high dividend stocks measured by S&P Low Volatility High Yield Total Return Index gained an impressive 12.42%.

The stout performance of high dividend-paying stocks can be sourced directly from the decline in interest rates. In November 2018, the yield of the U.S. 10-year Treasury Note reached 3.25%. By the end of the first quarter of 2019, the yield on 10-year dipped briefly below 2.50% at which point the Treasury "curve" inverted, whereby 3-month Treasury Bills were quoted at a higher yield than 10-year maturities.

An inverted yield curve garners attention because it can sometimes suggest the possibility of an economic recession followed by a resultant bear market. We emphasize "sometimes" because, as a predictor, yield curve inversions are not absolute. There are occasions when the curve inverts for reasons other than predilections.

We suggest investors read Jamie Dimon's 2018 JPMorgan Chase & Co. Shareholder Letter. He always writes an excellent summary that not only captures the state of the financial services industry but also weighs-in on the U.S. and global economy. Dimon suggests the recent yield curve inversion was likely a false signal citing multiple reasons why long-term bonds were heavily bought forcing yields lower.

To Dimon's list, we would point out the yield on the 10-year German Bund briefly turned negative this past month forcing a flight of bond investors to sell negative interest rates in search of positive rates with similar maturities. Because the yield on the Japan 10-year Bond is also negative, it left the U.S. 10-year Treasury as the best alternative. It is likely the decline in our Treasury yields was at least partially attributed to global investors selling negative interest rate bonds in Germany and purchasing U.S. maturities.

Outlook

Mario Draghi's March press conference likened the state of the European economy to a "dark room" requiring the Central Bank to "move with tiny steps." Draghi went on to say the European economic and political landscape was one of "pervasive uncertainty." In Europe, very much like the United States, there are many moving pieces making it very hard to predict the outcome.

When "uncertainty" elevates, the first thing markets do is pause—to a snail-like pace. This might sound odd given the big investment returns we have witnessed in the first quarter, but when we tabulate stock returns over the past six months, the Dow is actually down 2.00% and up only 7.57% over the past year. The wild market swings we have seen can be largely attributed to the computer-driven strategies, including momentum and risk-parity trades that move back and forth with lightning speed.

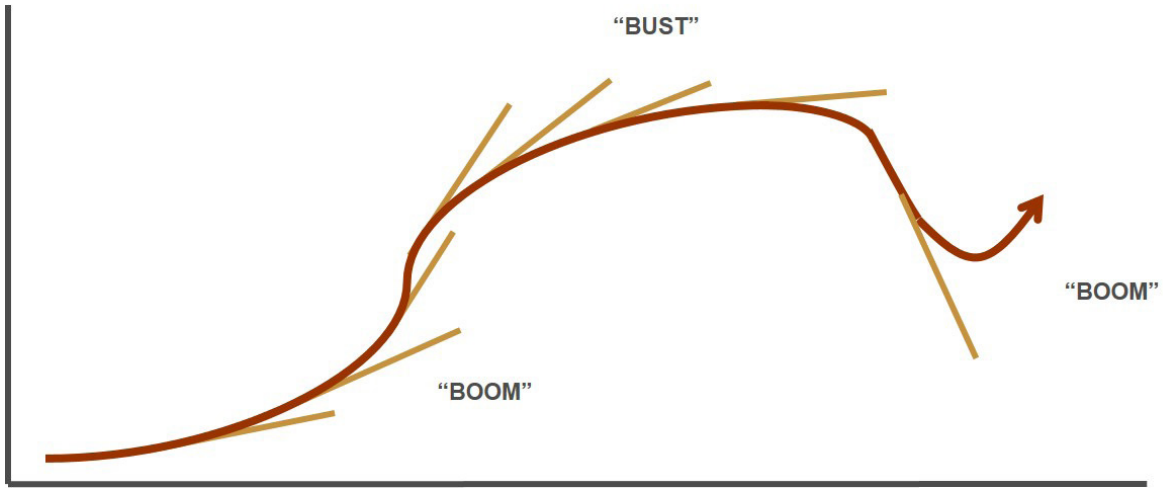
Earlier we mentioned investors often struggle with "deceleration" as it relates to economies and markets. It is not just investors who struggle with directional change but all individuals in most circumstances.

Ludwig Wittgenstein, the Austrian philosopher, said it best—"when we think about the future of the world, we always have in mind its being where it would be if it continued to move as we see it moving now. We do not realize that it moves not in a straight line and that its direction changes constantly."

Individuals, investors included, are linear thinkers. Linear forecasts are anchoring devices which are based on the history of a company or the economy. Most everyone understands

Investor Expectations Change Much Slower Than Economic Reality **Illustration 1**

Source: EquityCompass



Linear forecasts are anchoring devices which are based on the history of the company and/or the economy.

economies, markets, and companies have future growth rates that vacillate. But what we have learned is investor expectations change much slower than economic reality.

When an economy begins to pick up speed, investor expectations anchor to the last data point and draw a straight line forward based on the same trajectory. As the economy motors along picking up speed, investors continue to ramp up their expectations. But eventually, the economy begins to slow—trees do not grow to the stars. The economy's growth rate eventually begins to decelerate. However, investor expectations are still anchored to a higher growth plane.

When this happens, there is a gap between investor expectations and underlying economic reality. This resulting gap is addressed—sometimes quickly, sometimes with a lag effect.

We saw this unfold in the second half of 2018. When second quarter GDP growth reached 4%, and corporate earnings were posting double-digit returns, the belief was the trickle-down-effect of the Tax Cuts and Jobs Act, passed in the fourth quarter of 2017, would be long lasting.

When the economy and corporate earnings began decelerating in the months following the second quarter of 2018, investors were slow to shift expectations downward. Hope springs eternal. But when the evidence became overwhelmingly crystal clear in the fourth quarter of 2018 that the economy and corporate earnings were indeed decelerating, the change in investor expectations was instantaneous.

Slobalization

The term "slobalization" was first introduced by the Dutch writer Adjiedj Bakas in 2015. It was Bakas' contention that the global economy was indeed slowing for a variety of reasons. As such, Bakas argues we are entering a new era of economic sluggishness. The global synchronized growth phenomenon, last seen in 2017, is now becoming a synchronized global growth slowdown.

We can check off multiple reasons for the global slowdown. Chiefly, front and center are the trade wars. Beginning with negotiations for the new United States-Mexico-Canada Agreement (USMCA), which has yet to be ratified by Congress. Next up is the ongoing trade

negotiation between the U.S. and China. After that, we can expect new discussions, debates, and disagreements over trade relations between the U.S. and the European Union.

Two years ago, 75% of the world economy experienced an upswing in growth. Today, the International Monetary Fund (IMF) says 70% of the global economy is in a slowdown. Global gross domestic product (GDP) has been growing at better than 5% over the past several years, but this year estimates for global growth are rapidly coming down. Since January, the IMF has cut its estimates for global growth six times. It now estimates global growth in 2019 to slump to a 3.3% annual rate—mostly attributed to global trade wars.

But a deep dive into the reasons for slowing global growth reveals the downshift cannot be attributed to trade frictions alone. Although trade wars are the heaviest anchor preventing the global economy to move forward, there are other factors at play.

China's economy is now the second largest in the world, growing somewhere near 6% annually. The law of large numbers commands this growth rate will, by necessity, decline. The same will be said about India, now the world's fifth largest economy, growing at 7% annually.

Fifteen years from now, India may be the world's largest economy and the world's largest democracy. China may retain the second position. The United States may drop to third followed by Japan and Germany.

As exciting as it is to witness the explosive growth of China and India to transform these countries into developed economies, their respective economics will eventually slow, albeit a few downticks each year. This is occurring for much the same reason the U.S. economy has slowed over the past 20 years—demographics. Just as the majority of the U.S. population has morphed to older individuals who are saving more and spending less, so too will this demographic shift likely occur in China and India.

To this, we must note the rapidly changing footprint of global manufacturing transitioning from the largest economies to the smaller regional economies. According to McKinsey & Company, more manufacturing in the future will occur in countries like Vietnam, Malaysia, Indonesia, and the Philippines, away from the U.S. and China.

Lastly, as service economies grow in size, relative to manufacturing economies as a percent of the global economies, this too will impact global growth statistics. Not necessarily in a bad way, but a change nonetheless.

Trends of a System Versus Trends in a System

Changes in the makeup of global growth (trade wars, law-of-large numbers, demographics, regionalism of manufacturing, and the rise of the service economy) might suggest to a few we are bearish on the global economy. Nothing could be further from the truth.

Although the global economy is decelerating for the reasons outlined above, the overall global economy is still growing at twice the rate of growth in the U.S. and Europe, and nearly four times as fast as Japan. The car that is the global economy is still motoring down the highway at a very good speed, even though a downshift in acceleration is occurring.

A mental error investors often make is misunderstanding the difference between the trends of a system versus the trends inside the system. Because it is easy, we often think in broad averages then draw simple conclusions without investigating what is going on at a deeper level.

Some companies grow faster while others grow more slowly within the same sector. Now step up to the broader stock market. There are sectors within the stock market that grow at different rates than the overall stock market. Now expand your thinking to the broad global economy and reflect on where the pockets of above-average growth are occurring, relative to the parts of the global economy that are growing below average.

All this is to remind you that thinking in averages and calculating the changes in broad averages misses the investment opportunities that lie below the surface.

The IMF wrapped up its spring meeting in Washington, D.C. on April 13 releasing a communiqué saying "growth is projected to firm up in 2020, but risks remain tilted to the downside." On the list of IMF worries include "trade tensions, policy uncertainty, geopolitical risks, and a sudden sharp tightening of financial conditions."

This conclusion makes sense to us. We have stated throughout 2018, the downshift in growth, particularly in the U.S., was not a presage to a recession and resultant bear market but a gravitational pull towards the long-term secular economic opportunity. Although we all wished the economic stimulus of the 2017 Tax Cuts and Jobs Act would have been long lasting, the facts suggest otherwise.

Guidance in our year-end 2018 Commentary, Review, and Outlook remains the same. We believe the U.S. economy and the growth of corporate earnings are reverting to the long-term sustainable rate. Yes, there remains risk to the downside—mostly political in nature. That being said, we fully expect volatility in the stock market to remain elevated with ever changing headlines that will push investor psychology to and fro.

If our outlook is correct and we are indeed reverting back to the "old-new normal" post 2008, with modest- to below-average economic growth and lower interest rates as well, then our advice for investors is to seek reasonably priced growth companies, coupled with an emphasis on high-quality, high dividend-paying stocks while underweighting long dated fixed income bonds.

At EquityCompass, we remain committed to an evidentiary approach to investing. One that promotes thoughtful and successfully applied investment processes that ultimately provide solutions for our clients' long-term financial needs.

Robert G. Hagstrom, CFA, joined EquityCompass as a Senior Portfolio Manager in April 2014 and launched the Global Leaders Portfolio in July 2014. Prior to joining EquityCompass, he was the Chief Investment Strategist of Legg Mason Investment Counsel, and before that, the Portfolio Manager of the Growth Equity Strategy at Legg Mason Capital Management for 14 years. He has also served as President and Chief Investment Officer of Legg Mason Focus Capital, General Partner of Focus Capital Advisory, and Principal at Lloyd, Leith & Sawin.

Robert is the author of nine investment books, including *The New York Times Best Seller, The Warren Buffett Way* and *The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy.* He earned his Bachelor and Masters of Arts degrees from Villanova University and is a member of the CFA Institute and the CFA Society of Philadelphia.

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Strategies are based on fundamental, technical, and behavioral insights evolving from the empirical research conducted by EquityCompass professionals since 2001.

We follow a rules-based investment process for portfolio construction and risk control strategies overseen by the Chief Investment Officer, while Senior Portfolio Managers focus on quantitative and qualitative research for stock selection appropriate to the various investment strategies.

EquityCompass is committed to providing full transparency on investment decision-making so that financial advisors and investors can assess risk and return potential.

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Portfolios & Products

- Core Retirement Portfolio
- Core Investment Portfolio
- Core Balanced Portfolio
- Core Equity Portfolio
- Global Leaders Portfolio
- Quality Dividend
- Research Opportunity
- Select Quality Growth & Income
- Equity Risk Management Strategy

Investment Portfolios & Products	Inception	Description
Balanced		
Core Retirement Portfolio (CRP)	November 2015	Comprehensive stock/bond portfolio that seeks to provide reliable income and capital appreciation to fund lifetime retirement withdrawals.
Core Investment Portfolio (CIP) Core Investment Portfolio — Tax Advantaged (MCIP)	February 2018	Comprehensive stock/bond portfolio that seeks to provide long-term capital appreciation while helping to mitigate risk from bear market drawdowns. With MCIP, the fixed income component, 25% of the total portfolio is allocated to municipal strategies and tax-advantaged investments.
Global Asset Allocation		
Core Balanced Portfolio (CBAL) Core Balanced Portfolio — Tax Advantaged (MCBAL)	June 2009 December 2009	Stock/bond strategy that seeks to effectively capture market returns while minimizing volatility. With MCBAL, the fixed income component is allocated to municipal strategies and tax-advantaged investments.
Global Equity		
Core Equity Portfolio (CEP)	May 2011	Equity portfolio that utilizes risk management strategies and seeks to pursue returns in excess of the stock market returns while minimizing volatility.
Global Leaders Portfolio (GLP)	July 2014	Focused portfolio of leading global companies positioned to benefit from the unprecedented growth in worldwide consumer demand.
U.S. Equity		
Quality Dividend (QDIV)	January 2006	Diversified strategy of high-quality, high-yielding stocks that integrates quantitative and qualitative approaches.
Research Opportunity (ROPP)	January 2006	Integrates insights from Stifel and KBW's nationally recognized equity research and EquityCompass' quantitative investment process.
Select Quality Growth & Income (SQLT)	January 2006	Sector balanced strategy investing in high-quality, underpriced stocks that we believe have favorable value and price momentum characteristics.
Alternative Strategies		
Equity Risk Management Strategy (ERMS)	June 2009	Rules-based tactical asset allocation strategy designed to help reduce portfolio risk without curtailing the upside.

Disclosures

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The EquityCompass team of professionals represents deep industry experience in security analysis, capital markets, and portfolio management. We are committed to a consistent investment process that relies on enduring principles, sound empirical reasoning, and the recognition of a dynamic investment environment with a global reach.

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By assuming dividends are reinvested, you effectively have accounted for stocks in an index that do not issue dividends and instead, reinvest their earnings within the underlying company. The Dow Jones Industrial Average (DJIA) is an unmanaged, price-weighted index that consists of 30 blue chip U.S. stocks selected for their history of successful growth and interest among investors. The price-weighted arithmetic average is calculated with the divisor adjusted to reflect stock splits and occasional stock switches in the index. The NASDAQ Composite Index, comprised mostly of technology and growth companies, is a market value-weighted index of all common stocks listed on NASDAQ. The S&P SmallCap 600 covers approximately 3% of the U.S. equities market. Measuring the small cap segment of the market that is typically renowned for poor trading liquidity and financial instability, the index is designed to be an efficient portfolio of companies that meet specific inclusion criteria to ensure that they are investable and financially viable. The S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis. The S&P 500/Citigroup Growth Index is an index of stocks representing approximately half of the market capitalization of the stocks in the S&P 500 index that, on a growth-value spectrum, have been identified as falling either wholly or partially within the growth half of the spectrum based on a number of factors. The S&P 500/Citigroup Value Index is an index of stocks representing approximately half of the market capitalization of the stocks in the S&P 500 Index that, on a growth-value spectrum, have been identified as falling either wholly or partially within the value half of the spectrum based on a number of factors. The index is designed to serve as a benchmark for income-seeking investors in the U.S. equity market and provide exposure to high yield stocks in the U.S. while meeting stability and diversification requirements. The CAC 40 Index is a market-capitalization weighted index of the 40 largest and most liquid companies traded on the Paris Bourse stock exchange. The FTSE 100 is a market-capitalization weighted index of UK-listed blue chip companies designed to measure the performance of the 100 largest companies traded on the London Stock Exchange that pass screening for size and liquidity. The DAX (Deutscher Aktienindex) Index is a blue chip index in Germany tracking the performance (including dividends) of the 30 most actively traded stocks on the Frankfurt Stock Exchange. The Korean Composite Stock Price Index (KOSPI) is a market capitalization weighted index comprised of 200 of the largest and most liquid issues traded on the Korean Stock Exchange. The Nikkei 225 Stock Average is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange. The Hang Seng Index is a market capitalization-weighted index of the largest companies that trade on the Hong Kong Exchange. The index aims to capture the leadership of the Hong Kong exchange and covers approximately 65% of its total market capitalization. The S&P High Yield Dividend Aristocrats® index is designed to measure the performance of companies within the S&P Composite 1500® that have followed a managed-dividends policy of consistently increasing dividends every year for at least 20 years. The S&P 500 Low Volatility High Dividend index measures the performance of the 50 least-volatile high-dividend-yielding stocks in the S&P 500. The volatility of the indices identified in this report may be materially different from the volatility of the model portfolios presented by EquityCompass. Indices are unmanaged, do not include fees and expenses, and it is not possible to invest directly in an index. Changes in market conditions or a company's financial condition may impact a company's ability to continue to pay dividends, and companies may also choose to discontinue dividend payments. Diversification and/or asset allocation does not ensure a profit or protect against loss. 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