Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

DECEMBER 2018 | Volume 24, Issue 4

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One for the History Books

As the quarter began, it appeared trade policy would be the dominant headline for the remainder of 2018 – and for most of the quarter, it was. The narrative shifted on December 19th, however, following an unanimous vote by the Federal Reserve to raise interest rates and comments by the Fed Chairman stating that a slowing global economy and increased market volatility had "not fundamentally altered the outlook" for additional interest rate hikes. Throwing more fuel on the maelstrom of volatility was the President's tweet berating the Fed to "Feel the market, don't just go by meaningless numbers" as well as his private inquiry into his ability to remove the head of the U.S. Federal Reserve. Fears of an interest rate policy mistake by a Fed that may not be as independent as previously thought, coupled with a lingering trade war(s) by a "shut down" government were enough to push an already nervous market into bear territory. The quarter ended with a true "December to Remember" as the market posted it's worst final month of the year since 1931.

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Total Return	4Q18	1 Year
Russell 1000	-13.8%	-4.8%
Russell 1000 Growth	-15.8%	-1.5%
Russell 1000 Value	-11.7%	-8.3%
Russell 1000 Comm. Services	-13.2%	-14.3%
Russell 1000 Cons Disc	-16.1%	-1.0%
Russell 1000 Cons Stap	-5.3%	-8.1%
Russell 1000 Energy	-24.8%	-18.4%
Russell 1000 Financial	-13.2%	-12.9%
Russell 1000 HealthCare	-9.5%	6.1%
Russell 1000 Industrial	-17.7%	-13.6%
Russell 1000 Info Tech	-17.3%	0.4%
Russell 1000 Materials	-13.7%	-16.4%
Russell 1000 Utilities	1.1%	4.6%

Total Return	4Q18	1 Year
Russell 2000	-20.2%	-11.0%
Russell 2000 Growth	-21.7%	-9.3%
Russell 2000 Value	-18.7%	-12.9%
Russell 2000 Comm. Services	-18.7%	4.3%
Russell 2000 Cons Disc	-20.2%	-11.5%
Russell 2000 Cons Stap	-13.3%	-9.8%
Russell 2000 Energy	-41.2%	-39.1%
Russell 2000 Financial	-16.4%	-11.2%
Russell 2000 HealthCare	-25.7%	-6.3%
Russell 2000 Industrial	-21.4%	-17.7%
Russell 2000 Info Tech	-16.7%	1.4%
Russell 2000 Materials	-26.4%	-25.1%
Russell 2000 Utilities	-2.0%	2.9%

Total Return	4Q18	1 Year
S&P 500	-13.5%	-4.4%
MSCI AC World*	-12.5%	-7.7%
MSCI AC World Ex U.S.*	-10.9%	-10.7%
MSCI World (Developed)*	-13.1%	-7.4%
MSCI Emerging*	-7.4%	-10.1%
MSCI Dev. Europe*	-11.2%	-10.6%
MSCI Pacific Ex Japan*	-6.6%	-4.5%
MSCI Japan*	-17.2%	-15.2%
MSCI China*	-10.7%	-18.7%
USD/EURO	-1.2%	-4.4%
USD/Chinese Yuan	-0.1%	-5.4%
USD/MSCI EM FX	-0.04%	-4,5%

* in local currency, net of tax withholding

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S&P Earnings Report Update (4Q 2018) by Chris Zogg, CFA
Market Perspectives (September 2018) by Rick Villars, CFA

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The Financial Crisis led to the implementation of multiple monetary tools, most at a previously unprecedented scale. Two of most significant and long lasting tools have been Zero Interest Rate Policy and Quantitative Easing. At their inception there was considerable debate about whether or not the Fed could successfully navigate an exit strategy from each. Now, three years into the exit, the Fed Funds target rate has risen 2.25% and almost $500 billion has been drained from the Fed balance sheet. For much of that period markets took it in stride, but in the fourth quarter market volatility told us we are nearing the point where we find out if the current Fed is clever or lucky enough to guide monetary policy to a neutral stance without prematurely tipping the economy into recession.

Too tight for Markets, but How about the Economy

The Trump administration has a goal of above 3% GDP growth accompanied by high wage growth. That promise was a significant factor in winning the presidency. But that combination is also a key driver of the need for tighter monetary policy. We have always felt that wage growth would ultimately accelerate given the stimulus of last year. While core inflation seems to be under control, the speed of wage growth continues to edge higher and is now at an annual rate of 3.24% (Exhibit #1). Small systematic quarterly increases like the Fed has been doing are consistent with historical precedent around wage growth. So the question becomes, when is the Fed tightening too much? Historically, the real fed funds rate is quite elevated before a recession (see Exhibit #2). The current 0.35% has plenty of room to rise before reaching peaks like the ones preceding prior recessions (peaks preceding the last three recessions were 3.1%, 4.3%, and 5.4%). So the prediction that the economy could withstand higher interest rates better than the stock market appears to be playing out. Of course, the road to higher rates is filled with potholes along the way. Negotiating those obstacles is part science, part art. A pause that refreshes could be a welcome respite as trade issues, fiscal fights, a slowing global economy, and the growing possibility of a no deal BREXIT work their way through the domestic economy. Slower growth could even head off further acceleration of wage growth and lessen the speed of rate normalization.

Optimistic, but Cautious

Nevertheless, a broad-based drop of 20% or more across most markets is not easily dismissed. Growth is clearly slowing despite still elevated U.S. optimism. Businesses still think the future is above average, as indicated by high survey readings. But the public negotiating style of a deal making administration has the side effect of creating uncertainty. Ongoing trade negotiations leave a big question as to the final landscape for expanding capacity and supply chains. Early signs of how the President will deal with a divided Congress also adds to the feeling of uncertainty. So businesses appear to be deferring some of the investment the 2017 tax package was

Exhibit #1: Fed Funds vs. Wage Growth

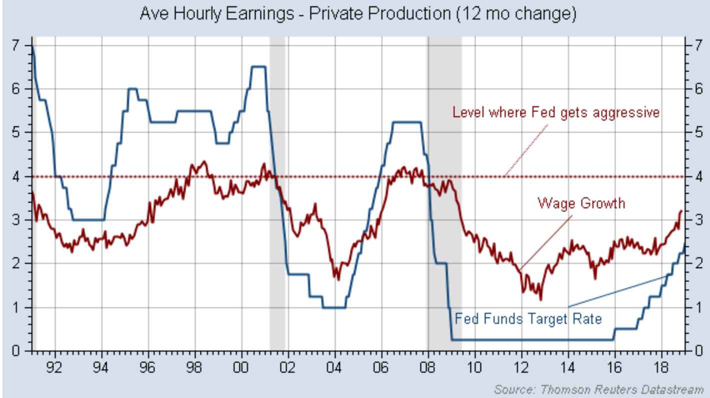
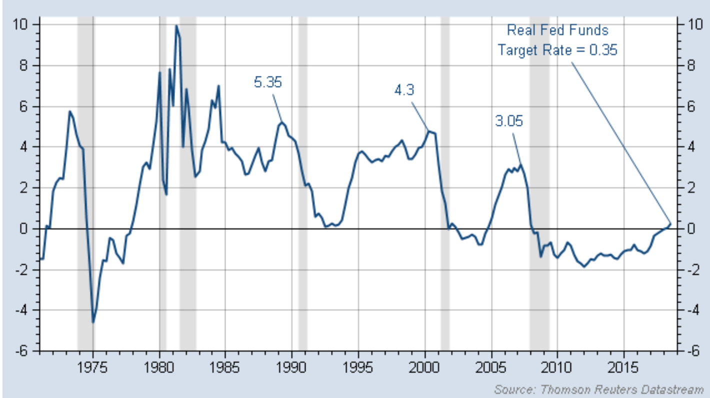


Exhibit #2: Real Fed Funds Target Rate



intended to unleash. This delay has derailed some of the industrial investment we had anticipated in previous newsletters. If that fog clears there may in fact be another strong leg up in capital expenditures. The capacity to invest and need for facility expansion or upgrade still exists. But for now the jury is still out on the willingness of businesses to spend. Until it becomes easier to envision the long-term future, businesses are apt to invest as needed as opposed to in anticipation of the future.

Despite the December optimism reading by the Conference Board sliding sharply, consumers are still optimistic relative to history. Mastercard reported a 5.1% increase in holiday sales, the best growth in years. The University of Michigan Consumer sentiment metric also improved. This is largely being discounted as old news by the market. With consumption being such a large part of the economy, understanding the moving parts is pretty important. On the positive side is strong employment and wage growth. Clearly, the normal late cycle dynamic of waning job growth has been forestalled, while at the same time employers are starting to share the wealth with employees. Regardless, more money in more pockets is a key ingredient to consumption health. Moderate inflation is also supportive of consumption. Too little and consumers delay purchases, while too much makes things expensive and hard to buy. The current level of core

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inflation appears to be just about right. However, without offsetting productivity businesses will be attempting to offset rising labor costs with price increases. Rising import prices due to tariffs are likely to result in a similar response. The feeling of wealth also has an impact. The Federal Reserve has done some research linking the prices of assets like stocks and real estate to consumption. They found that for instance, a 10% correction in the stock market on average is associated with a 3% drop in consumption. Thus this quarter's market swoon could contribute to a slowing consumer economy.

Does Bear Market = Recession

There are a host of potential market outcomes to the current unpredictability in the economic landscape. A market drop of the magnitude experienced in the fourth quarter is generally considered a bear market and can be unnerving. But while a bear market is often associated with a recession, they have a mixed record as a predictor of one. Using the S&P 500, bear markets have been a false indicator seven times since 1964 and a coincident indicator five times. There really has only been one instance where the S&P 500 was down 20% before the recession started and one recession in which the market selloff never reached those depths. Being earnings driven investors, we look to the change in forward earnings expectations for confirmation when there are large market moves. Table #1 below gives a bit of perspective. There have been four previous bear markets since forward earnings estimates have been broadly collected and available. Of those, two are associated with recessions and two are not. In the two associated with recessions expectations for the following year (the cleanest forward looking estimate) had dropped by more than -12% by the time the market reached bear territory. In the two where no recession eventuated expectations had dropped less than -2%. In the current market swoon expectations for next year have dropped -2.2%. There are not enough past examples to draw concrete conclusions and there are a lot of moving parts to the drivers of the 2018 bear market, but so far it feels more like the examples where a seemingly imminent recession was avoided.

Table #1: S&P 500 Drawdowns of 20% or more*

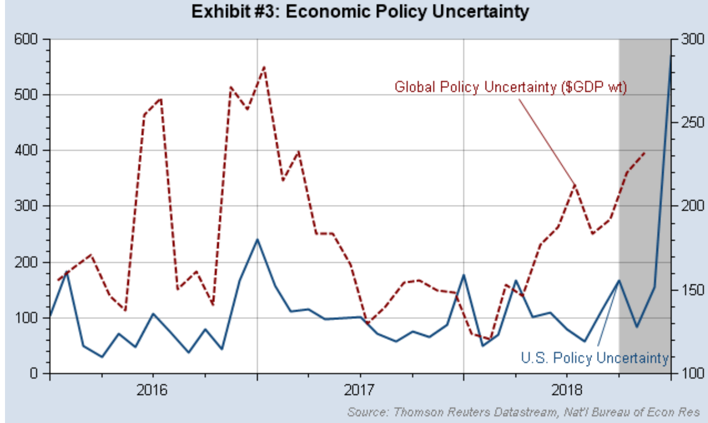
Peak Date	Date of 20% Drop	Drop in FY2 Earnings expectations	Date of final Bottom	12 month return from date of 20% Drop	Recession?
7/20/1998	8/31/1998	-1.1%	10/8/1998	+39.2%	No
9/4/2000	3/12/2001	-12.1%	4/4/2001	-1.2%	Yes
10/9/2007	7/7/2008	-14.8%	3/9/2009	-29.6%	Yes
5/2/2011	10/4/2011	-1.7%	10/4/2011	+30.0%	No
9/20/2018	12/24/2018	-2.2%	?	?	?

** since earnings expectation data has been collected*

Source: ThomsonReuters Datastream

Markets hate uncertainty and there is no lack of it right now. It is notable that U.S. economic policy uncertainty spiked in the fourth quarter as stocks were selling off (Exhibit #3). The fog of a trade war, prospect of a divided government, and monetary policy entering a more neutral stance all added to a giant question mark. While we do not necessarily disagree that the Fed could be more dovish with a slowing economy, high level criticism of the Fed and rumors of a desire to fire the chairman surely added to the uncertainty. Couple that with rising global policy uncertainty and it is not all that surprising that stocks have been a bit of a scapegoat of late. A no deal BREXIT is looking to be more of a possibility when a year ago that outcome was dismissed as folly. As Angela Merkel phases herself out of politics, Emmanuel Macron struggles with domestic unpopularity, Italy flirts with anti-Euro populism, and Mario Draghi weighs stepping aside there is an economic leadership vacuum on the continent. It is hard to get overly optimistic that economic policy has a clear direction.

Exhibit #3: Economic Policy Uncertainty



Abenomics has made progress in Japan, but true structural reform has been elusive. The story continues to play out, but uncertainty is still a

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factor. While we believe uncertainty is a factor in the fourth quarter selloff, we admit that spikes in uncertainty have not always led to tough markets in the past. For instance, uncertainty spiked in December 2016 after the election but markets roared. Hopefully some of the current questions about policy will abate, yielding to a clearer view forward and less stock market stress.

Is the Chinese Economy Growing Up

The growing impact of China on the world economy and the trade war has led to a heightened awareness and market sensitivity to their growth prospects. It might even be justified to add them to the phrase, "When America or China sneezes, the rest of the world catches a cold". But the growth dynamics between China and the U.S. are very different. For instance, Chinese manufacturing purchasing managers survey (PMI) results have dropped below the 50 threshold. In the U.S. we interpret that as an indication that the manufacturing sector is contracting. In China it has historically meant that growth is slowing. In 2016 the index dropped below 50 and industrial production still grew 6% for the year. In 2012 it dipped into contractionary territory, but industrial production still was up 10% for the year. So the sub-50 reading this week is relevant, but does not necessarily represent Armageddon. However, investor worries go beyond what the impact on China will be to what impact slower Chinese growth will have on the rest of the world. Concerns about Chinese growth slowing from double digits to around a paltry mid-single digit rate seem a bit overblown. True, the IMF expects Chinese growth for 2018 around 6.5% and still above 6.0% for next year, which would be a slowing of the economy. The worry is that China has been a primary growth driver of the world economy. But 6.0% growth for the second largest economy can still be a global growth driver.

Table #2 below helps to add some perspective. In 2003, the first year China achieved a 10% growth rate, its GDP was about 4% of the world economy in U.S. dollar terms according to the IMF. That 10% growth accounted for the same percentage of global economic growth that year. At the peak of Chinese growth in 2007 it had grown to 6% of the world economy and accounted for about 14% of world growth. Today, using 2017 as the most recent complete year, it has grown to be 15% of world output and accounts for 27% of world growth despite the slower growth rate. That is more than double the contribution of 2003. Because of their current size they have a greater impact on global growth than when growth rates were substantially higher.

Of course, the China story is more than just one of output and exports. As the emerging middle class has grown in heft the demand for imports has also grown. Since 2000 imports have grown at a rate of about 14% per annum and are currently running ahead of that rate for 2018. While the table below does not directly relate to Chinese consumption of other countries' products, it is indicative of the size and growth of the market in the broader economy. A protracted economic cold war would damage the Chinese and world economies, but the odds are against that happening at this point. We are of the opinion that while the trade war has the potential to get out of hand, stock markets have discounted a worse outcome than is likely.

Table #2: Chinese Contribution to World Growth

Year	China Growth[1]	China/World GDP (US$)	China GDP Change[2] (US$ bil)	Chinese Contribution[3] to World Growth (%)	World Growth (Constant Prices %)
2003	10.0%	4.3%	147	0.43%	4.3%
2007	14.2%	6.1%	394	0.76%	5.6%
2017	6.8%	15.0%	769	1.02%	3.8%

[1] local currency, constant prices
[2] local currency, constant price change times US$ GDP at beginning of period
[3] local currency, constant price change times US$ GDP at beginning of period divided by World US$ GDP at beginning of period
Source: IMF WEO database

Emerging from their Slumber

There has been some nascent interest in emerging market stocks of late. In fact, they have even played a defensive role in the fourth quarter selloff of developed markets. All developed regions except the Pacific ex.-Japan fell further than emerging markets as a whole. Normally, emerging markets outperform in the early stages of an economic and market cycle—not in an aging one. So what is going on? Many emerging countries have historically been driven by cyclical industries, thus the propensity to outperform early in cycle when those industries are benefiting the most and earnings growth is accelerating faster than those of many developed market countries which have a higher proportion of non-cyclical industries. For

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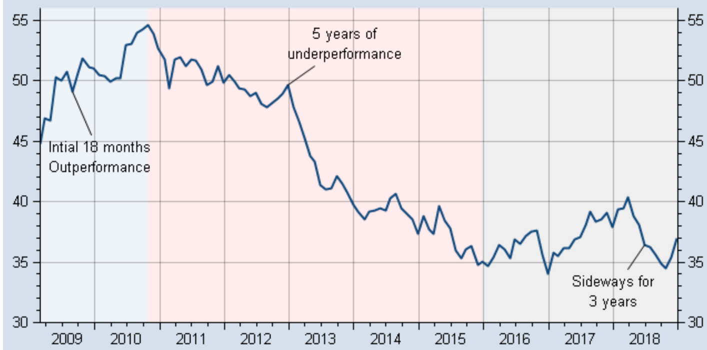
the first 18 months of this bull market emerging stocks performed as expected, handily outpacing developed markets (see Exhibit #4) as relative expected earnings growth accelerated. Then the relationship between emerging and developed country earnings growth went through a period of inconsistency. For the last three years emerging growth expectations have been consistently superior to developed markets in general and the slide in relative performance was arrested. Until recently the exception to that rule was the relative earnings growth and price change against U.S. stocks. But forward earnings expectations shifted to favor emerging markets in October (Exhibit #5), which happened to coincide with when emerging market stock prices began to outperform U.S. stocks. It appears that investors have begun searching for growth in a slowing global profit picture and are shifting allocations to where growth prospects are the brightest. But attractive valuations have also played a role. That anemic emerging market growth between 2011 and 2014 left investors less than enthusiastic and valuations waned. Since that time emerging market price/earnings ratios relative to developed markets have floated in a range even lower than those reached at the depths of the 2009 bear market (exhibit #6). If they are able to deliver some of the earnings growth expected, investor attitudes towards emerging markets could shift further.

Issues Abound, but are they Priced In

There are plenty of issues that could further derail stocks, both domestic and around the world. But stock prices have already corrected sharply. In the U.S., 2018 saw stock prices drop for the first time since the recession, while earnings are on track to be up almost 20%. That correction has a huge impact on valuations that had been looking stretched. Exhibit #7 shows just how low valuations have gotten. Both the S&P 500 and Russell 2000 are back down to levels last seen in 2013, five years ago. Market timing using valuation has long been folly, but long-term investors should find a lot to like with valuations they have not seen in some time and earnings growth likely to remain positive. One could say the second derivative, slower earnings growth, is well accounted for at this point.

Exhibit #4: Emerging vs Developed Markets
Relative Price*

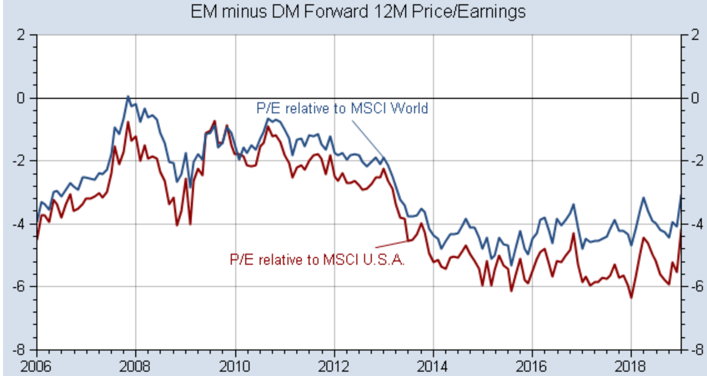


Source: Thomson Reuters Datastream, MSCI, * Em Mkts/World

Exhibit #5: Emerging vs. U.S. Markets
Relative Prices¹ & Earnings Growth Outlook²

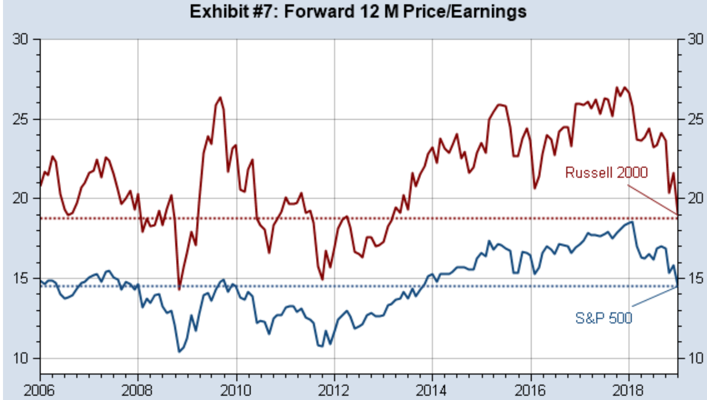
Source: ThomsonReuters Datastream
¹ MSCI EM/MSCI US, ² MSCI EM minus MSCI US F12M earnings growth

Exhibit #6: Relative Emerging vs Developed Markets
EM minus DM Forward 12M Price/Earnings



Source: Thomson Reuters Datastream, MSCI

Exhibit #7: Forward 12 M Price/Earnings



Source: Thomson Reuters Datastream, MSCI

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