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ECONOMIC & MARKET COMMENTARY

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BULL BEAR
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"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions." – Seth Klarman

Human beings are blessed with emotions that help us survive, focus our attention, and motivate us towards action. However, left unchecked, some of those same emotions will frequently cause us harm. The "fear of missing out" is one such emotion that makes us chase positive market returns far longer than we should. People read the news and listen to friends and family describing investment gains that were missed. The fear of missing out in the future causes us to dive headfirst into what appears to be an endless bull market. The tendency is to regret the opportunities that were lost in the past and try to catch up by doubling down in the present. However, that emotional response is often the very reason that a market cycle lasts longer than it otherwise should.

People regret what they could have achieved and assume it is still achievable which helps perpetuate demand for investments at irrational levels. Market prices go higher and higher until something finally changes, usually in a violent way, and people are forced to reset their expectations. Unfortunately, then it is too late and significant market corrections have permanently damaged the portfolios of those same investors who feared that they were missing out.

Markets in Review

Records were broken this quarter as volatility continued to quiet down. Anyone who considers the start of the current bull market to be March 9, 2009, which was the low of the last bear market, viewed August 22nd, 2018 as the record-breaking date that marked the longest bull market in history for U.S. stocks.[1] As of the end of the third quarter, the S&P 500 Index has gained 331% since that March 2009 low. Also, on September 20th, the S&P 500 Index closed at its all-time high as did the Dow Jones Industrial Average the following day. The NASDAQ Composite also closed at an all-time high on August 29th.

Solid economic growth and strong corporate earnings results, boosted in part by tax cuts, helped fuel this quarter's rally. In a September speech, Federal Reserve Bank of Chicago President Charles Evans said, "The U.S. economy is firing on all cylinders, with strong growth, low unemployment, and inflation approaching our 2% symmetric target on a sustained basis."[2]

In contrast to the second quarter, large capitalization value stocks significantly outperformed small and mid-cap ("SMID") value stocks. The Russell 1000 Value Total Return Index, which tracks large-cap value stocks, returned 5.70% for the period whereas the Russell 2000 Value Total Return Index, which tracks SMIDs, returned only 1.60%.

The global expansion continued as well but at a much slower pace, and showed signs of weakness due in large part to the impact of ongoing trade risks that directly affected China and several Emerging markets. Europe also experienced the greatest slowdown in economic growth among developed regions.

Index Type	Selected Index	Q3 2018	YTD 2018
US Overall Equity	DJIA	9.01%	7.04%
US Overall Equity	S&P 500	7.20%	8.99%
US Overall Equity	NASDAQ Composite	7.14%	16.56%
US Large Cap Value Equity	Russell 1000 Value TR	5.70%	3.92%
US SMID Value Equity	Russell 2000 Value TR	1.60%	7.14%
US Overall Value Equity	Russell 3000 Value TR	5.39%	4.17%
Global Equity	MSCI ACWI	3.77%	2.19%
US Fixed Income	Barclays US Aggregate TR	0.02%	-1.60%
Global Fixed Income	Barclays Global Aggregate TR	-0.92%	-2.37%

Unless otherwise indicated, the source for all price and index data used in charts, tables and commentary is Bloomberg. Past performance is not a guarantee of future results. You cannot invest directly in an index.

Fixed income investors also struggled with a small 0.02% increase in the Barclays US Aggregate Total Return Index, as strong economic data and another September hike in interest rates by the Federal Open Market Committee ("FOMC") put upward pressure on yields which move in the opposite direction of bond prices.

Many investors probably saw these all-time record-breaking highs in the U.S. stock market and reports of economic strength as a sign that they should "push all their chips in" and avoid missing out on potential gains that lie ahead.

However, risks to both the economy and market remain on the horizon. The FOMC appears ready to raise interest rates again one more time this year with several additional hikes expected in 2019. Higher interest rates will create a drag on corporate profits as the cost of borrowing increases for companies which have enjoyed a long period of low-cost debt issuance. Mid-term elections could result in significant changes to the political landscape that will be viewed poorly by the markets. Increasing trade tensions between the U.S. and China also remain as trade tariffs went into effect on $250 billion of Chinese products this quarter, and the possibility of a full-blown trade war seems more likely than it did just a few months ago.

Should We Be Concerned About a Recession or the Stock Market?

To some, it appears that we still have plenty of time before the next recession. Strong economic growth, low unemployment and record-breaking corporate earnings continue to bolster the Fed's hawkish stance and yet many analysts don't see a recession happening soon. A recent poll of 51 U.S. economists showed 10% expect the next economic contraction to start in 2019, 56% expect a recession in 2020 and 33% believe it won't happen until 2021 or later.[3]

Last quarter, we discussed the slope of the yield curve, or specifically, the spread between yields on two-year and ten-year U.S. Treasury bonds (commonly referred to as the "2s-10s spread") which is one widely followed indicator of a potential recession. We pointed out that the yield curve closed out the second quarter at 30.7 basis points (a basis point is one hundredth of one percent) which was the lowest level seen since 2007. An inverted yield curve, which occurs when the slope becomes negative and yields on two-year bonds are higher than ten-year bonds, has historically been a good predictor of recession. Every recession in the past 60 years was preceded by an inverted yield curve, although the timing of each recession occurred between 6 and 24 months following that inversion.[4] The 2s-10s spread ended the third quarter at 23.8 basis points, even lower than previously noted, and at one point, dropped as low as 18.8 basis points suggesting that inversion, and a subsequent recession, continues to be likely at some point in the near future.

As investors we need to look beyond current conditions to plan for what will happen next. With the Fed raising interest rates, the elongated economic recovery and bull market is starting to show signs of stress, which may cause positive investing trends to turn negative. The reason we worry about recession is because significant stock market declines typically occur before recessions rather than as a result of them.

In the chart above, we have plotted the S&P 500 Index since 1998 with gray bars marking the last two recessions that occurred during that time period. One can easily see that the market dropped significantly before the 2001 recession. Specifically, between the market high on March 23, 2000 and the beginning of the recession in March of 2001, the S&P 500 fell by -22.12%. Similarly, the index dropped -10.09% between October 9, 2007 and November 26, 2007 before the "Great Recession" began. Certainly, the stock market continued to decline throughout both recessionary periods, but a material amount of damage had already occurred.

Should We Be Concerned About Corporate Earnings?

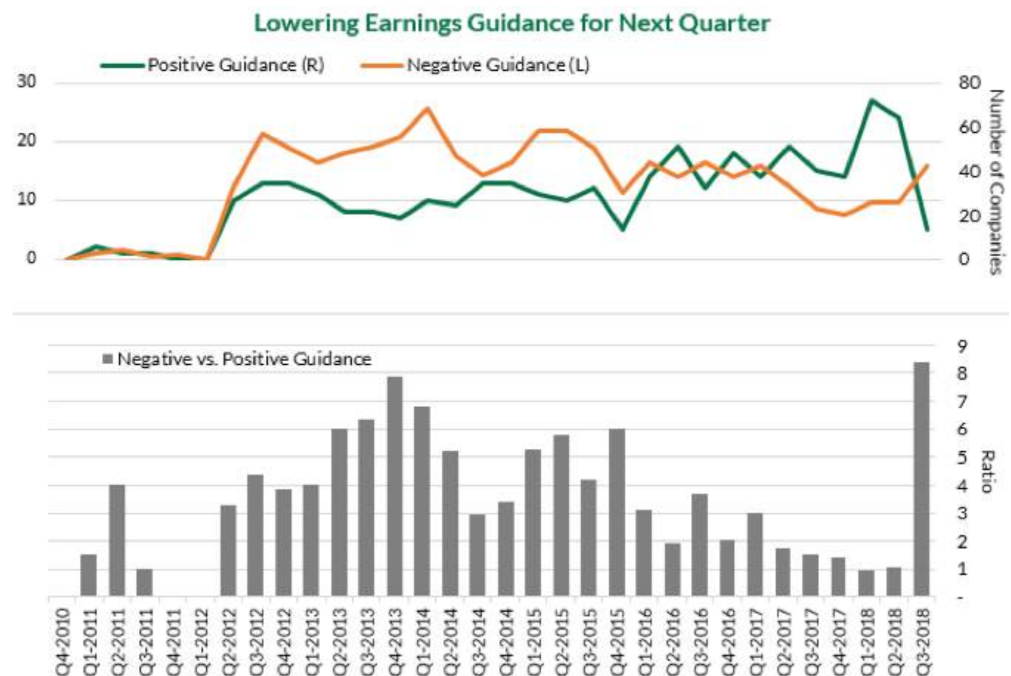
As discussed earlier, corporate earnings continue to grow and hit new record-breaking highs. That impressive performance has certainly helped fuel the market, but what happened the last time earnings were breaking records?

In Chart 1, we have plotted the S&P 500 Index since 1995 against the S&P 500 Index's Earnings Per Share ("EPS") which is an overall market analyst gauge of U.S. corporate profits. As one can see, corporate earnings were at record highs back in 2007 and 2008 too, peaking just before investors would begin to experience a -57% decline in the S&P 500 Index in the bear market that coincided with the "Financial Crisis".

There could be another red flag to watch regarding corporate earnings according to a recent Bloomberg article.[5] Caterpillar Inc. shook the market in April when it suggested that its first quarter earnings results were "as good as it gets" and would be the "high watermark for the year".[6] As it turns out, Caterpillar's comments were early because corporate earnings were even better in the second quarter and look to be higher for the third quarter as well. However, Bloomberg noted recently that the number of companies providing negative profit guidance is outpacing the number of companies providing positive profit guidance by the most since 2010. Further, companies saying profits will trail analyst estimates outnumbers those saying profits will exceed analyst estimates by a ratio of 8-to-1 in the third quarter.

Chart 1

Chart 2



Growth vs. Value and Dividends

In late stage bull market rallies, growth stocks tend to outperform value and dividend stocks by a wide margin and this market cycle is no different. Year to date, the 10 largest capitalization weighted stocks have contributed more than 50% of the S&P 500's return. This handful of mostly non-dividend paying growth and momentum stocks has driven large-cap index performance for the past few years. The top 25 stocks by capitalization are just under 5% of the number of constituents in the index, but they contributed 75% of the S&P 500's return. The other 95% of stocks in the index have only eked out a slightly positive return for the year.

Over the long run, value and dividend paying stocks have outperformed growth stocks by a wide margin. From 2000

to 2017, the S&P 500 Growth Total Return Index produced an annualized return of 4.6% while the S&P 500 Value Total Return Index turned in 6.0%. Recently, investors have favored the growth trade over value and high-yielding stocks. This stark contrast is easily seen by comparing the trailing 12-month returns of the S&P 500 Factor Indexes for growth, value and high dividend through the end of the third quarter. The S&P 500 Growth Factor Index was up 25.21% vs. the S&P 500 Value Index which was up only 10.06% and the S&P 500 High Dividend Index up only 9.79%.[7]

The significant outperformance of growth also comes with a dramatically higher risk profile due to overvaluation and concentration risks. As the Fed interest rate policy starts to affect the economy and markets, growth and momentum investors typically face larger losses when markets correct. On the other hand, as markets break down, value and high dividend stocks tend to outperform on a relative basis as investors seek the safety of value and the traditionally more defensive higher yielding dividend paying stocks.

Control the Fear of Missing Out

Clearly, even with the risks of higher interest rates, political turmoil, trade tensions and peak corporate earnings, people are still fearful of missing out. Investors plowed more money into the market in the third quarter and "allocations to U.S. stocks jumped 10 percentage points [in August] to a net 19 percent overweight, the highest since January 2015" according to a survey of fund managers by Bank of America Merrill Lynch.[8]

Our advice would be that you should not focus on missed opportunities in the past. Rather, focus on what could lie ahead. If you could look back five years from now, what do you think that you would advise yourself to do at this moment in time? Would you tell yourself to double down and try to capture whatever remaining upside might exist in the longest bull market cycle in history? Or would you tell yourself that it is time to be careful, forget about the fear of missing out, and work to protect against losses that severely impact your ability to be financially successful?

This is exactly why WBI Investments continues to try and help investors avoid the dangers that lurk in an environment when emotions and greed cause people to abandon risk protection and chase returns. WBI remains focused on capturing the upside potential of the market but our primary goal is to protect investors from significant loss of wealth, so they have a larger capital base which can compound more effectively over time.

WBI's portfolio management approach applies an active quantitative risk management overlay process that focuses on managing risk and minimizing loss by raising cash as market trends turn bearish. WBI's process was specifically designed to take the emotion out of investing while targeting a larger capital base so you won't miss out on those opportunities offered by the next bull market cycle.

- *Don Schreiber, Jr.*

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Annualized Rate of Return is the return on an investment over a period other than one year (such as one quarter or two years) multiplied or divided to give a comparable one-year return. Dow Jones Industrial Average (DJIA or "The Dow") is a price-weighted average of 30 of the largest and most significant blue-chip U.S. companies. S&P 500 Index is a float-market-cap-weighted average of 500 large-cap U.S. companies in all major sectors. NASDAQ Composite Index (NASDAQ) is a market-value weighted index of all common stocks listed on NASDAQ. Russell 3000 Index is a float-adjusted market-cap weighted index that includes 3,000 stocks and covers 98% of the U.S. equity investable universe. Russell 1000 Index is a float-adjusted market-cap weighted index that includes the largest 1,000 stocks by market-cap of the Russell 3000 Index. Russell 2000 Index is a float-adjusted market-cap weighted index that includes the smallest 2,000 stocks by market-cap of the Russell 3000 Index. Russell 3000 Value TR Index uses the value characteristic book-to-price ratio to create a total return style index based upon the Russell 3000 which includes the performance effect of the dividends paid by stocks in the index. Russell 1000 Value TR Index uses the value characteristic book-to-price ratio to create a total return style index based upon the Russell 1000 which includes the performance effect of the dividends paid by stocks in the index. Russell 2000 Value TR Index uses the value characteristic book-to-price ratio to create a total return style index based upon the Russell 2000 which includes the performance effect of the dividends paid by stocks in the index. MSCI ACWI Index is a free-float weighted index including both emerging and developed world markets. Barclays U.S. Aggregate TR Index is calculated based on the U.S. dollar denominated, investment grade fixed-rate taxable bond market including treasury, government-related, corporate, MBS, ABS and CMBS debt, and includes the performance effect of income earned by securities in the index. Barclays Global Aggregate TR Index is calculated based on global investment grade debt from twenty-four local currency markets including treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers, and includes the performance effect of income earned by securities in the index.

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SOURCES

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