Stembrook Asset Management

# Stembrook Market Review — Second Quarter 2018

News headlines focused on a number of factors that riled equity markets in the second quarter. Threats of a trade war, continued fears of populist movements globally and rising energy prices had an adverse impact on equity returns. International stocks were negatively impacted by a rising U.S. Dollar. We are closely monitoring these issues and how they might impact our portfolio.

The bull market in U.S. equities continued in its 111th month. The only bull market to exceed the current one in length and return was that of the 1990s, based on data from 1926. Thus far in 2018, the lift of accommodative fiscal policy and the continuation of strong earnings growth has far outweighed the drag of tariffs on the U.S. equity market. The VIX Index, a measure of implied volatility in the U.S. equity market fell from the beginning of the quarter to finish at a level of 16.1, below its long-term average.[1]

Global economic indicators look strong. International equity valuations continue to look more attractive than U.S. equities, as displayed in the chart in the center of this page. Based on a core understanding that future earnings and the price one pays for those earnings drive future returns, we continue to overweight non-U.S. equities.

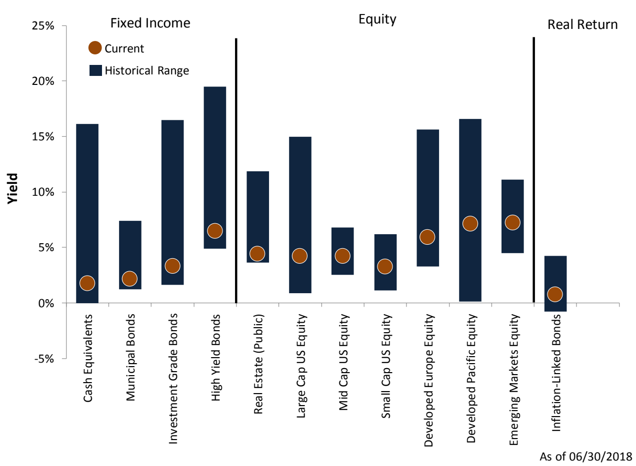
Our proprietary models forecast long-term pre-tax returns ranging from 2% to 3% for fixed income-like asset classes and 4% to 11% for equity-like asset classes (see table to the right). We continue to favor equities over fixed income for long-term investors, though fixed income and cash equivalents have become more attractive as rates have risen. Our more detailed observations and current portfolio positioning are outlined in the following comments.

## Expected Market Returns and Risks 7-10 Year Horizon

| | Pre-Tax Annualized Return | After-Tax Annualized Return | Volatility[1] |
|---|---|---|---|
| Inflation | 2.1% | 2.1% | 3.1% |
| Cash Equivalents | 1.6% | 0.9% | 3.5% |
| Municipal Bonds | 2.1% | 2.1% | 4.4% |
| Inflation-Linked Bonds | 2.7% | 1.5% | 5.6% |
| Investment Grade Bonds | 3.1% | 1.7% | 6.7% |
| High Yield Bonds | 3.3% | 1.6% | 13.2% |
| Real Estate (Public) | 4.4% | 2.4% | 17.5% |
| Broad Market US Equity | 8.3% | 6.5% | 16.9% |
| Developed Non-US Equity | 8.4% | 6.4% | 21.4% |
| Emerging Markets Equity | 10.5% | 6.9% | 29.6% |

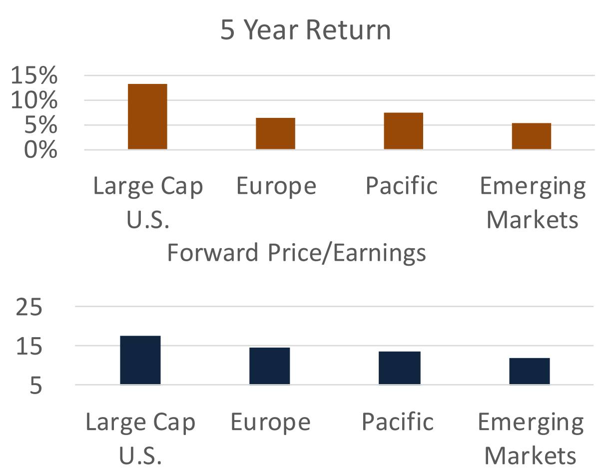
*A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.*

## Yields Across Asset Classes



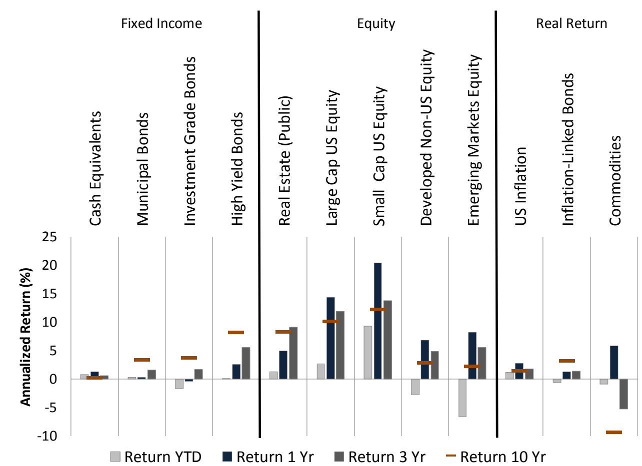

*Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Yields are generally low versus their historical range.*

## Global Equity Returns and Valuations




*U.S. equities have outperformed Non-U.S. equities. Non-U.S. valuations are more attractive on a prospective basis.*

## Historical Market Returns




*Historical market returns as of June 30th, 2018. Note that looking backwards at recent returns is not a reliable method for predicting future returns.*

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## Global Asset Class Returns

| Asset Class Name | Last 10 Years | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Small Cap US Equity | Small Cap 8.6% | Inv Grd Bnd 5.2% | EM Eq 79.0% | Real Estate 28.6% | Infl-Indx Bnd 14.0% | EM Eq 18.2% | Small Cap 41.3% | Real Estate 31.8% | Real Estate 2.8% | Small Cap 26.5% | EM Eq 37.3% |
| Large Cap US Equity | S&P 500 7.0% | CPI 0.1% | HY Bnd 56.3% | Small Cap 26.3% | Real Estate 9.2% | Real Estate 17.6% | S&P 500 32.4% | S&P 500 13.7% | S&P 500 1.4% | HY Bnd 17.5% | Intl Eq 25.0% |
| High Yield Bonds | HY Bnd 6.5% | Infl-Indx Bnd -1.2% | Intl Eq 31.8% | EM Eq 19.2% | Inv Grd Bnd 7.8% | Intl Eq 17.3% | Intl Eq 22.8% | Inv Grd Bnd 6.0% | CPI 0.8% | S&P 500 12.0% | S&P 500 21.8% |
| Real Estate (Public) | Real Estate 6.4% | HY Bnd -26.2% | Real Estate 28.6% | Commod 16.8% | HY Bnd 4.5% | Small Cap 16.3% | HY Bnd 7.4% | Small Cap 5.8% | Inv Grd Bnd 0.5% | Commod 11.4% | Small Cap 13.2% |
| Investment Grade Bonds | Inv Grd Bnd 3.3% | Small Cap -31.1% | S&P 500 26.5% | HY Bnd 15.2% | CPI 3.0% | S&P 500 16.0% | Real Estate 1.9% | Infl-Indx Bnd 4.6% | Intl Eq -0.2% | EM Eq 11.3% | Real Estate 8.7% |
| Inflation-Linked Bonds | Infl-Indx Bnd 2.9% | Commod -35.6% | Small Cap 25.6% | S&P 500 15.1% | S&P 500 2.1% | HY Bnd 15.4% | CPI 1.5% | HY Bnd 2.5% | Infl-Indx Bnd -1.4% | Real Estate 8.6% | HY Bnd 7.5% |
| Developed Non-US Equity | Intl Eq 1.8% | S&P 500 -37.0% | Commod 18.9% | Intl Eq 7.8% | Small Cap 1.0% | Infl-Indx Bnd 7.2% | Inv Grd Bnd -2.0% | CPI 1.3% | Small Cap -2.0% | Infl-Indx Bnd 3.6% | Inv Grd Bnd 3.5% |
| Emerging Markets Equity | EM Eq 1.5% | Real Estate -39.2% | Infl-Indx Bnd 10.1% | Infl-Indx Bnd 6.5% | Intl Eq -12.1% | Inv Grd Bnd 4.2% | EM Eq -2.6% | EM Eq -1.8% | HY Bnd -4.6% | Inv Grd Bnd 2.6% | Infl-Indx Bnd 3.0% |
| Inflation | CPI 1.4% | Intl Eq -43.4% | Inv Grd Bnd 5.9% | Inv Grd Bnd 6.5% | Commod -13.3% | CPI 2% | Infl-Indx Bnd -9.4% | Intl Eq -4.5% | EM Eq -14.8% | CPI 1.8% | CPI 2.1% |
| Commodities | Commod -5.8% | EM Eq -53.2% | CPI 2.7% | CPI 1.5% | EM Eq -18.4% | Commod -1.1% | Commod -9.5% | Commod -17.0% | Commod -24.7% | Intl Eq 1.6% | Commod 0.7% |

*Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.*

### Economic Backdrop

- Global GDP is expected to increase to 3.6% in the second quarter for G-20 countries.[2] Inflation is also expected to increase to 2.7% for the same group.[3]
- GDP growth in the U.S. is expected to double to 4.0% in the second quarter.[2] It is important to note that this growth rate is not expected to persist as the labor market continues to tighten and the lift from the corporate tax cuts begins to fade.
- In the Eurozone, GDP growth is expected to fall by 0.2% to 2.3% in the quarter.[2]
- GDP growth in Japan is expected to increase to 2%. This comes after a contraction of -0.6% in the first quarter of this year.[2]
- GDP growth in emerging markets is expected to remain at 5%. All members are expected to grow by over 1.5%, demonstrating stronger breadth within the group.[2]
- As expected, the U.S. Federal Open Market Committee raised the federal funds target interest rate by 0.25% to 2.00% in their June meeting. The majority of economists polled by Bloomberg expect 1-2 additional rate hikes in 2018 and target 2.25% to 2.50% by the end of the year.
- The Global Purchasing Managers Index remains elevated at 53.0 with North America and European countries signaling very high levels of optimism. Emerging market economies remain elevated at a level of 51.2. Readings above 50 indicate expansion, while readings below 50 indicate contraction.[4]

### Currencies

- The U.S. Dollar reversed its downward trajectory in the quarter and was up by 5%.[5] This gain in the dollar reduced returns on non-U.S. equities owned by U.S. investors.
- Note that non-U.S. companies should become more competitive as the price of their goods and services drops due to depreciation of their currencies versus the U.S. Dollar.

### Equities

- The broad U.S. equity market was up 3.7%.[6] Developed Non-U.S. stocks were up 4.7% in local terms but fell by -1.1% in U.S. Dollar terms.[7]
- Emerging markets equities were most adversely impacted by fears of a potential trade war. The index fell by -4.2% in local currency and was down -7.9% in Dollar terms.[8]
- Within the U.S., small cap equities, which tend to be less exposed to global commerce, rallied, up 8.8% in the quarter,[9] while large cap stocks were up 3.4%.[10] Technology heavy Nasdaq stocks continued to rally, finishing the quarter up 6.6%.[11]

### Fixed Income

- Yields continued to increase in the quarter, and investment grade bonds returned -0.2%.[12] Credit continued to outperform other fixed income asset classes and high yield bonds were up 1.0% in the quarter.[13]

### Current Positioning

- After over 7 years of outperformance, we **reduced our floating rate bond allocation** in taxable and tax-deferred portfolios and reinvested the proceeds in **shorter duration core fixed income.**
- We maintain our recent shift to marginally **underweight large cap U.S. equities.** After years of holding an overweight position in an outperforming market, valuations have risen to above average levels and our models indicate that a reduced allocation to the U.S. market is prudent despite strong recent relative performance.
- We also maintain our recent shift to **overweight developed non-U.S. and emerging market equities**, where valuations and long-term growth potential remain attractive.
- We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility.
- We remain **overweight municipal bonds** for taxable investors.
- Our fixed income portfolio continues to be positioned for a normalization of central bank policy. Given our significant concerns regarding a longer-term, secular rise in interest rates and the resulting negative impact on bond prices, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries.**

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses time-tested return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA        Thomas Kosinski

## Endnotes and Sources:

**Text:**

(1) Bloomberg: CBOE VIX Volatility Index. As of 6/30/18. Long term average from 1/30/90 to 6/30/18 is 19.35.
(2) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 6/30/18.
(3) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 6/30/18.
(4) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 6/30/18.
(5) Bloomberg: Dollar Index. 3/31/18-6/30/18.
(6) Bloomberg: S&P 1500. 3/31/18-6/30/18.
(7) Bloomberg: MSCI EAFE. 3/31/18-6/30/18.
(8) Bloomberg: MSCI Emerging Markets. 3/31/18-6/30/18.
(9) Bloomberg: S&P 600. 3/31/18-6/30/18.
(10) Bloomberg: S&P 500. 3/31/18-6/30/18.
(11) Bloomberg: NASDAQ Composite. 3/31/18-6/30/18.
(12) Bloomberg: Bloomberg Barclays Aggregate Bond Index. 3/31/18-6/30/18.
(13) Bloomberg: Bloomberg Barclays U.S. Corporate High Yield Index. 3/31/18-6/30/18.

**Charts:**

**Expected Market Returns and Risks, 7-10 Year Horizon: As of 6/30/18.**
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

**Yields Across Asset Classes: As of 6/30/18.**
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

**Global Equity Returns and Valuations: As of 6/30/18.**
Source: Bloomberg
Indices: S&P 500, MSCI Europe, MSCI Pacific and MSCI Emerging Markets. All returns in U.S. Dollars.

**Historical Market Returns: As of 6/30/18.**
Source: Bloomberg, Stembrook Research.
Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

**Global Asset Class Returns: As of 12/31/17.**
Source: Thomson Reuters, Bloomberg, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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Additional information is available upon request.