Our View
April 2019

Preface

In the first quarter, the Federal Reserve made four separate statements to the effect that they had, or would, stop tightening and left the unstated impression that their next step might even be to start easing. One would be justified in thinking that they had decided to give the stock market a reason to go up. If that was in fact their intention, it worked. The S&P 500 which had been down 13.5% in the fourth quarter, was up 13.6% in the first quarter (see Table 1). As a result, equity holders should be more than satisfied with returns for the quarter. However, a closer look at fundamental developments present a more nuanced view, one that highlights a deceleration in the growth trajectory of the U.S. economy and corporate earnings.

Late Cycle (U.S.)

It is often hard to know the specific elements and their mix that spooks or rallies a market, but as we look back to the fourth quarter of 2018, one of the overlying fears in the market was a concern that the Fed would raise rates too fast and far, which historically almost always led to a recession. That fear seems to have been laid to rest, for now. However, one must consider what changed for the Fed to pivot so quickly. One logical conclusion is that the rate of growth of the U.S. economy decelerated, producing a noticeable and meaningful slowdown in corporate earnings growth (see Chart 1).

Chart 1: S&P 500 Earnings[1]

Year over year earnings growth in Q4 2018 was still very high at +16%, but this was a notable deceleration from 29% growth in Q3 2018, which included the peak impact of the corporate tax cut and, of course, will not be repeated. The rapid decline in the impact of the tax cut on corporate earnings growth will continue in the first quarter of this year; the consensus earnings estimate for the S&P 500 now stands at +5%.[1]

Table 1: 2019 Performance YTD[1]

Index	Q1
S&P 500	13.6%
MSCI All Country World Index ex -U.S.	10.4%
Barclay's Aggregate Index	2.9%

Ultimately, the path of the market will be driven by the trajectory of earnings. One might hypothesize that the market's behavior in the first quarter reflects expectations that future growth will pick up, but we think that there are several elements that make accelerating U.S. earnings growth a challenge. For example, some economists see a deceleration in the economy as their base case, reflecting an aging U.S. economic cycle. Additionally, continuing wage increases, higher short-term interest rates today than a year ago, and a strong U.S. Dollar are all threats to historically high corporate profit margins (see Chart 2). In aggregate, fundamental uncertainty, both economic and geopolitical, is rising which leaves us with the same conclusion we had six months ago -- an underweight to U.S. equities appears to be a prudent position at this stage of this cycle.

Chart 2: S&P 500 Corporate Profit Margin[1]

[1] Source: Bloomberg.

Long Cycle (Asia)

One of the natural places to find compelling long-term investments is to look at what has been out of favor, or where there is an excessive amount of skepticism already priced into the underlying securities. For us, Asia fits this definition, whether it is India or SE Asia (not well understood), or China (the epicenter of investor fear). Simplifying the potential opportunity to its core, Asia presents the best intersection of market inefficiencies, growth rates that are multiples of those possible in the western world, and attractive valuations, making it a rich hunting ground for investments.

To be clear, we are not investing via broad Asian indices which are often dominated by large banks and commodity producers, or in state-owned enterprises which employ sub-optimal corporate governance. Instead, we favor managers who seek to invest in owner-operated entities, many of which have little or no sell-side research coverage, which amplifies the inefficiencies of the market to the advantage of the investor. In addition, the sheer size of Asia, 4.5 billion people covering 48 countries and nearly 50% of the world's GDP,[2] means that our managers are sifting through very diverse economies and end markets, with vastly different demographic profiles, wealth distribution, and growth trajectories. While many researched opportunities will not be investible, there will be numerous end markets and thus companies where our managers' research focus will produce undiscovered gems.

The combination of social transformation such as the move toward continued urbanization, rising consumption, growth of new service-oriented economies and transformational technology adoption is leading to long-term economic and earnings growth rates that will be significantly higher than what can be achieved in "more mature and wealthier" western markets. Today, this growth is being valued at a meaningful discount, which further accentuates the attractive risk-reward opportunity available to long-term investors (see Table 2).

Current Positioning

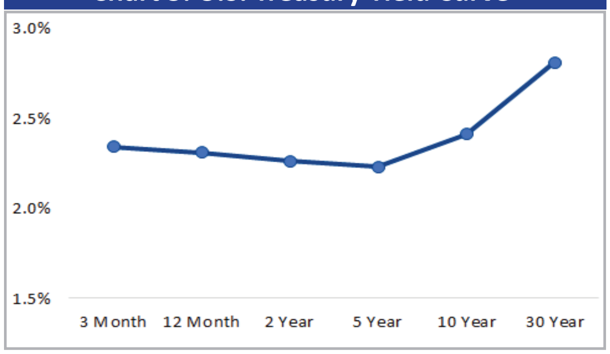
Because we had repositioned our equity exposure before the market declines in the fourth quarter of last year, we did not make substantial changes to portfolios in the first quarter. Client specific mandates can differ, but our typical portfolio is underweight exposure to U.S. equities and overweight Asian equities.

Table 2: Valuations[3]

Index	P/E	P/B	P/S
S&P 500	17.2x	3.4x	2.2x
MSCI Asia ex-Japan	13.4x	1.6x	1.2x
MSCI AC Asia Pacific	13.7x	1.5x	1.3x

As one can see in Chart 3, the U.S. yield curve now provides essentially the same yield for one-year and ten-year Treasuries, with a very slight inversion (lower yields) in between. As a result, we continue to be comfortable with fixed income exposure of one-year (short duration) U.S. Treasuries. Arguments can be made on both sides for higher or lower rates from here. Certainly, the forward path is likely to be noisy and in our view a position in one-year Treasuries is a safe and liquid security that provides portfolios the market yield until a more obvious opportunity arises.

Chart 3: U.S. Treasury Yield Curve[1]



[2] Source: Financial Times. GDP using Purchasing Power Parity.
[3] Source: Bloomberg. Price/Earnings ratio uses forward 12-month earnings.