Preface

Equity markets declined sharply in the fourth quarter ending the year in negative territory globally (Table 1). While it is difficult to pinpoint a single factor that caused the market reversal, the culprits were concerns about rising interest rates, geo-political uncertainties such as Brexit, trade war escalation and increased concern about the possibility of a material policy mistake. While there is a universal abhorrence for negative returns, the quarter was made more tolerable as New Providence had positioned portfolios to be underweight equities and other risk assets. In addition, volatility creates silver linings amidst the storm clouds, especially for the patient investor with a long-term perspective.

Table 1: 2018 Performance

Index	Q4	2018
S&P 500	-13.5%	-4.4%
MSCI All-Country World Index ex-U.S.	-11.4%	-13.8%
MSCI Emerging Markets	-7.6%	-14.2%

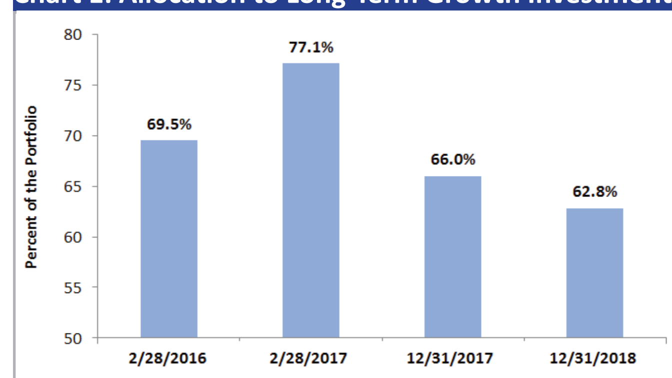
Note: Total return in U.S. Dollars. Source: Bloomberg.

Storm Clouds

The S&P 500 decline from its peak in September through year end was -14.5%. The last time we had a decline of this magnitude (-14.1%) was from July 20th 2015 through February 11th 2016[1]. In February of 2016, we circulated an internal memo, which ultimately was the crux of our first quarter client letter that year, that set out our conclusion that the economic facts were positive despite the market reaction indicating the opposite. At that time the "facts" included the following: monetary policy was very accommodative; there were no signs of recession; there were no substantial excesses in the business sector; the consumer's balance sheet was improving; the housing and auto sectors were strong; corporate profits were accelerating; inventories were at appropriate levels; and the price of oil was extremely low. All of this informed our decision at the time to increase our already overweight exposure to equities.

In the spring of 2017 we began to gradually reduce equity exposure and we continued to do so on market strength through the third quarter of 2018, a period of six quarters (Chart 1). As a result, we entered the fourth quarter underweight equities. With the recent market decline, equity valuations are now lower than in February 2016, so it is worth reviewing what is materially different from three years ago, when after a stock market decline, we positioned portfolios to be overweight equities and risk assets. First, the Federal Reserve is no longer highly accommodative, rather it has raised interest rates nine times and has begun quantitative tightening (QT) of its balance sheet. The amount of QT so far is believed to equal two or three additional interest rate increases of 25 bps. This drain on liquidity will be further exacerbated by rising federal deficits, which absorb capital that could have been invested elsewhere with greater productivity and higher returns.

Chart 1: Allocation to Long-Term Growth Investments



Note: The allocations illustrated above are representative of the New Providence Balanced Portfolio, LP (NPBP). Long-Term Growth Investments include U.S. Long-Only Equity, Global Long-Only Equity, International Long-Only Equity, Private Equity

In addition, we are seeing signs of growth deceleration, both in the global economy and in corporate earnings. Focusing on U.S. corporate earnings specifically, it is a consensus view that earnings growth will sharply decelerate in 2019, having risen steadily since 2016. Today, with a strong U.S. dollar, rising labor costs, and the anniversary of U.S. corporate tax cuts, there is a concern that U.S. corporate profit margins have peaked. The impact from trade wars has been minor on corporate earnings thus far, comprising mostly proposed future increases and an exchange of negotiating positions. If, however, there were a material escalation and implementation of tariffs, whether it be on auto imports and/or China Inc., it would be negative for corporate margins, profits, and of course, confidence.

Silver Linings

The recent elevated volatility has led to some degree of indiscriminate selling, and therein lies the opportunity for investors with relatively long performance measurement horizons. Today's news flow is highlighted by "if it bleeds it leads," and squawk box hyperbole and noise, all of which is focused on an extraordinarily short perspective. Predicting the exact outcome and timing of the trade war with China, or other disruptive

[1] Price return ex-dividends. Source Bloomberg.

acts such as Brexit, is impossible. What we do know is that concerns related to these shorter-term events are at least partially factored into market valuations. This is creating interesting opportunities. Investing entails at a minimum the discounting of future cash flow streams from a given asset, including its terminal value (if any!). The recent sell off has reduced the cost to acquire these cash flows, and valuations today are significantly more attractive than a year ago (Table 2). For an investor who has been partly in cash, the opportunity to begin gradually taking on some equity exposure has greatly improved.

Table 2: Price Earnings Ratios

Index	Current P/E	1 Year Ago P/E
S&P 500	14.6x	20.0x
MSCI All-Country World Index ex-U.S.	11.6x	15.6x
MSCI Emerging Markets	10.6x	14.2x

Note: Price earnings ratio based on consensus estimates of forward 12 month earnings. Source: Bloomberg.

Current Positioning

Early in the fourth quarter we sold our short duration high yield investments, a hybrid investment of bonds with equity-like risk characteristics. Our basic thesis was that the opportunity in high yield had played out and that the risk-reward going forward was asymmetrically skewed against the asset class. (The New Providence website[2] has a presentation detailing our thoughts about the current U.S. high yield market.)

We are looking at opportunities in Asia, including China, where stocks have declined by 25% to 35% from the January 2018 peak. Furthermore, we continue to look for uncorrelated investment opportunities that add a yield component or have the capability to hedge certain risk factors within our portfolios. A recent investment in a relative credit strategy is one example. The strategy seeks to benefit if/when there is a dislocation in the investment grade credit markets while simultaneously providing a modest yield.

Our fixed income exposure remains in short duration U.S. Treasuries as we outlined last quarter. While portfolio liquidity will differ for client-specific reasons, in general, we continue to favor maintaining higher than usual cash reserves so clients can fund annual draw requirements without concern, and to provide the ability to take advantage of opportunities in equity markets as they arise.

[2] https://newprov.com/news-publications.