

## Preface

U.S. equities performed well in the third quarter +7.7% (see Table 1), significantly outperforming all other geographic areas, particularly Asia ex-Japan, which declined 1.5% for the quarter, a continuation of a divergence trend that we saw emerge in the middle of the second quarter. Exposure to U.S. equities remains the largest geographic allocation in client portfolios but an area where we have been trimming exposure on market strength. While we did not make substantial changes to portfolio allocations in the third quarter, our bias today is that the next portfolio move is likely to be to further trim exposure to equities as the current cycle ages.

### Table 1: 2018 Performance

Index	Q3	YTD
S&P 500	7.7%	10.6%
MSCI Asia ex-Japan	-1.5%	-6.2%
Barclays Aggregate	0.0%	-1.6%

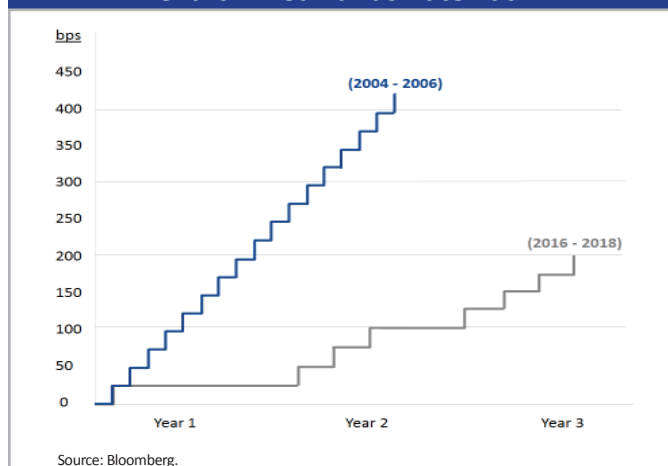
Note: Total Return in U.S. Dollars. Source: Bloomberg.

## U.S. Equity Market

Several positives have driven the U.S. equity market higher this year, foremost has been very strong earnings growth. However, markets are leading indicators, and when things are “as good as it can get” that is the time to be concerned. The consensus view, with which we agree, is that earnings growth in the U.S. will decelerate in 2019 (from +32% to +10%)<sup>1</sup>. The corporate tax cut of 2018 will not be repeated, nor will the windfall of corporate profits used in part to repurchase corporate stock in record amounts. The absence of these tailwinds, coupled with rising wages, increasing interest rates, a strong U.S. dollar and higher energy costs will markedly slow the growth of reported U.S. corporate earnings per share.

Inflation has not been problematic yet, and because growth has been generally suppressed this cycle, the Federal Reserve has been slow to raise rates in comparison to the last cycle (see Chart 1). This has allowed for a historically long cycle, one which can continue until tight credit conditions and/or large financial imbalances prove overwhelming. It is notable that U.S. trade policy is beginning to create some unintended side effects. Trade wars and tariffs are bad for both sale volumes (lower) and sale prices (higher). We are concerned that if the current tariffs and on-going negotiations are left in place too long they are likely to add to inflationary pressures. One cannot forget that the longer the positive economic cycle continues and inflation increases the more the Fed will raise rates, and rising rates have always brought a bull market to an end; the only question is when?

## Chart 1: Fed Funds Rate Path



## Asia

Investors familiar with New Providence know that we are positive on Asia long-term, specifically India, and to a lesser degree China. Last year Asian market performance was very strong, Chinese equities were up 32% to 54%, and Indian equities rose 39% to 46%, depending on the specific index. The last few months of this year has been a different story for a variety of reasons.

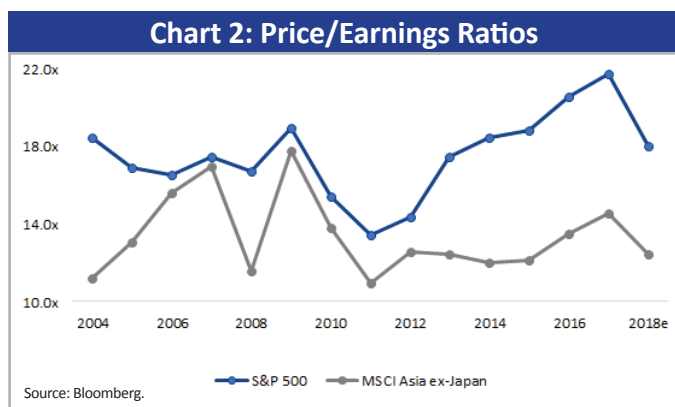
- Due to a confluence of a hawkish U.S. administration and legitimate concerns about China’s intellectual property and trade practices, and growing geopolitical influence, China has become a politically acceptable target in the U.S. China’s stated goals of “China 2025” and “One Belt, One Road” are not verbal puffery but legitimate long-term threats to U.S. economic interests in Asia and beyond. The United States has had one massive economic advantage over the rest of the world as the U.S. dollar has been the global reserve currency. China and other trading partners would like to see multiple reserve currencies, in effect loosening the global markets dependence on the U.S. dollar. This is truly a long-term game but one that is of enormous strategic importance. As a result, trade discussions with China are inherently different than those regarding NAFTA and the EU, where the U.S. tactic has been to complain loudly, settle for some minor concessions, take a victory lap, and move on. The end game for China-U.S. trade relations is opaque because the stakes are higher. With that in mind, the China trade issues are much noisier and will drag on longer. We suspect this will create a long-term opportunity for investors, but the calculus will be complicated, and timing it will be challenging. If our base case does not play out and a resolution occurs quickly, there will likely be a very positive reaction for Chinese equities and its currency.

- India’s equity market had been flat to slightly negative year to date through August but declined roughly 10% in September. While one can come up with several reasons for the recent weakness, the September catalyst was a debt default by IL&FS,

<sup>1</sup> Source: Bloomberg.

an infrastructure finance company that had a “AAA” rating as recently as June. This raised market fears that other financial institutions had similar credit quality issues and led to a broad selloff. Complicating factors, but ones not unusual to investing in India, include the fact that India’s currency has weakened versus the U.S. dollar. India is a large importer of oil, and rising energy prices in the face of an oil embargo on Iran coupled with a weaker currency is causing concern for investors, and an outflow of dollars. As for IL&FS, our discussions with managers and contacts in India suggest there is not a systemic credit problem, although it will have a negative short-term impact on credit availability. Concerns have bled into October and we will look for opportunities to take advantage of the volatility just as the managers we employ there are doing now.

- It is normal for U.S. equities to trade at a premium valuation to Asian equities as Chart 2 shows. However, the spread between valuations is now relatively wide on both a multiple point and percentage basis which creates a potential opportunity. This valuation disparity is not just on earnings but also exists using metrics such as price to book, price to sales and price to cash flow.



## Current Positioning

Recently, and including the beginning of October, we have seen a meaningful rise in U.S. Treasury bond yields. The question is what is the driving force? The usual culprit is accelerating growth and/or rising inflation. In this case there are two additional possibilities: a growing concern about rising fiscal deficits, and a potential disruption to global supply chains and goods flow from a trade war. Regardless of the cause and without knowing how far or how fast rates could rise, we remain focused on short duration fixed income investments as the relatively flat shape of the yield curve does not currently provide an appropriate risk/reward opportunity in longer term bonds. As we have mentioned previously, we also are looking for diversifying investments that are uncorrelated to equity markets and provide an attractive yield and/or provide a protective role in the event of market turbulence.

With regard to private equity, we are following this industry’s evolution carefully. As these funds attract record amounts of capital on a global basis, the competition for deals and purchase price multiples are increasing substantially. While we have committed capital to select international/global private equity opportunities where we believe the competitive landscape and manager strategies are attractive, it is fair to say that the bar for commitments has risen in the current investment environment.

All of this leads us to conclude that it is prudent to be more cautiously positioned despite the “as good as it gets” high frequency economic data. Even with that in mind, the divergence in equity market relative performance may also provide an opportunity to add to our highest conviction long-term ideas at attractive levels.