



## WealthShield Quarterly Outlook | Q1 2019

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# INVESTMENT FRAMEWORK

## MARKET SENTIMENT

Are asset classes in positive or negative trends? How are asset classes trending relative to each other?



## VALUATIONS

How expensive are assets? Where do they stand relative to historical prices?

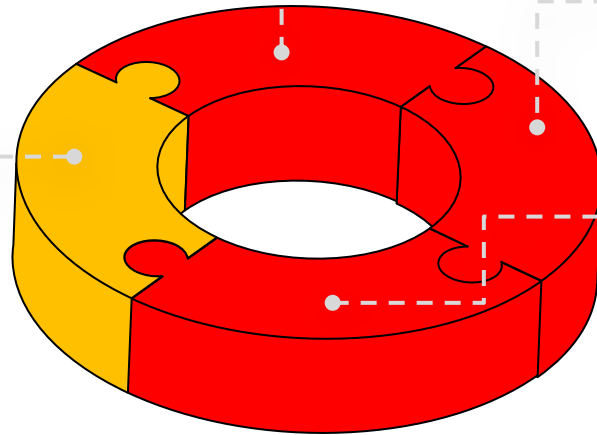
## FEDERAL RESERVE ACTIVITY

Expansionary or Restrictive?



## ECONOMIC ACTIVITY

Is the economy growing or shrinking?



# THE THIRD MANDATE

Six months ago the Federal Reserve was tightening policy by raising interest rates systematically and reducing the size of their balance sheet by selling bonds in the open market. The US and global economies had been in a growth accelerating regime whereby both growth and inflation were moving upward. Cooperative global stimulus, negative interest rates, and quantitative easing helped spur the economic acceleration after the contraction of 2015-2016. The growth, however, was met with a tightening Fed and global central banks that were not as keen on continuing to ease policy. That was the case until economic growth and inflation started to decelerate.

Growth and inflation, accelerating together, are historically later cycle phenomena. That is why the Fed tightened policy. Ultimately, the tightening of policy created a headwind for economic growth and inflation. That turning point was met with market volatility. However, what is so amazing is that now, six short months later, the Federal Reserve is on hold. No more interest rate hikes, and by October, no more balance sheet reductions. White House economic adviser, Larry Kudlow, is even calling for an immediate 50 basis point rate cut.

What caused the complete 180 from the Federal Reserve? How could six months alter their forecast and economic view so much? To start, we will say that, in our opinion, the Federal Reserve is completely correct in stopping their tightening of policy. The reason why is that we believe the US and global economies are extremely fragile today. Since the global financial crisis, almost continuous central bank support has been required to reflate asset prices and spur subpar economic growth. In hindsight, it is quite simple to see that every time the stimulus starts to wind down, economic growth slows and asset markets become more volatile. The global economy has been reliant on central bank support and the Fed is right to consider this in their policy actions.

Furthermore, it is clear that the Federal Reserve has a third, unspoken mandate. Many consider the third mandate to be the stock market. However, it is more than that in our opinion. We think it is all about confidence, and what better confidence barometer than the stock market. The response by the Fed wasn't because of terrible economic data. It was because of the pick up in equity market volatility, which to them, suggested a deterioration in confidence. Maintaining confidence, we believe, is why the Fed pivoted in a dovish fashion. It is also the reason why an interest rate cut is most likely on the way if markets respond negatively to continued slowing economic data.

# THE THIRD MANDATE

The economic data over the last quarter has continued to support the notion that economic growth is decelerating. The Atlanta Fed GDP Now has real GDP forecasted at 1.7% quarter over quarter for the first quarter of 2019. That is down from 2.2% quarter over quarter in the fourth quarter of 2018 and down from the peak of 4.20% in the second quarter of 2018. Coupled with a 20% decline in US equities and a deeper retrenchment in foreign stocks, it is no wonder the Fed has worked to restore market confidence.

We have to wake up to the reality that the Fed has evolved. They are more sensitive to economic activity and equity market volatility than historically evident. This presents an interesting set of market regimes and realities that investors must adapt to. Market participants have to remember not to fight the Fed. However, the Fed cannot be the only factor one considers when making investment decisions. Knowing that they are keen on maintaining confidence can aid in helping investors know their next move. If inflation is under target and growth is continuing to slow, most likely the Fed will continue to ease policy. If stock market volatility picks up in response to economic growth slowing, one can expect the Fed to respond with even more urgency. These responses can create impressive rallies and even more impressive declines in equities markets with any mishap.

We are facing one of the most perilous market backdrops of any time in history. Valuations are in the top decile of historical observations and suggest below average returns for US equities markets. Seven year forecasted returns across all asset classes are below average across the board according to GMO. This implies a late cycle environment and one that is getting harder to support by stimulus and accommodative policy. Pair that up with global stocks still in negative trends relative to US Treasuries, as well as slowing economic and corporate profit growth, and you have a recipe for a higher level of equity market volatility than we have become accustomed to over the last few years. This is the type of environment we will likely see for the next few quarters: one in which equity market volatility will elevate in response to slowing economic growth. Therefore, an easing Federal Reserve (not simply a dovish one) should become a reality. How the market will react to an easing Fed is anyone's guess. We have to remember that the market is not the economy.

Despite the rebound in risk assets over the first three months of 2019, our framework continues to support a defensive posture. We believe we are in a higher equity market volatility regime and negative divergences have been continuing to pile up over the last several weeks, thus implying that a consolidation period or correction may be in our future. As far as the playbook is concerned, we continue to believe that low volatility and quality factors, dividend growth stocks, defensive sectors, and government bonds are the optimal places to position for the current environment. If the facts change (i.e. growth starts to accelerate), we will change with them. Right now, the Fed is the only thing within our framework that has improved in a meaningful manner.

**Bloomberg**  @business · Mar 29

White House chief economic adviser **Larry Kudlow** called on the Federal Reserve to “immediately” cut interest rates by a half percentage point



**Trump Scolds the Fed Over ‘Mistakenly Raised Interest Rates’**  
President Donald Trump ratcheted up his pressure on the Federal Reserve, saying that if the central bank had “not mistakenly raised interest rates,” ...  
[bloomberg.com](https://www.bloomberg.com)

165 118 133

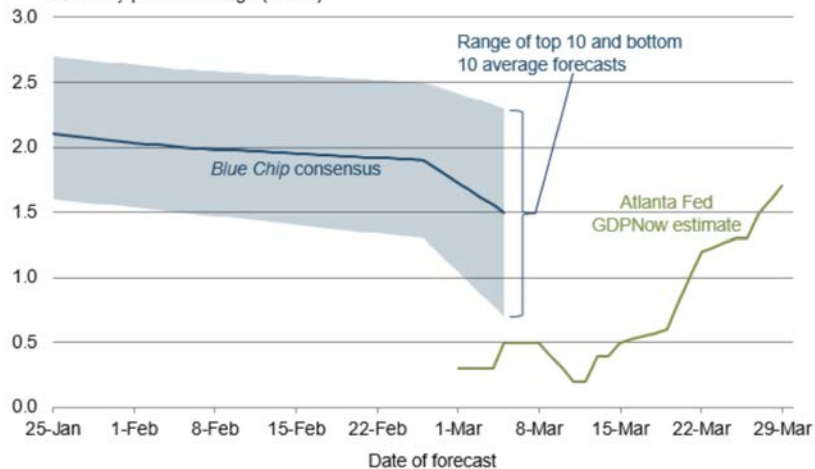
 **Donald J. Trump**  @realDonaldTrump · Mar 29

Had the Fed not mistakenly raised interest rates, especially since there is very little inflation, and had they not done the ridiculously timed quantitative tightening, the 3.0% GDP, & Stock Market, would have both been much higher & World Markets would be in a better place!

13K 20K 85K

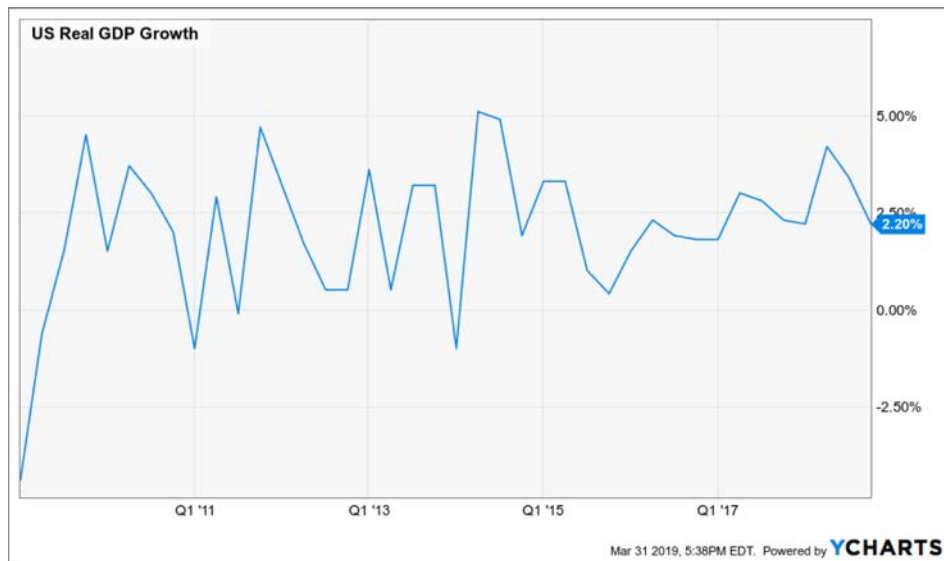
**Evolution of Atlanta Fed GDPNow real  
GDP estimate for 2019: Q1**  
Quarterly percent change (SAAR)

**GDPNow**



Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.



Mar 31 2019, 5:38PM EDT. Powered by YCHARTS

Chart 1 & 2: Growth is slowing.

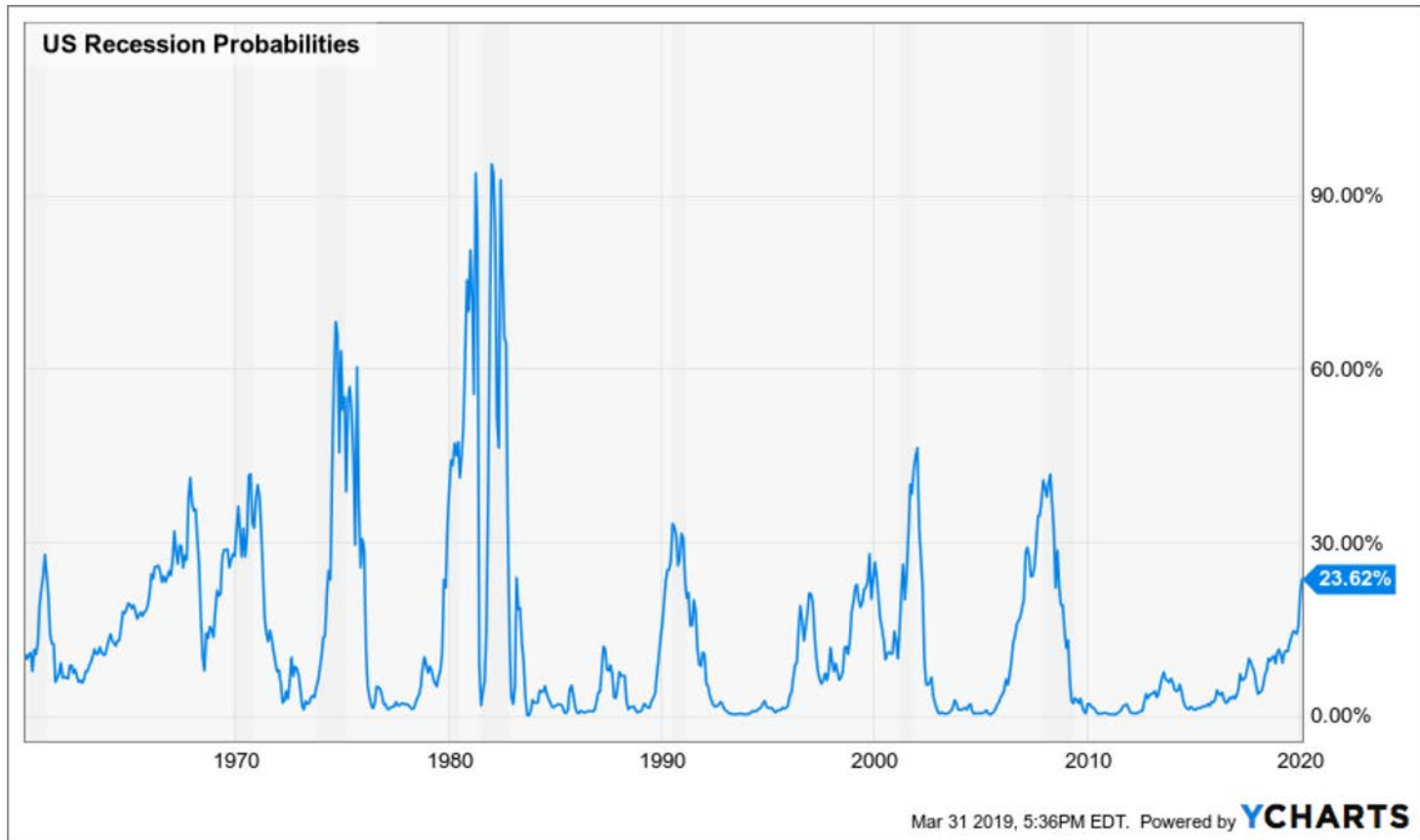
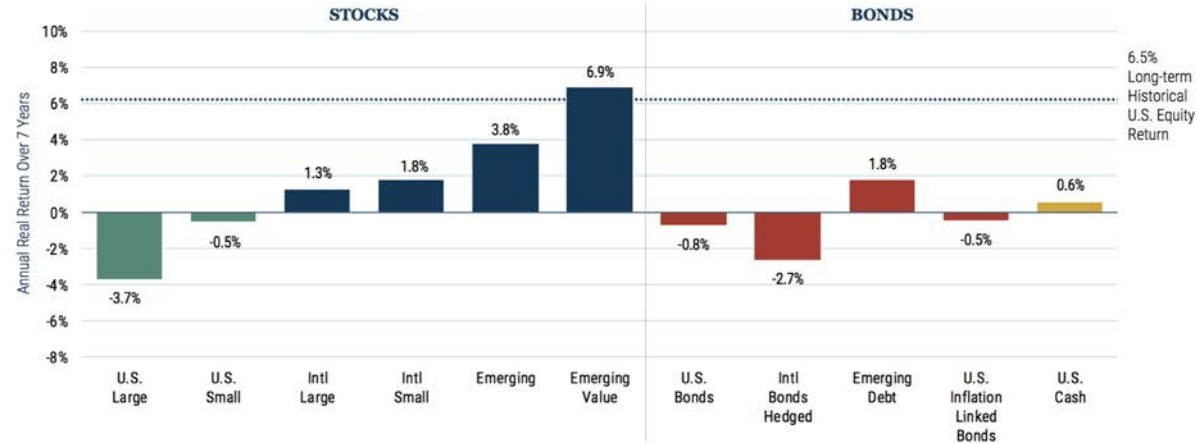


Chart 3: Pick up in US Recession Probabilities.

# 7-YEAR ASSET CLASS REAL RETURN FORECASTS\*

As of January 31, 2019



Source: GMO

\*The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

Chart 4: Asset class return forecasts from GMO, LLC.



— \$VIX (Weekly) 13.71

Open 17.76 High 17.85 Low 13.64 Close 13.71 Chg -2.77 (-16.81%)

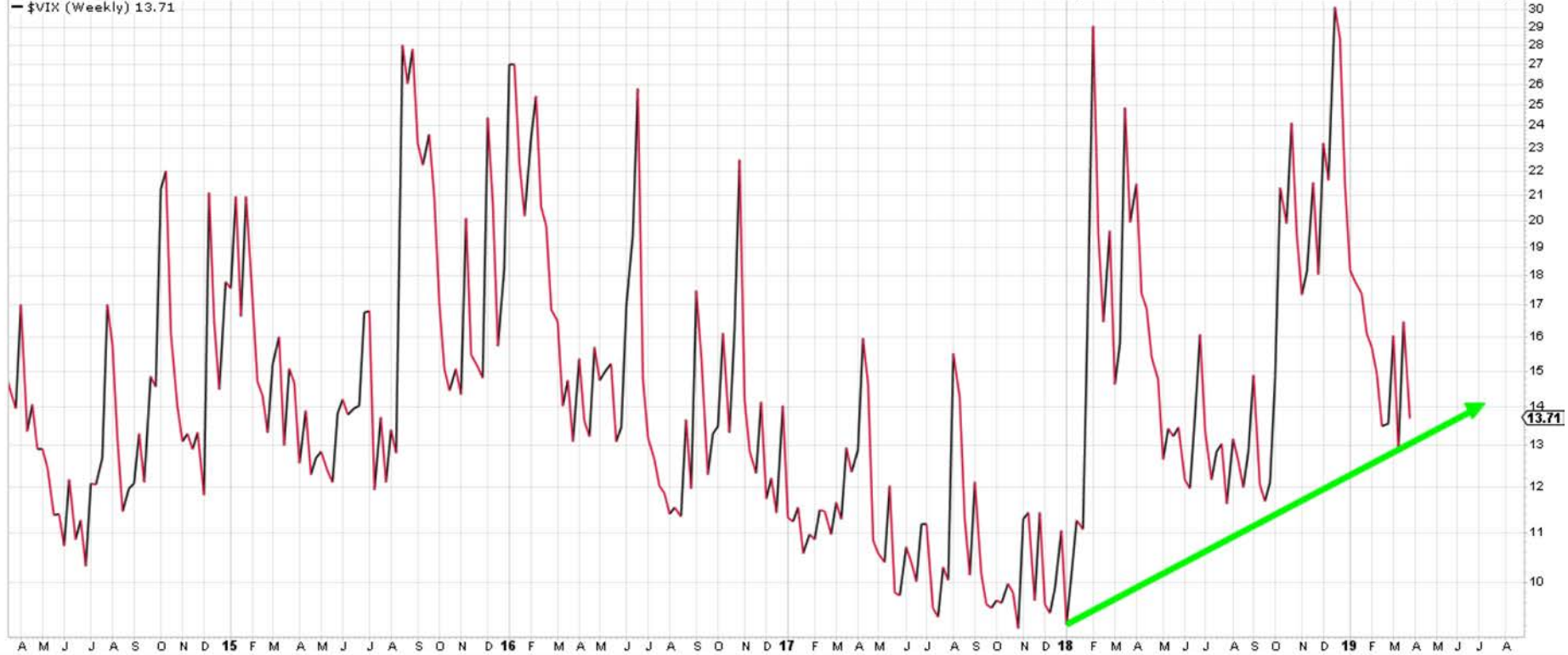


Chart 5: Volatility in US equities continues to make higher lows.

# QUARTERLY SUMMARY

## 16%

The Nasdaq finished the quarter up over 16%.

Q1 was a strong quarter for equities markets as they experienced impressive rallies from deep oversold conditions.

- Technology was the top sector.
- Domestic outperformed international.
- High Beta outperformed other factors.
- Low volatility and quality factors outperformed the S&P.

## -10%

The 10 year Treasury yield dropped -10% for the quarter.

Treasury yields dropped in response to economic growth slowing and a dovish pivot from the Federal Reserve.

- High Yield and emerging market bonds rallied as spreads tightened.
- Long-term Treasuries are still the leading segment over the last six months.
- The yield curve inverted in Q1.

## 26%

Energy prices surged 26% as they rebounded in Q1.

Commodity prices rallied broadly as the Fed pivoted Dovish and asset prices rebounded from oversold lows.

- Energy was the top performing commodity segment.
- Agriculture was the weakest.
- Precious metals remain one of the strongest segments over the last six months.

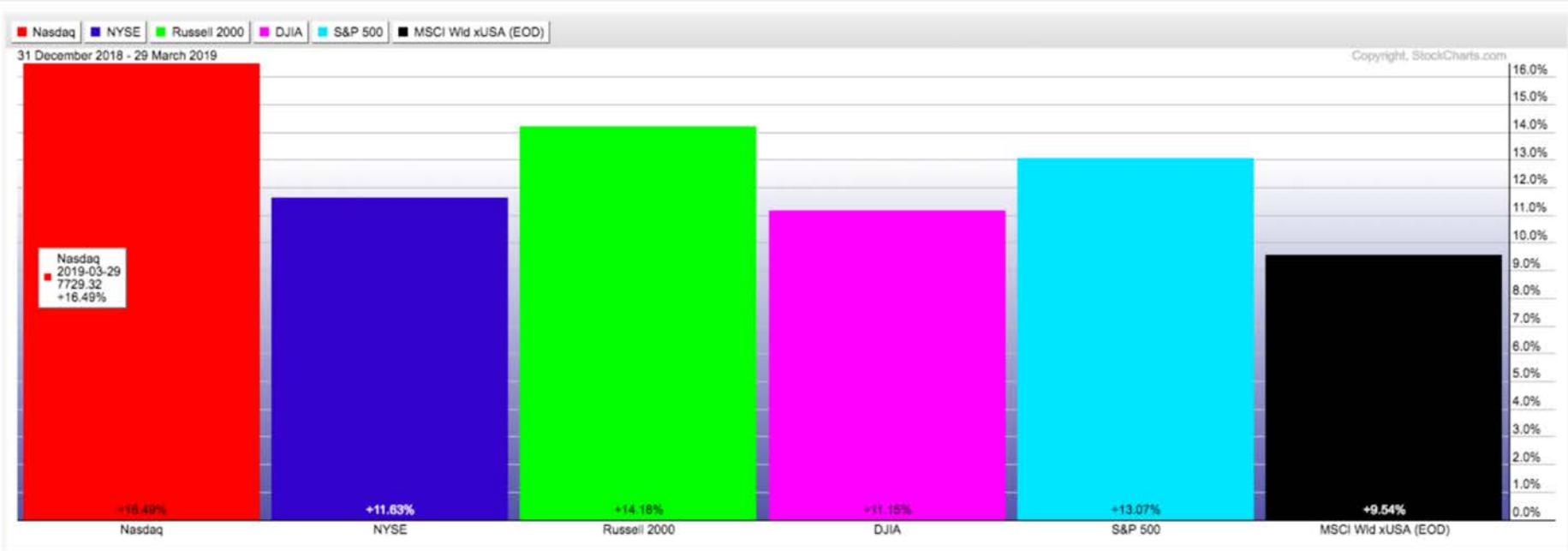


Chart 6: The Nasdaq rallied 16.49% for the quarter. The laggard was the MSCI World Ex-USA which gained 9.54%. The S&P 500 rallied 13%.

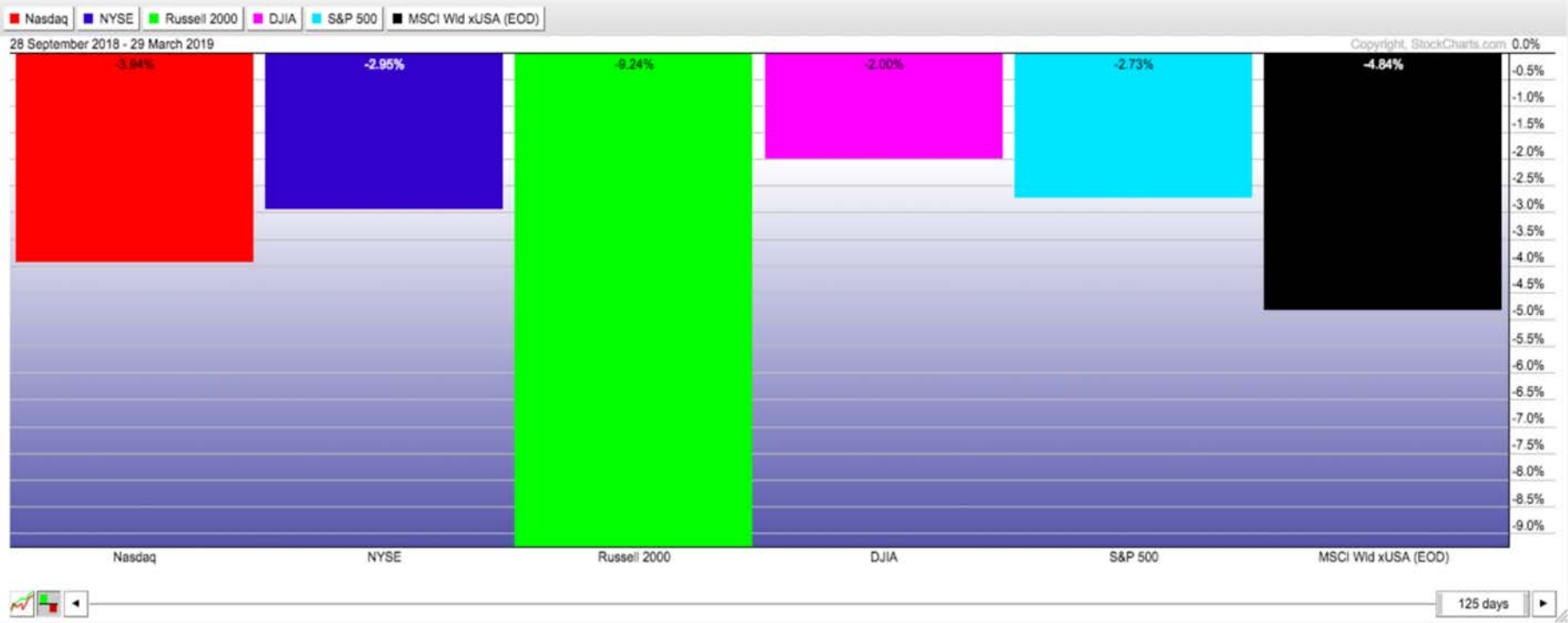


Chart 7: Over the course of the last six months; however, it is clear that a slow down in growth has had a negative effect on equity markets. The Russell is still down over -9% since the end of September.

\$RUT Russell 2000 Small Cap Index INDX

29-Mar-2019

— \$RUT (Daily) 1539.74

© StockCharts.com  
Open 1536.61 High 1546.97 Low 1532.22 Close 1539.74 Chg +4.63 (+0.30%)▲



Chart 8: The Russell 2000 Index rallied substantially throughout the first quarter, but is still down considerably from the peak in September.

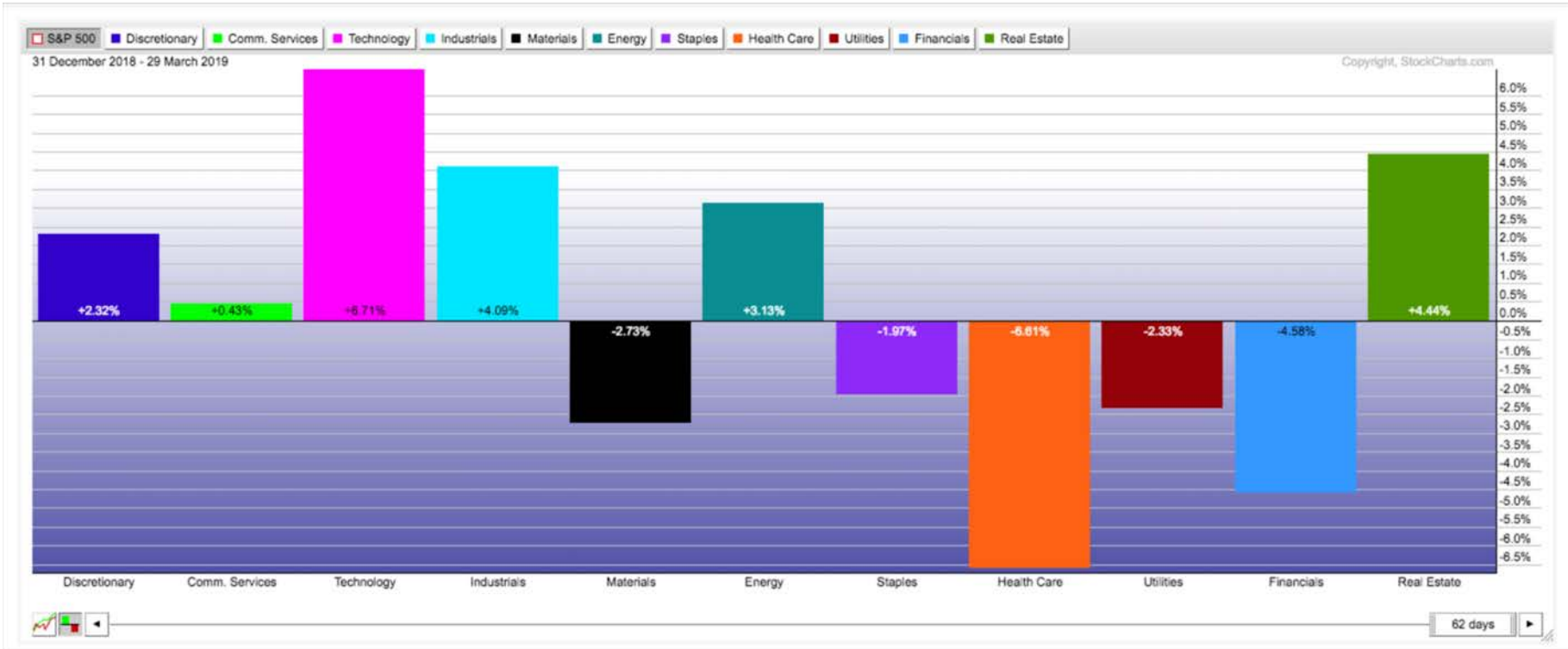


Chart 9: The top performing sector for the first quarter was technology. Technology gained 6.71% for the week while healthcare was the clear laggard, falling over -6% for the quarter. Real estate, industrials, energy, discretionary, and communication services all had positive quarters. Staples, utilities, materials, and financials joined healthcare, all down for the quarter.

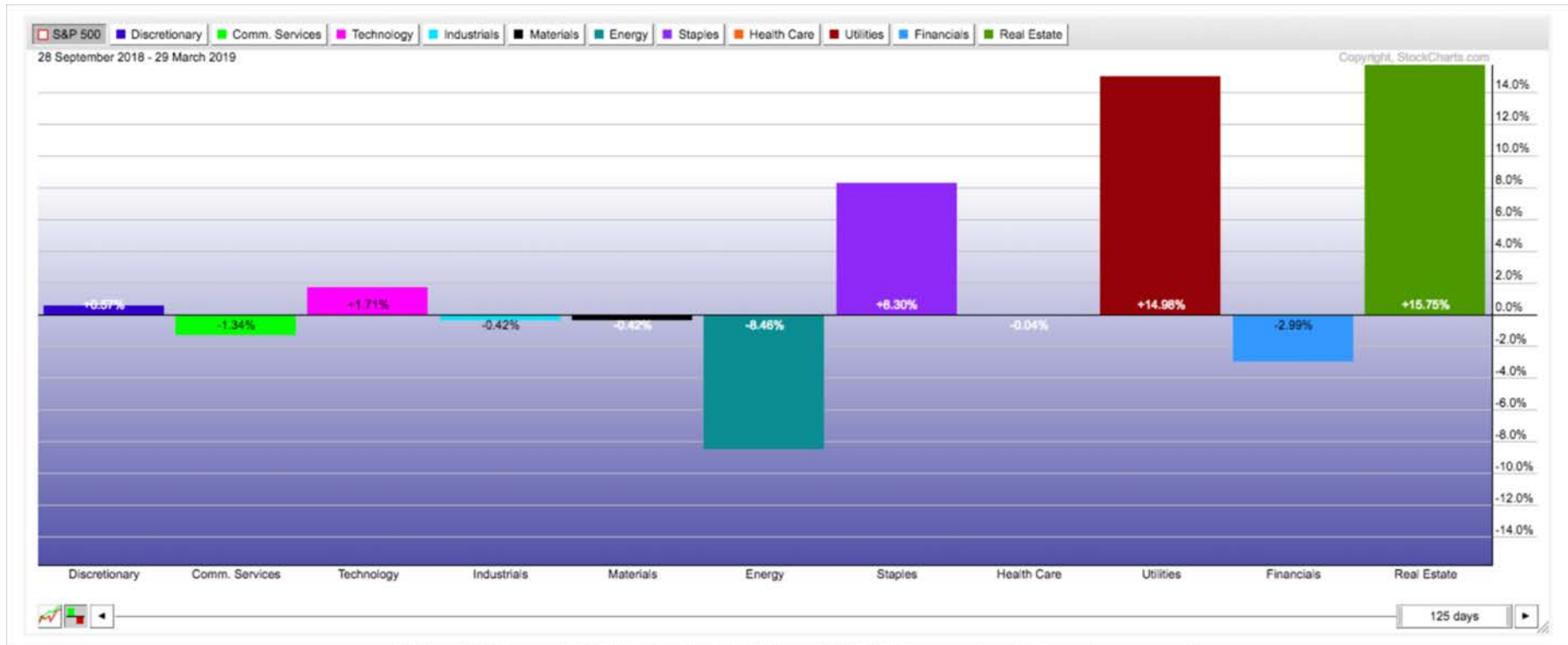


Chart 10: Over the last six months, the sector leadership was far different than the last three months. Real estate was the top performing sector and is up almost 16% over the last six months. Utilities are second, up almost 15%. Staples, technology, and discretionary are positive over the last six months, while communications, industrials, materials, and healthcare are all negative.

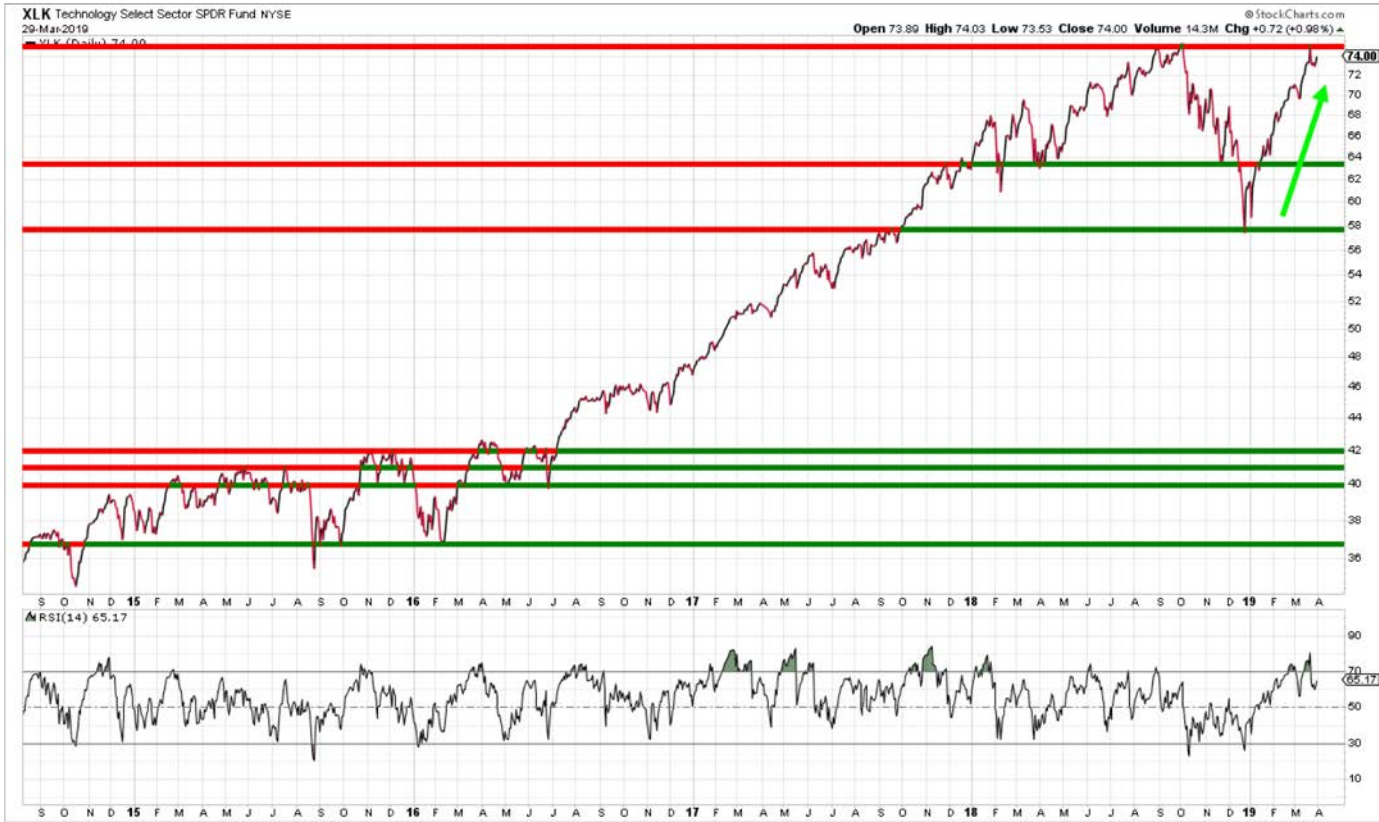


Chart 11: Technology rallied back to the 2018 highs to finish the quarter as the strongest sector over the last 3 months.



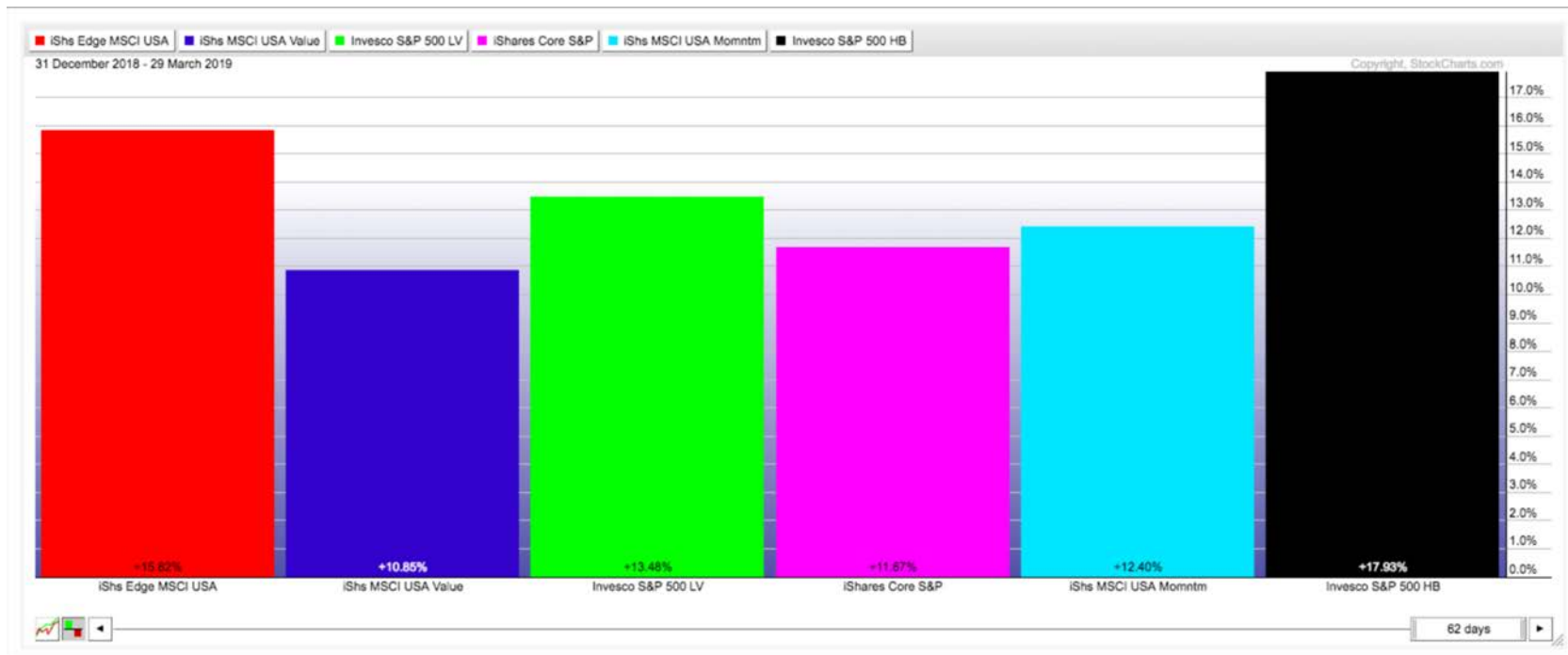


Chart 12: High Beta stocks were the top performing factor ETF over the first quarter, closing up 17.93%. The worst performing factor was value, finishing up 10.85%. High quality and low volatility stocks finished stronger than the S&P 500 for the quarter, up 15.82% and 13.48% respectively.

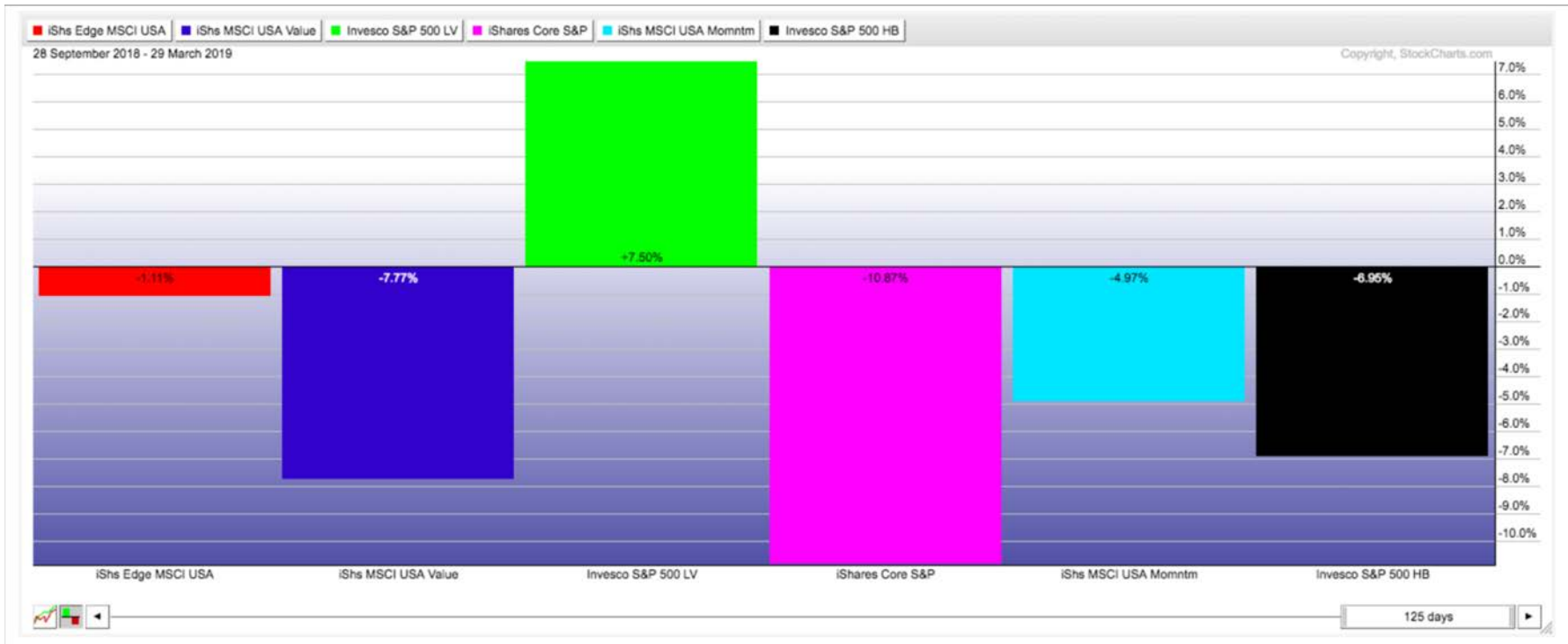


Chart 13: The only factor with positive returns over the last six months is the low volatility factor. It is up 7.50% over the past six months. The worst performing factor is the small company factor. Despite the strong quarter, high beta is down -6.95% over the last six months.



Chart 14: Since late 2018, the Low Volatility ETF (SPLV) has been rallying against the High Beta ETF (SPHB). Over the first quarter, that rally has consolidated. Market internals are currently not supportive of offensive positioning as long as this ratio is above support. A breakdown of this ratio would imply an improvement in risk sentiment among market participants. However, continued strength from low volatility equities would imply a more defensive positioning.

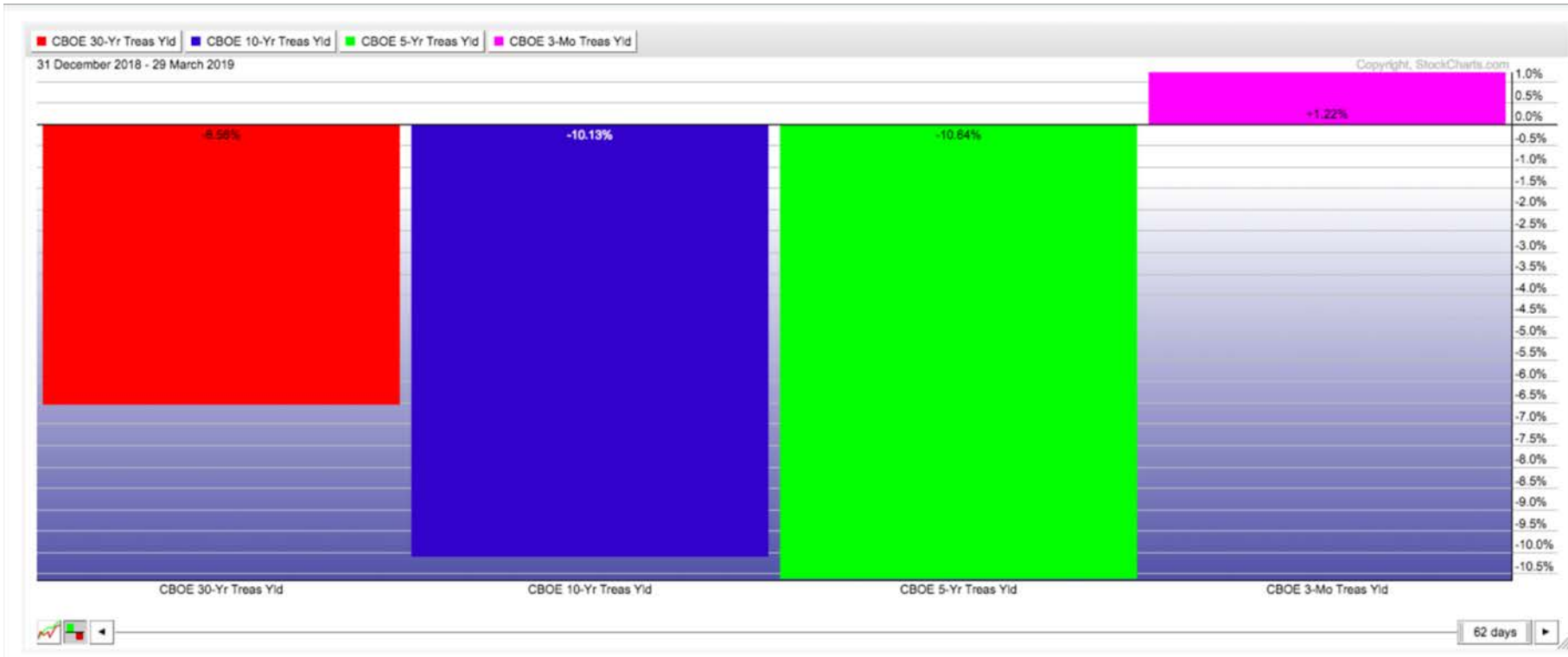


Chart 15: Interest rates have fallen across the US Treasury curve from 5 years and beyond. Last quarter, the 5 year yield led the way, dropping -10.64%. The US 10 year yield fell -10.13% and the 30 year fell -6.56%. The 3 month Treasury bill rate was actually up 1.22% last quarter. The yield curve inversions were the most notable events over the first quarter.



Chart 16: The benchmark 10 year yield fell over -10% for the quarter. It reached a high of over 3.2% in late 2018 but has since fallen to 2.41%. The 10 year yield is telling a different story than the equities markets currently.

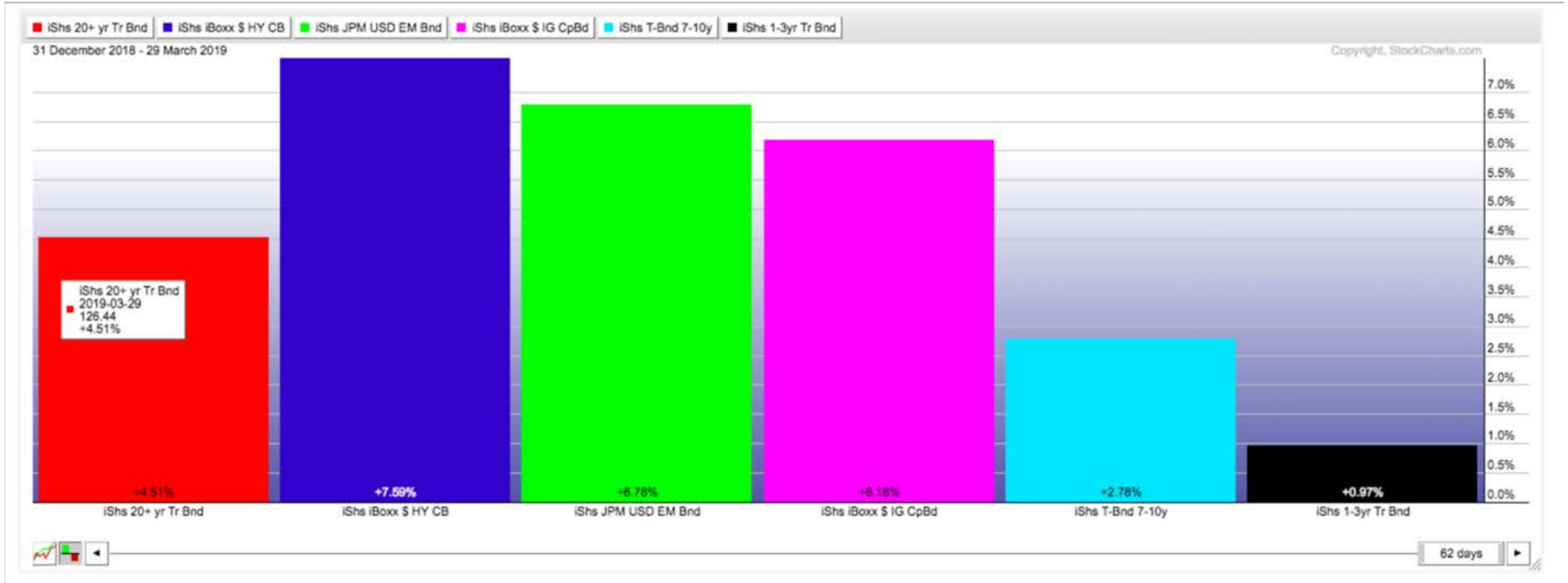


Chart 17: The first quarter saw strong performance from bond markets. The strongest performers were high yield corporates (up 7.59%), emerging market bonds (up 6.78%), and investment grade corporates (up 6.18%). Long-term Treasury bonds were up 4.51% and intermediate term Treasuries were up 2.78%.



Chart 18: Over the last six months, long-term Treasuries are still in the leadership position, up 9.31%. Intermediate term Treasuries are up 6.75% as well. High yield and cash are the laggards over the last six months, up 2.85% and 2.28% respectively.

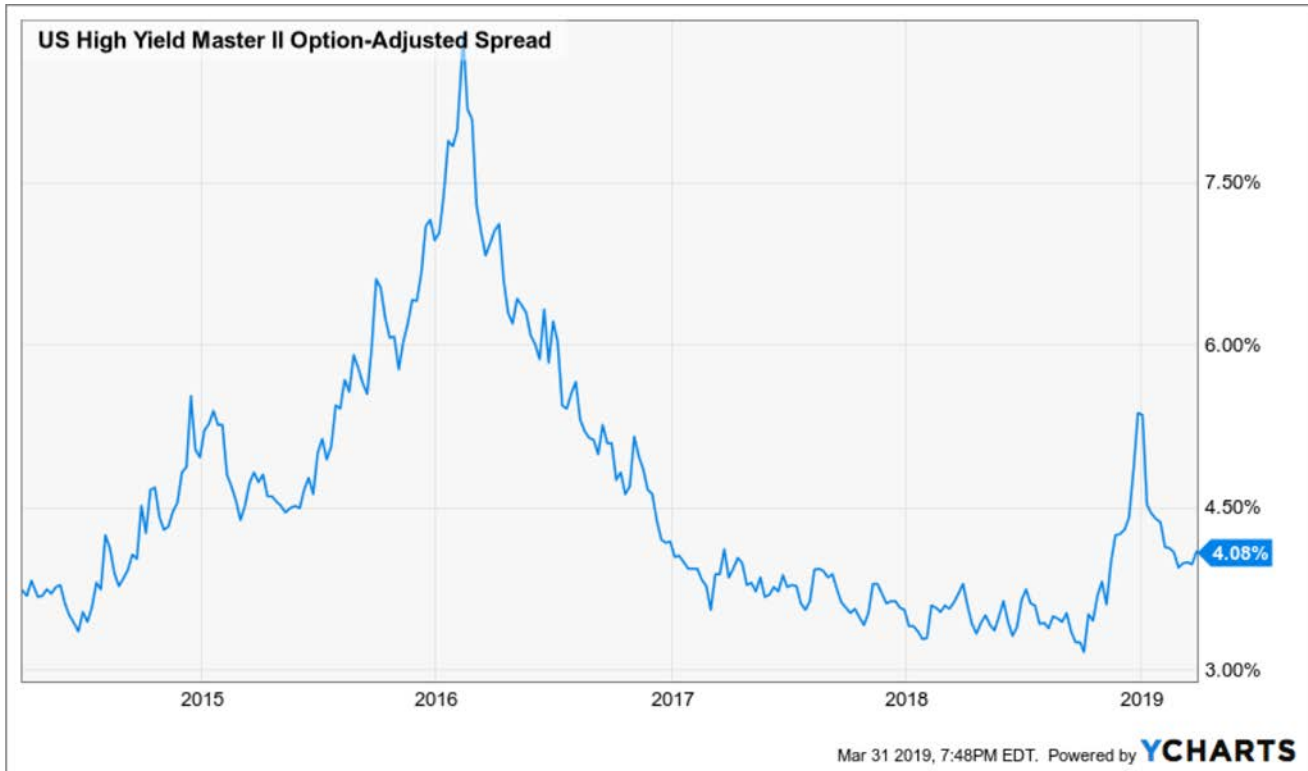


Chart 19: High Yield spreads widened considerably in the latter part of 2018. However, they tightened over the first quarter finishing at 4.08%. This is above the lows of 2018. For continued strength in equities markets, we would want to see spreads tighten to new lows. Otherwise, we believe this is a negative divergence that should be monitored.





Chart 20: Energy was the leading commodity segment in the first quarter. The S&P GSCI Energy index finished up 26%. Agriculture was the weakest performing segment. The CRB index was up 8.22%. The dovish Fed caused asset price reflation that resulted in a broad commodity market rally.

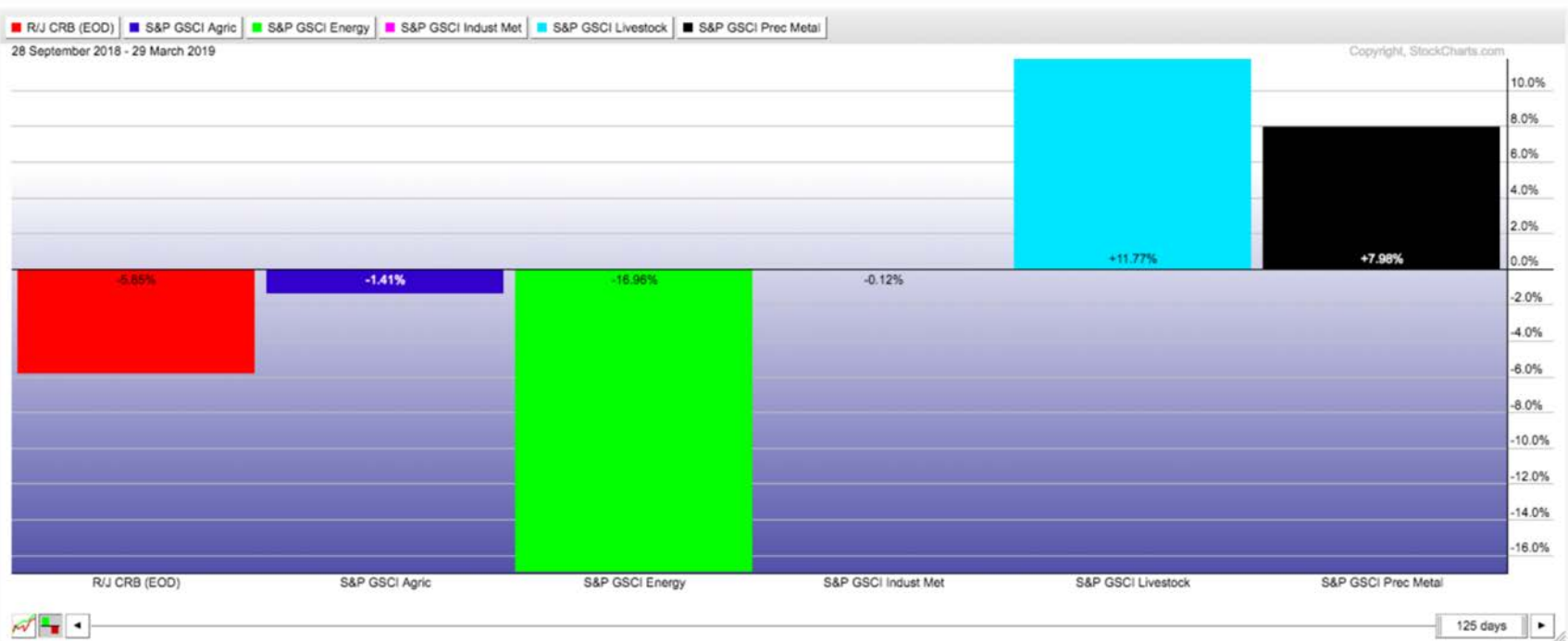


Chart 21: Over the last six months, energy is the worst performing segment of the commodities market. Livestock and precious metals are the two strongest performing, up 11.77% and 7.98%. The CRB broad commodity index is down -5.85% over the last six months.



Chart 22: Commodities, after the rally in the first quarter, are back in the middle of the trading range that has governed price activity since 2015. It will be interesting to see whether the dovish Fed is enough to cause commodity prices to test the top end of the range. Will inflation expectations pick up with the increase in commodity prices? If so, are they temporary? This is important as inflation will directly impact how the Fed is able to respond to continued economic deceleration.

# VALUATIONS

## High Valuations

US Market Valuations are in the top decile historically.

## Low Returns

Forward returns in the US equity market are expected to be well below average for the next 10-20 years.

## Risk Management

Diversification and risk management is now more important than ever.

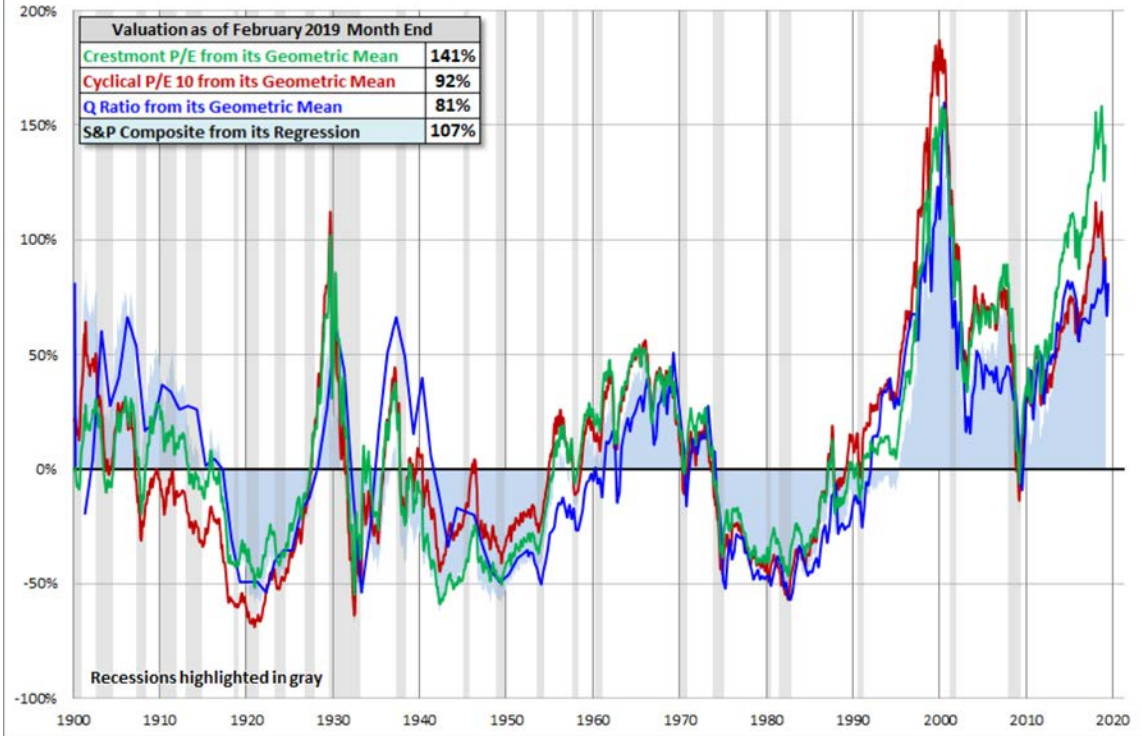


Chart 23: S&P 500 Large Cap Index

- Fair value for the S&P 500 according to trailing earnings is 1956 (P/E = 15)
- Undervalued for the S&P 500 is 1304 (P/E = 10)
- The S&P 500 is trading well above 20x earnings (2608).

## Q Ratio and P/E10 Adjusted to Their Geometric Means with the Real S&P Composite Regression to Trend

dshort.com  
March 2019  
Data through February



- Most measures of market valuation suggest that the market is between 81% and 141% above their geometric mean.
- Historically, higher deviations from the mean have occurred closer to secular peaks in market prices.
- Returns are higher for equities markets when they are below their historical mean valuations and lower when above.

Chart 24: The Russell 2000 Small Cap Index fell -3.06% last week. It failed at resistance and is nearing support at 1475.

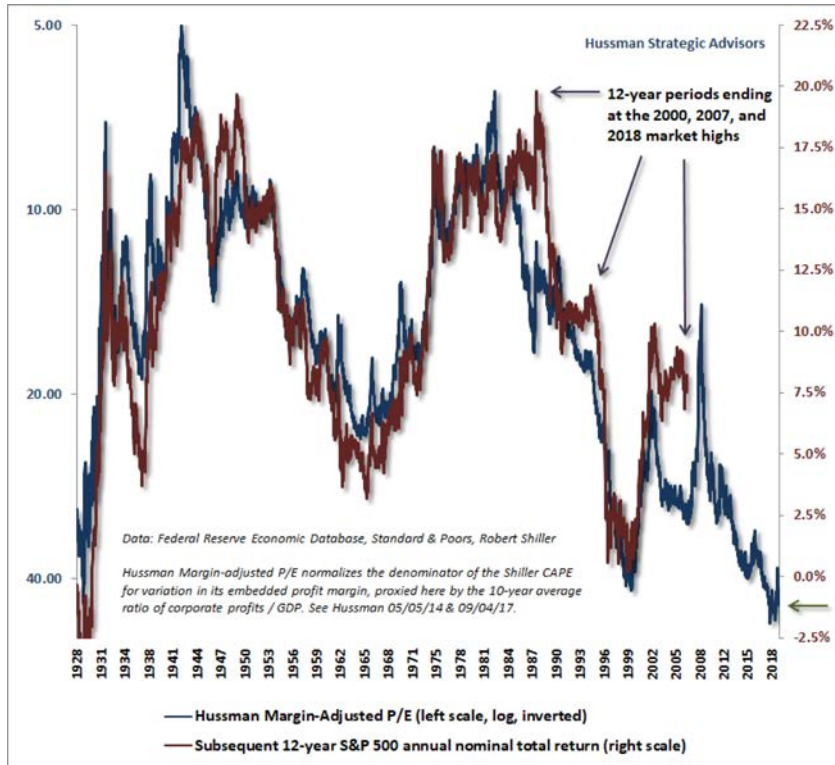


Chart 25: Hussman Margin Adjusted CAPE ratio; Source: Hussman Strategic Advisors

- According to the Hussman margin adjusted CAPE ratio, the S&P 500 is priced for negative returns over the next 12 years.
- This is far below the average of 6.5% real returns for the S&P 500 since 1900.
- We have no idea what the path will look like, only that this suggests the average return will be unacceptable given the current valuations.
- Earnings would have to skyrocket or markets would need to crash in order to correct this over the short-term.

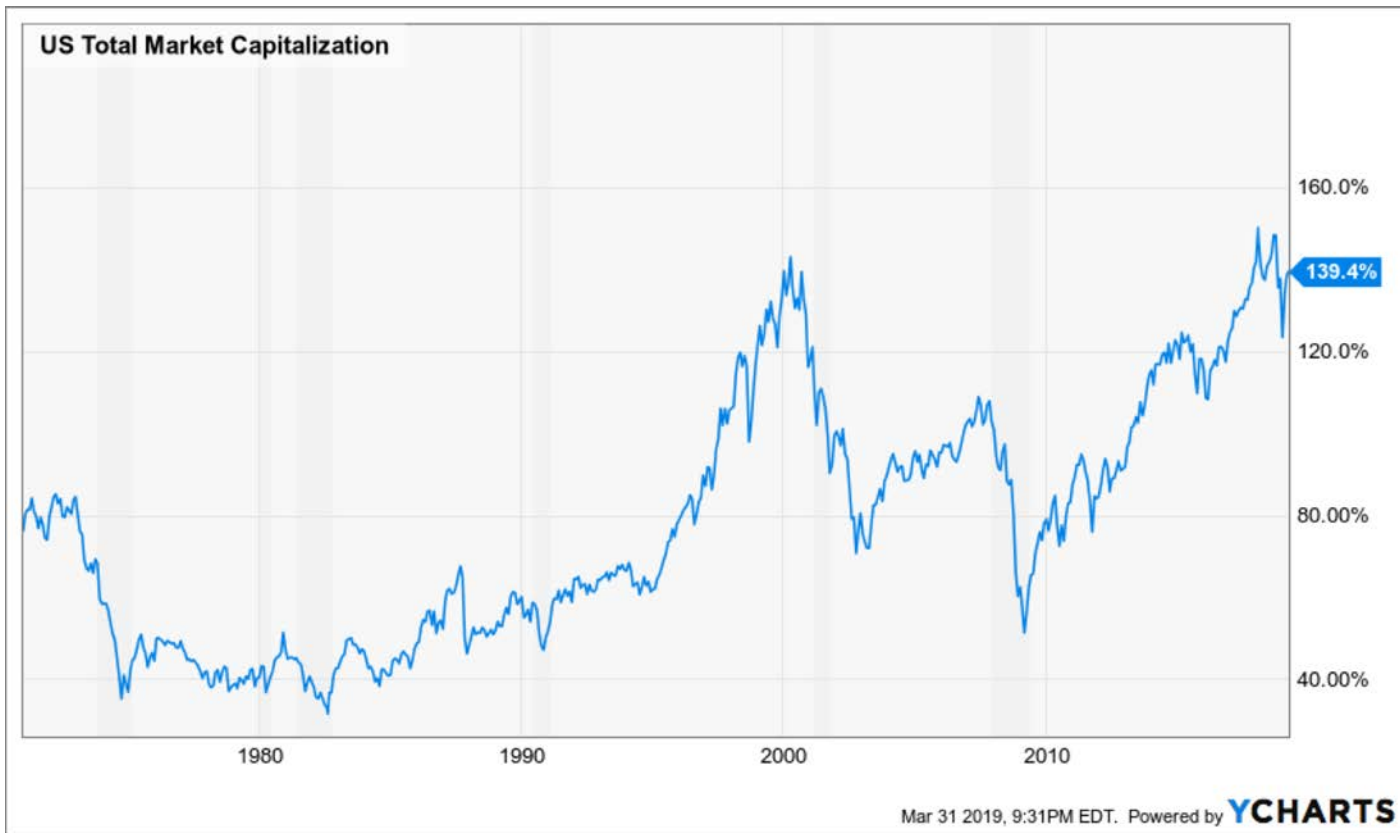
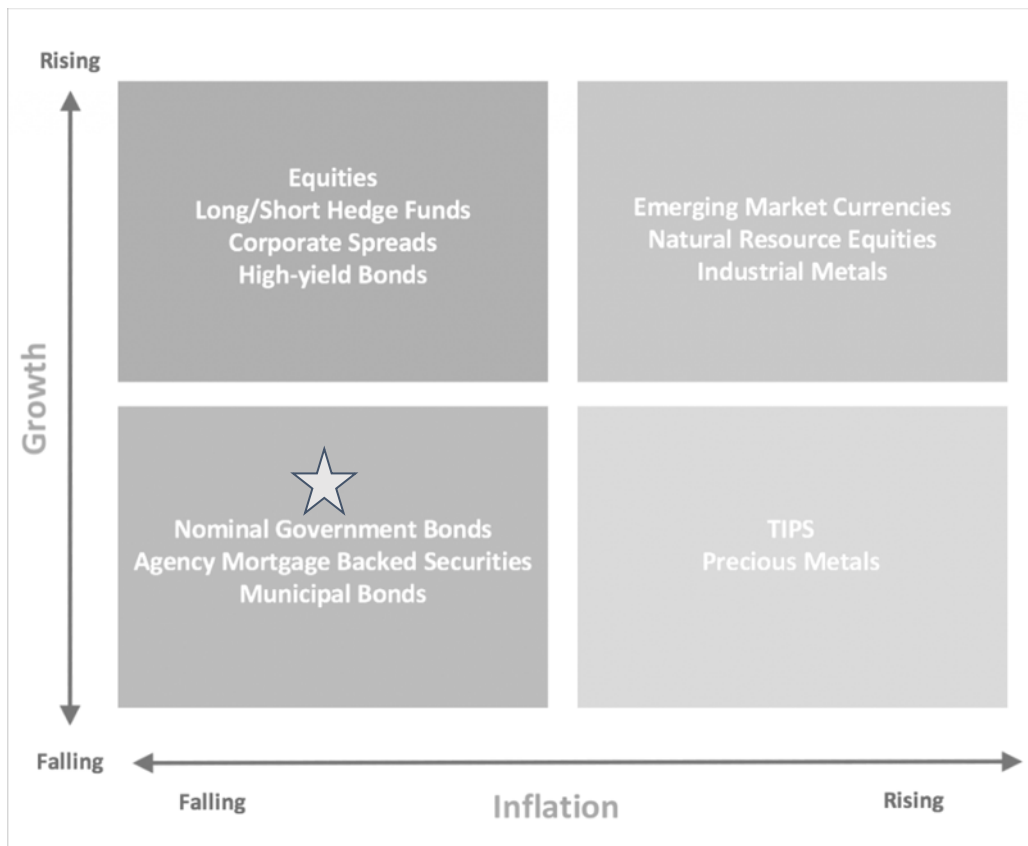


Chart 26: The Buffett Indicator of Market Capitalization to GDP is back near the highs seen during the technology bubble (139.4%).



# ECONOMIC GROWTH & INFLATION



### ECRI Weekly Leading Index Year-over-Year of the Four-Week Moving Average

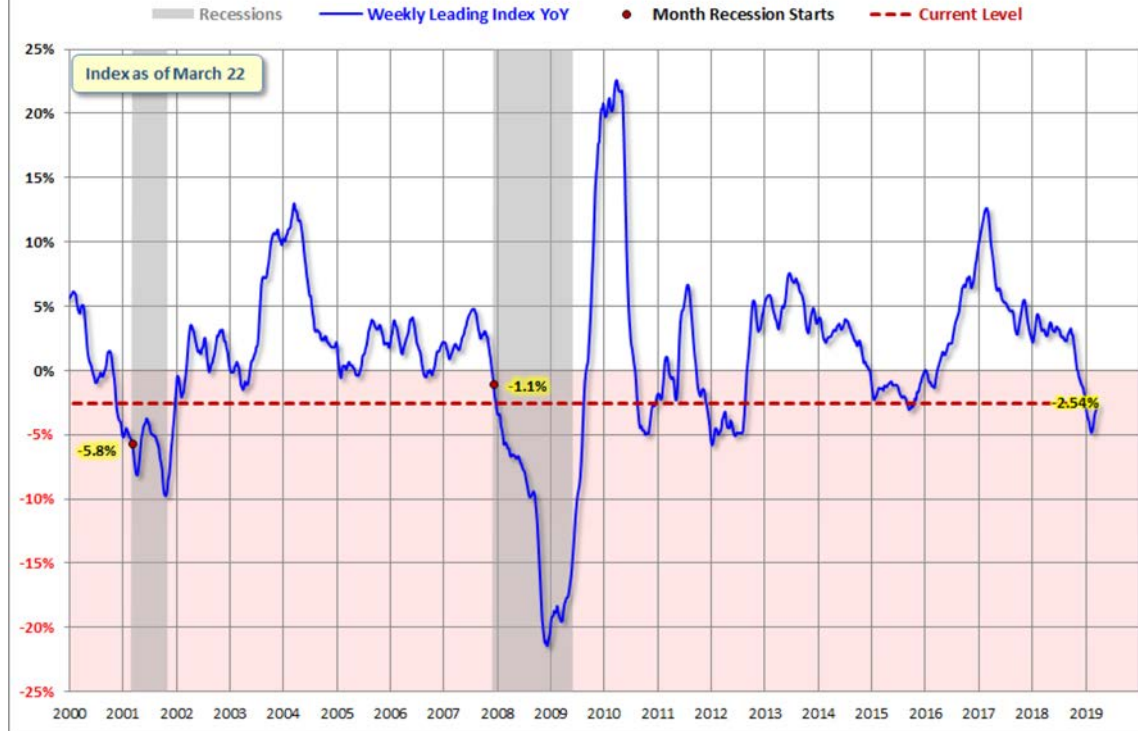


Chart 27: ECRI Year over Year growth rate of the four week moving average of the Weekly Leading Index is down -2.54%. Growth is still slowing in the US.

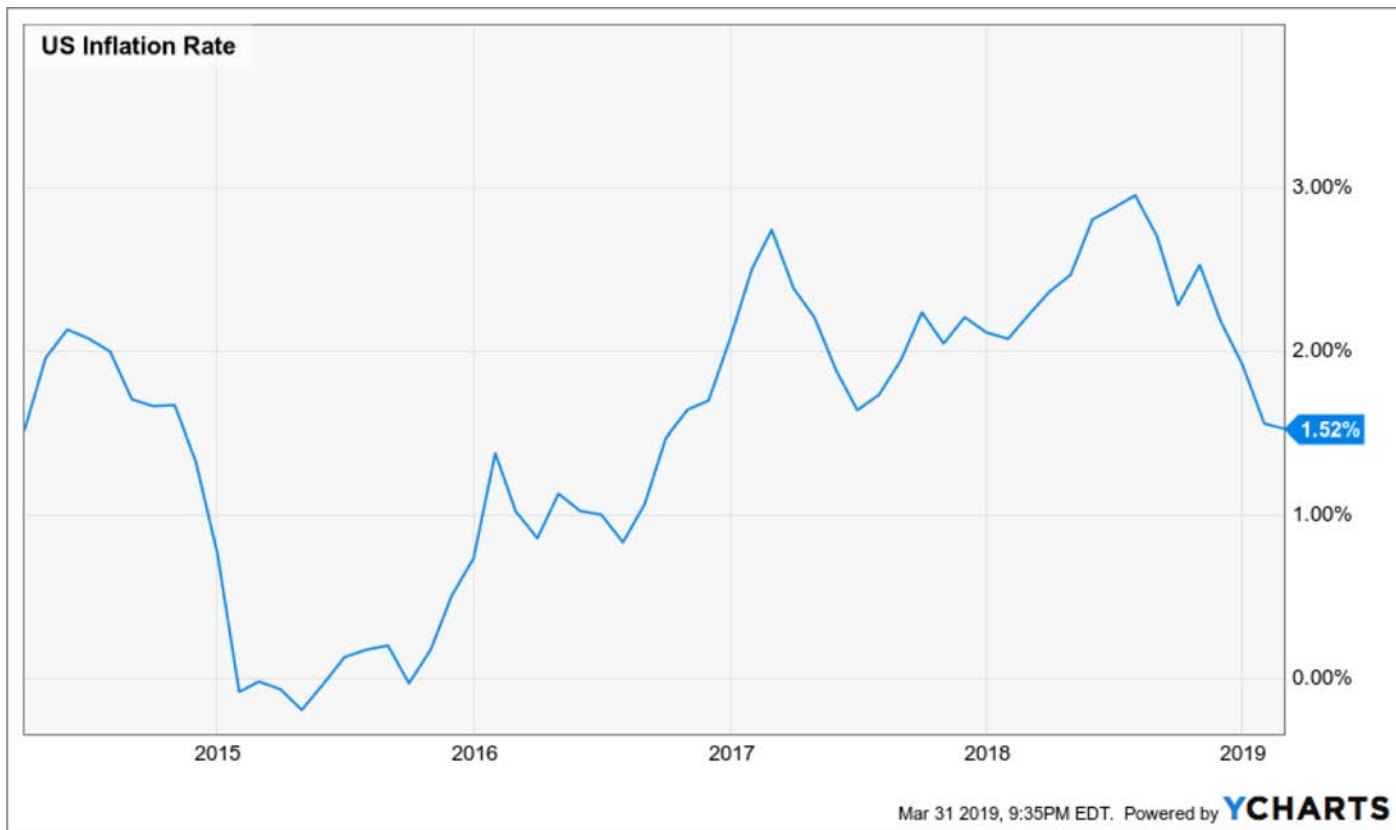


Chart 28: Inflation slowed to +1.52% year over year. This is down from the peak seen in mid 2018, where inflation was near 3% on a year over year basis.

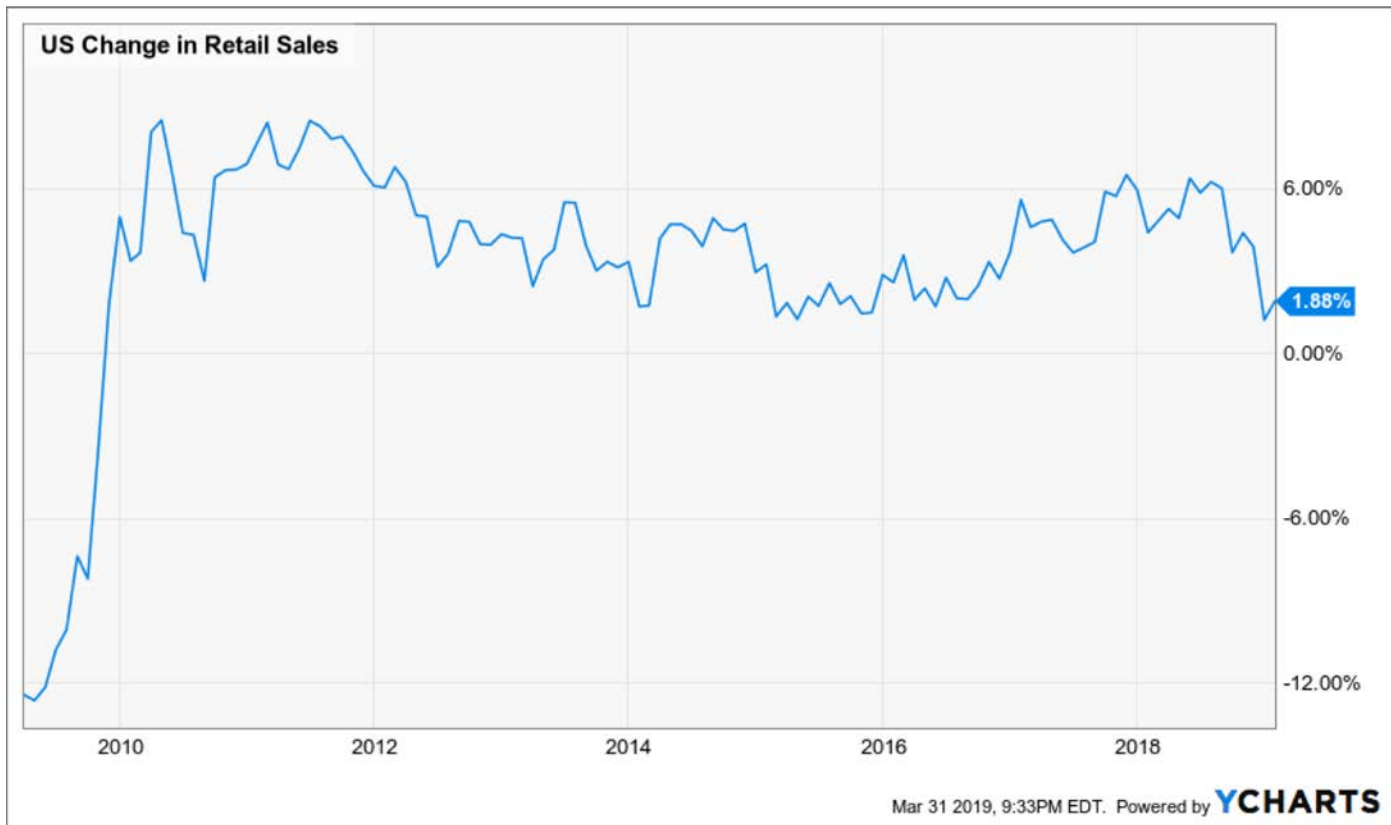


Chart 29: Consumption is a large part of GDP. Retail sales have plummeted to 1.88% year over year. This is near the low seen during the 2015-2016 economic contraction.



Chart 30: Industrial production is up 3.54% year over year and has slowed from over 5% growth seen in late 2018.

## Historical

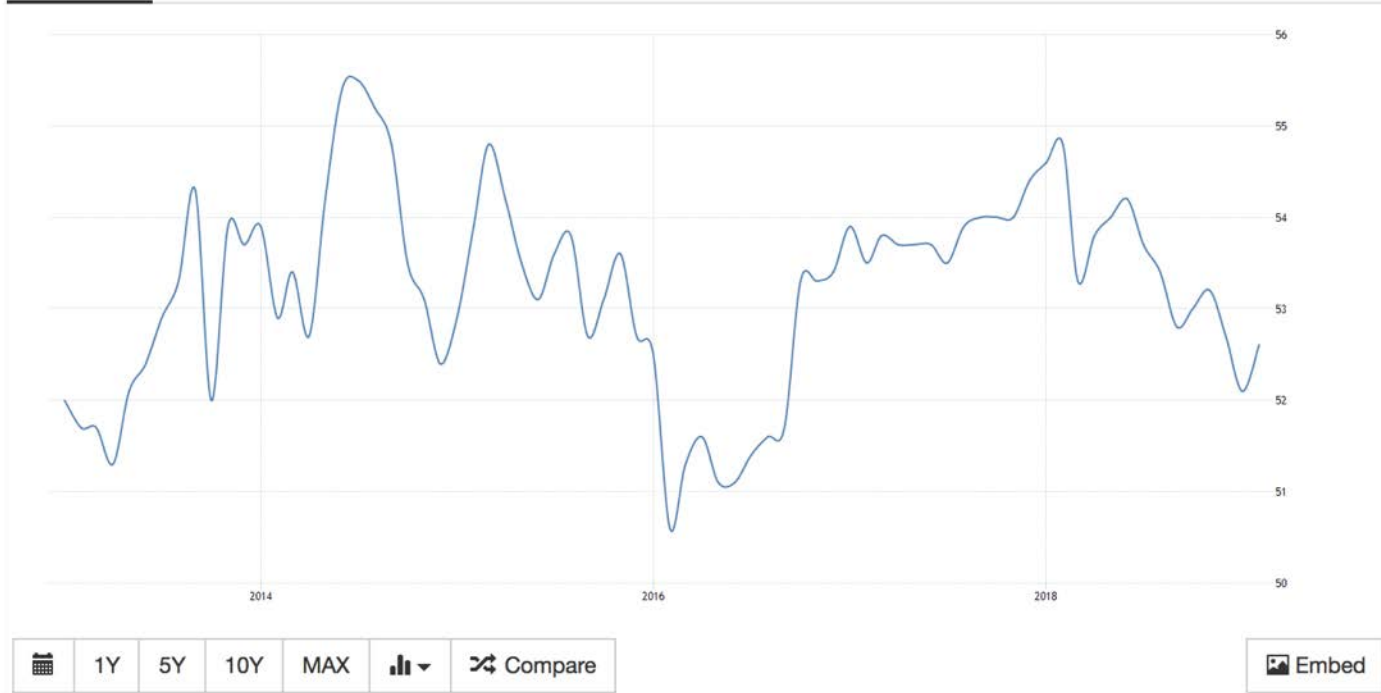


Chart 31: Global PMI slowed from almost 55 to 52.60 recently. The global economy is slowing together. This makes the Fed's response even more important.



# MARKET SENTIMENT

## Short-term Trend

- Over the short-term, the top ranked asset class is US equities based on our assessment. **The Total World market is in a positive trend.**
- International emerging and developed are also in positive trends relative to a risk-free asset.
- High yield bonds and commodities are in positive trends as well.

## Intermediate Trend

- US and international stocks, high yield bonds, and commodities are in negative trends.
- Based on our assessment, emerging markets are the top ranked asset class behind the risk-free asset.
- **The Total World market is in a negative trend.**

## Long-term Trend

- US stocks are the top ranked asset based on our assessment.
- High yield and US stocks are in positive trends.
- Developed and emerging market stocks, as well as commodities, are in negative trends.
- **The Total World Market is in a negative trend.**



# MARKET SENTIMENT: **NEGATIVE**

Symbol	Short-term	Intermediate-term	Long-term
US Treasury	3.17%	6.75%	5.86%
Global Equities	12.87%	-2.37%	1.77%

Table 1: In two out of three time-periods, the risk free asset is above global equities. Therefore, our framework is still negative on market sentiment for global stocks. Global equities are in a positive trend over the short-term. The global equity index includes US and foreign stocks and is 98% of the investable universe.





Chart 32: The Total World Stock Market ETF is in a negative trend relative to Treasuries. The downward sloping 10 month moving average is indicative of a strong negative trend.



Chart 33: The Wilshire 5000 relative to US Treasuries is still in a negative trend as indicated by the downward sloping 10 month simple moving average.

— \$MSWORLD:\$UST (Monthly) 15.06  
— MA(10) 15.57



Chart 34: Global stocks ex- US are in a negative trend relative to US Treasury notes as denoted by the downward sloping 10 month simple moving average.

# SUMMARY & PLAYBOOK

- Valuations remain elevated for US equities and future returns look set to be below average.
- Economic growth continues to slow globally and domestically.
- The 4 week average of the WLI is down -2.54% year over year.
- Stocks had a great quarter with the S&P 500 up 13%. It was the best quarter for equities since 1998.
- The FTSE Total World Stock Market index remains in a negative trend relative to Treasury notes across intermediate and long-term time frames. It is positive in the short-term.
- Over the last quarter high beta dominated the factor landscape. Low volatility is the top performing factor over the last six months.
- Technology was the top performing sector for the quarter. Real estate is the top sector over the last six months.

## Overweights:

Treasuries, Low Volatility, Utilities,  
REITS, Healthcare, Dividend  
Growth, High Quality

## Underweights:

Credit, Momentum, Cyclical,  
Growth.

# DISCLOSURE

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