WEALTHSHIELD

December 7th, 2018

BEAR MARKETS & OPPORTUNITIES

We gave a short presentation yesterday on our framework. In discussing the current conditions we found the response rather negative. Sure, it is the truth and what it indicates is more volatile conditions within equities and risk assets. However, the volatility can create amazing opportunities. It is not a time to hide out or run scared.

In this commentary we want to explore what we see as some possible opportunities in today's market environment—an environment where valuations, market trends, Fed policy, and economic growth all inspire poor market results, at least in the US.

We felt a good exercise would be to analyze each of the four areas of our framework with an eye to the ultimate opportunities that exist today.

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VALUATIONS

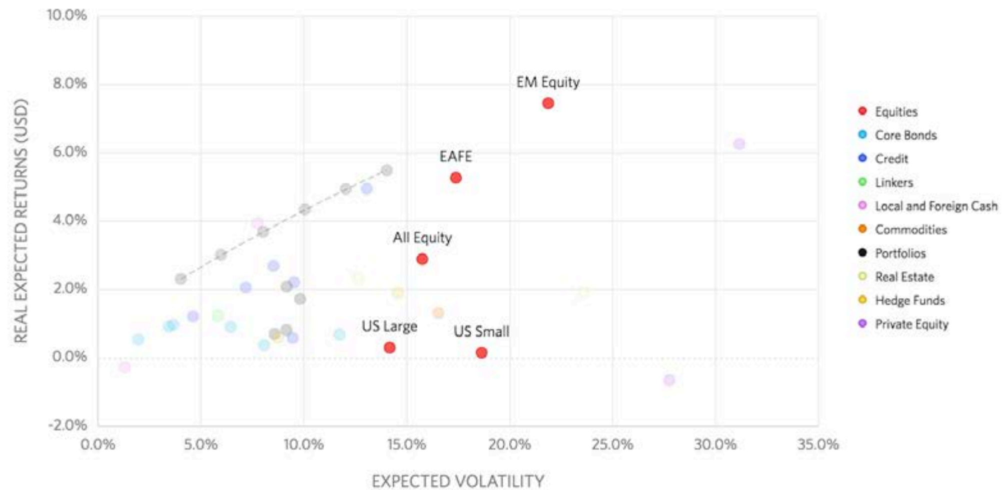

Chart 1: Portfolio and Asset Class Expected Returns; Source: Research Affiliates

Valuations are the first component of our framework. In the US valuations are negative because they are in the top decile of historical observations. In other words, US stocks are highly valued, and according to Research Affiliates, are expected to earn nothing over the next 10 years. The All Country World Index (labeled as all equity in the graphic) is expected to return around 3% per year for the next 10 years, on average. This is why valuations are red within our framework, because the expected return is far below the average annual return of the market.

Opportunities do exist according to long-term top down valuations. Emerging markets are currently valued to earn 8% per year over the next 10 years, according to Research Affiliates. The expected returns on emerging markets are significantly above the 0% expected for the US stocks. Therefore, we believe that despite the high values in the US, the emerging markets offer a compelling opportunity.

From a global perspective, Russia, China, and Brazil are some of the lowest valued markets in the world. Russia and Brazil are performing well this year while China is down big. If low valuations suggest higher than average returns going forward, then we should expect Russia, China, and Brazil to generate attractive gains. We will have to wait and see.

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INTERMARKET TRENDS

We believe that Dividend Growth equities are attractive during the current volatile times. These equities are able to capitalize on several factors that explain investment returns. Essentially, in our opinion, the Dividend Aristocrats index is the ultimate smart beta play. Stocks that pay and have a history of increasing dividends are typically lower valued than the broad market, have lower volatility, and are higher quality.

The dividend aristocrats index broke out against the S&P 500, demonstrating strong relative strength. This trend has been supportive of the S&P 500 over dividend growth equities since 2016. In October the trend reversed, supporting the Dividend Aristocrats index. The relative strength may present an awesome opportunity in dividend growth stocks.

Chart 2: The Dividend Aristocrats index is still in a positive trend despite the decline in broad equity markets.

Chart 3: Dividend Aristocrats versus the S&P 500.

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INTERMARKET TRENDS

Value is breaking out against growth. Value as a factor may also be a good opportunity, warranted by market trends. The recent relative strength in value is the first time where value has been favored over growth since the end of 2016.

Chart 4: Value versus Growth. The trend is changing to support value over growth**.**

Chart 5: Consumer Staples sector ETF (XLP).

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INTERMARKET TRENDS

Consumer staples may present an interesting opportunity given their strong positive trend despite the market weakness. This sector is a defensive sector historically and has shown strong relative strength. Healthcare, utilities, and real estate are three other sectors that are historically defensive in nature. They are also all in positive trends despite the negative trends and current weaknesses within cyclical sectors and broad markets at large.

Chart 6: Healthcare (HLV)

Chart 7: Utilities (XLU)

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INTERMARKET TRENDS

Chart 8: Real Estate

FED POLICY & ECONOMIC GROWTH

Economic growth and inflation are both slowing. In our opinion, this presents an interesting opportunity in fixed income. Furthermore, due to growth and inflation slowing, we expect the Fed to move dovish in the quarters to come. This will most likely be done through communication at first. If communication does not ignite further growth, then the Fed will most likely pause additional rate increases in the coming year. We believe this reaction to the data presents an incredible opportunity in long-term Treasuries.

When growth and inflation are slowing, Treasuries tend to be one of the best asset classes to invest in, especially if the Fed starts to ease through communication. The yield curve, on the short end (3 year minus 5 year Treasury yields) has already inverted, suggesting that slowing economic growth is becoming more commonplace. However, the 10 year Treasury bond yield minus 3 month T-bill rates has not yet inverted and is currently at 0.46%. This suggests to us that there is room for the long-end of the curve to come down further, supporting bond prices.

The point and figure chart of the long-term Treasury bond ETF (TLT) broke out on a buy signal with a break above 115.37. This was the first buy signal generated this year as bonds have been in a negative trend. If growth and inflation continue to slow and the Fed pivots dovish, we expect bonds to continue to move positively.

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FED POLICY & ECONOMIC GROWTH

Chart 9: 10 year Treasury bonds minus 3 month Treasury Bill yields.

Chart 10: Interest rates on the 10 year Treasury bond have broken to a short-term negative trend and are down significantly from the highs set earlier in the year.

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FED POLICY & ECONOMIC GROWTH

Chart 11: Long-term Treasuries on buy signal

SUMMARY:

Instead of focusing on the negative condition of our framework and the implications, we wanted to reframe and introduce the opportunities that we believe are present in the current environment. From a valuation perspective, emerging markets (especially Brazil, Russia, and China) look attractive as long-term investment opportunities. Intermarket trends suggest that dividend growth and value stocks, consumer staples, utilities, healthcare, and real estate present potential upside as well. Long-term Treasuries also look attractive based on the notion that growth and inflation will continue to slow and Fed policy will move dovish in response.

These opportunities demonstrate that there are always bright spots that we can focus on despite the negative implications of our framework. One common theme we recognize in the US is the fact that defensive equities are the ones demonstrating positive relative strength. Also, we are aware that Treasury bonds are showing constructive signs. This implies that defense is still warranted.

In our opinion, building a watch list in emerging markets and positioning in defensive equities and Treasury bonds is most likely the right course of action given the current conditions of our framework.

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