Market and economic outlook

Brinker Capital

December 2018

Higher volatility persisted throughout November as increasing global trade tensions and concerns over a too aggressive Federal Reserve (Fed) led to a risk-off environment for most of the month. However, a market bounce during the last week of the month led to most risk assets finishing in positive territory. Among the positives, Fed Chair Jay Powell's speech at the Economic Club of New York took a more dovish tone, helping to ease concerns of a Fed policy mistake. Likewise, the G20 meeting, beginning on the last day of November, resulted in the US and China agreeing to a temporary truce on their ongoing trade war. The outcome of the mid-term elections was also as expected with the Democrats gaining control over the House of Representatives and the Republicans gaining a larger majority in the Senate, removing some uncertainty from markets. However, a divided Congress reduces the possibility for extended fiscal stimulus and may lead to future slower US growth.

After nearing February lows, the S&P 500 Index rallied at the end of the month and finished up +2.0%. Year-to-date the index is up +5.1%. Sector performance was mixed with healthcare (+7.1%) leading performance as a divided Congress will likely lead to legislative gridlock within the sector. Materials (+4.1%) and industrials (+3.8%) benefited from the temporary cease fire of escalating trade wars. Information technology (-1.9%) was down for the month, hurt by the threat of increased government regulations. Energy (-1.7%) was negatively impacted by decreasing oil prices. Mid cap equities outperformed large cap and small cap equites. Value outperformed growth for the month but lags by a significant margin year-to-date.

Developed international equities, as measured by the MSCI EAFE Index, were down -0.1% for the month and -9.0% year-to-date. Progress was made on Brexit as a withdrawal agreement was agreed upon between the UK and European Union, but it remains uncertain whether the deal will be passed by Parliament. A high level of skepticism also remains on whether the European Central Bank will be able to successfully implement quantitative tightening next year as per its current guidance. Emerging markets was up +4.1% for the month but remains down -12.0% year-to-date. Decreasing oil prices served as tailwind for countries such as India and Indonesia that are net importers of oil. Likewise, China benefited from increased fiscal stimulus as well as a temporary pause to trade wars with the US.

The Bloomberg Barclays US Aggregate Index was up +0.6% for the month and is down -1.8% year-to-date. The 10-yield Treasury yield reached a peak of 3.2% before falling 19 basis points, based off Jay Powell's comments that interest rates are close to a neutral level, and ended the month at 3.0%. Credit spreads widened with high yield spreads increasing 47 basis points, a level not seen since 2016. However, spreads remain low relative to historical levels and we haven't yet seen a significant deterioration in fundamentals.

Despite the recent sell-off in equity markets, we remain positive on risk assets over the intermediate-term. The technical backdrop has weakened following the recent market action. While investor sentiment has moved more negative in response, it has not yet reached extreme pessimism territory. However, the fundamentals have not changed. In determining our macro outlook, we continue to believe the weight of the evidence leans positive; however, we remain cognizant of the potential risks to that outlook.

We find a number of factors supportive of the economy and markets over the near term.

- **US economic growth:** Sound fundamentals and pro-growth fiscal policies such as tax reform and deregulation have led to solid economic growth within the US.

- **Continuation of strong earnings growth:** The outlook for corporate earnings growth remains favorable and corporate tax reform has further benefited US-based companies.
- **Elevated business and consumer sentiment:** Measures like CEO Confidence, NFIB Small Business Optimism, and Consumer Confidence are at elevated levels. This typically leads to an increase in capital spending and hiring within corporations and an increase in spending amongst consumers, all of which should support economic growth.

However, risks facing the economy and markets remain, including:

- **Global fiscal and monetary policy uncertainty:** The Fed continues on its normalization path, but there is concern it will be too aggressive, pushing the economy into a recession. On the fiscal policy side, the development of tariffs and other restrictive trade policies have led to tensions between the US and its global trading partners. Rising populism and political turmoil have increased the possibility for global geopolitical missteps.
- **Interest rate environment/yield curve:** The yield curve has flattened meaningfully this year, but the curve has not yet inverted, which would be cause for further concern.
- **Potential for accelerating inflation:** Inflation has ticked up but is manageable at current levels and inflation expectations remain muted. Should inflation move meaningfully higher, the Fed may be forced to shift to a more aggressive tightening stance.

Despite the volatility experienced recently, economic fundamentals remain solid. Credit conditions are still supportive, US economic growth is positive, and business and consumer confidence are elevated. Global policies and actions of central banks may lead to higher volatility, but our view on risk assets remains positive over the intermediate term. The higher volatility has resulted in wider dispersion of returns across and within asset classes, an attractive environment for our diversified, active investment approach.

Brinker Capital Market Barometer (as of 11/12/18)

Factors		Change	Negative	Neutral	Positive	Commentary
Short-term factors (<6 months)	Momentum	←	●			Momentum weaker acrosss global equity markets
	Trend	←	●			US equity above 200-day MA; US small cap and international below
	Investor sentiment			●		Remains neutral; recent sell-off not enough to wash out sentiment
	Seasonality	→			●	4Q strongest period for equities; positive following mid-terms
Intermediate-term factors (6-36 months)	Fiscal policy				●	Fiscal stimulus (tax cuts, deregulation), but uncertainty over tariffs
	Monetary policy			●		Global monetary policy directionally tighter; Fed continues on path
	Inflation	←		●		Wage growth has ticked higher; few signs of broader inflation
	Interest rate environment			●		Rates biased higher but choppy; flat yield curve a concern
	Macroeconomic				●	US GDP growth has accelerated; growth outside US slowing
	Business sentiment				●	CEO and small business confidence at high levels
	Consumer sentiment				●	Remains elevated; driven by income and employment conditions
	Corporate earnings				●	US earnings growth has accelerated; softened outside US
	Credit environment				●	Credit spreads still behaved; few signs of credit market stress
Long-term factors (36+ months)	Valuation			●		Multiples contracted in October; slightly below long-term averages
	Business cycle				●	Long recovery but has been muted; few signs point to recession
	Demographics			●		Mixed (US and EM positive; developed international negative)

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