SEGALL BRYANT & HAMILL

4TH QUARTER
2018

SBH NEWSLETTER

Thoughts on the Current Environment

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"What if they gave a recession and no one came."

-With apologies to Carl Sandburg

Over the summer, a report crossed my desk that really caught my attention. Perhaps it was the fact that it was very brightly colored in a variety of hues and I liked the pattern the lines drew out. I would like to think, however, that it was the insight imparted by the chart that made me pay attention. The chart—which we have included as Exhibit 1 below—portrayed the correlation of the price behavior of a number of asset category exchange-traded funds (ETFs) to each other on a rolling three-month basis. The chart included ETFs of nine different asset categories, ranging from U.S. Large Cap equities to U.S. Investment Grade bonds to U.S. Real Estate to Commodities over a period of 15 years. What it showed was that all these ETFs are currently trading in a positively correlated fashion to each other. This has been the case since 2016, making it the longest period of positive correlation recorded. ***In other words, it hasn't mattered what asset class an investor has bought in the last few years; they have all behaved the same.***

EXHIBIT 1: PRICE BEHAVIOR IN EXCHANGE-TRADED FUNDS ACROSS ASSET CLASSES

Diversification Opportunities are Scant, There's Nowhere to Hide!
Correlation (65-day) of ETF Returns to Average

Data Source: Bloomberg, LP
Source: Bianco Research, L.L.C.
Data through September 30, 2018
Past performance is no indication of future results.

From the perspective of an investor who pays even just lip service to the notion of diversification as a key element of risk control for their portfolio, this is troublesome. Where can one hide if there is nowhere to hedge? For example, back in 2008, when the financial crisis exploded and the stock market reacted, one could seek shelter with high-quality bonds and still expect to earn a return that would meet a "normal" spending target, such as 5%. This crisis, as we all know, was met by the U.S. Federal Reserve (Fed) and other central banks by both supplying liquidity to the market and cutting short-term rates to zero. That effort gave way to a theoretical—and untested—cure: the purchase of financial assets (bonds) in the open market to raise their price and thus stimulate the economy by making bondholders feel wealthier. One of the byproducts of the effort, as we have discussed in many editions of ***Thoughts on the Current Environment***, is that the cure the Fed and other central banks used to fight the crisis has proven to have side effects that are in some ways as bad as the "disease" they fought. By driving interest rates to zero and pinning them there, investors on the one hand have been forced into asset classes and securities that are riskier than preferred, while borrowers on the other hand have borrowed funds to pursue projects, real or financial, that would likely not have made sense had interest rates been higher. (Very recently, long-dated U.S. Treasury bonds, U.S. inflation-protected bonds [TIPS] and municipal bonds are no longer correlated to each other, but just barely.)

At this juncture, when we ask ourselves the age-old question—"What is cheap?"—the reply is, "Not much." Nine years of a continuous bull market will have that kind of effect, after all. A corollary question might be, "What's different this time?" As every professional investor knows, this question must be accompanied by the obligatory warning that the four words "this time is different" are known to be highly dangerous to the value of capital and can have toxic effects on a portfolio. Acknowledging the risk, if the question of what's different this time is posed, our answer might be along the following lines:

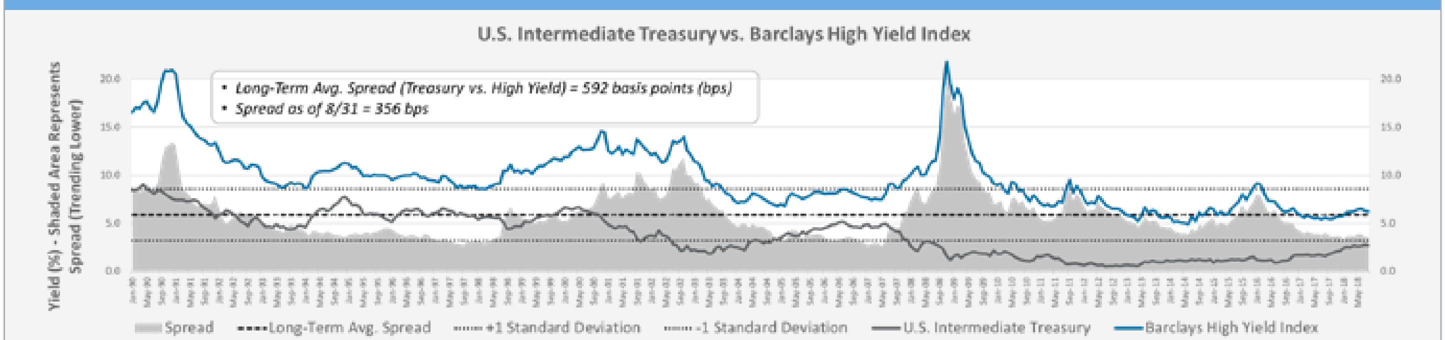
For the last nine months, we have written that 2017 may have belonged to Wall Street, but 2018 was more likely to belong to Main Street. What we were suggesting is that the tax bill was designed to stimulate the economy. It has done so, but the immediate effects were felt in the stock market last year, which moved smartly to fulfill its role of discounting future events by aggressively bidding up stock prices. Moving at the more realistically slower pace of real life, the economy has by now shown that it has moved to a higher level of activity, as the expansion has accelerated at a steady and apparently sustainable pace. Many forecasters are now debating when the economy will peak, a question we think is off the mark. One of the principal reasons that business cycles come to an end is that an excess of some sort builds up that must be liquidated. A mild version of this, for example, is a build-up in the inventory of some product. Producers become too excited and build too much of a product (cars, semi-conductors, etc.). The residential real estate bubble in 2008 was an example of the more extreme version. To stem the over-enthusiasm, the Fed raises interest rates to choke off demand and cool off the economy. It is the effect of higher interest rates that causes weakness in financial asset prices. As interest rates rise, bond prices decline, and price-earnings (P/E) multiples of stocks come under pressure.

What we believe is different this time is that we see no glaring excess that needs to be worked off, and we see an economy that is operating at a reasonable pace without major stresses building. As such, we would not expect to see the Fed compelled to raise interest rates. Nonetheless, the Fed, under the new leadership of Chairman Jay Powell, has clearly said they want to end quantitative easing (QE) and bring interest rates back to a more "normal" (whatever that means) level.

For investors, the paradox will be that the economy can continue to expand, but financial asset prices will likely labor as the overall capitalization rate for financial assets is pushed higher by the actions of the Fed, thus ending the era of administered interest rates. We will continue, of course, to need to be cognizant of the economy as we develop our earnings forecasts for the companies we own or are considering. We will have to expect that P/E multiples may not behave as traditionally expected as the pull exerted by rising interest rates constrains any expansion of equity valuation metrics.

And this brings us back full circle. If there is a governor on the upside potential for financial assets for a period but no corresponding safety net below, how and where do we ride this one out? In times of uncertainty, one of the first places to turn is quality. Note Exhibit 2 below. The spread of Treasury bonds over below-investment grade bonds ("junk bonds") is as low as it typically gets as investors have pushed the envelope in search of income. Almost half of the investment grade universe among corporate issues is found in the lowest level of the investment grade rating scale, and spreads there are correspondingly tight to Treasuries. In short, with interest rates on the rise, fixed income investors may not be getting adequately compensated for stepping down in credit quality. *[We interrupt this essay to bring you a paid political announcement: careful research can uncover specific bond issues at all quality levels for which one is being properly compensated. Active bond management can help identify those opportunities. We are SBH, and we approve this message.]*

EXHIBIT 2: MONETARY POLICY HAS TIGHTENED YIELD SPREADS



Monetary policy has artificially decreased the cost of capital, allowing highly levered entities to stay solvent. In such an environment, the market does not adequately compensate investors for the safety that well-capitalized entities provide. As monetary stimulus is reversed, we believe that owners of quality assets will be sufficiently rewarded for the financial strength of their holdings.

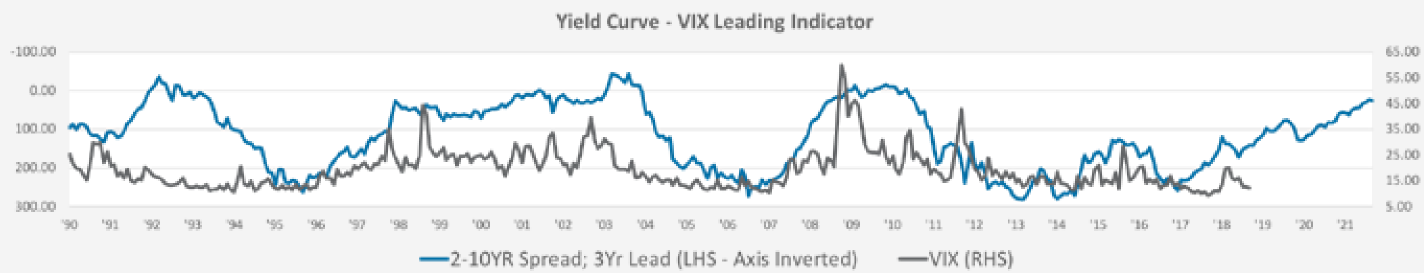
Source: FactSet, Bloomberg

In the equity markets, while we have long been believers that high-quality stocks are the best opportunity for long-term wealth creation at a reasonable risk, this may be an especially opportune ttime to overweight high-quality stocks. Note Exhibit 3 below. As the yield curve, which is a measure of the spread between short-term rates and long-term rates, approaches zero (or goes negative), the curve is said to be "flattening." In Exhibit 3, we invert the yield curve (in blue) and lag the measure of the VIX curve, which measures stock market volatility. Note that a flattening curve generally portends a pick-up in volatility. The curve may well continue to flatten as the Fed raises short-term rates and long-term rates remain stable. If so, the VIX is more likely to rise, suggesting higher stock market volatility could be in store.

Exhibit 4 shows the relative superior performance of high-quality stocks in times of volatility, sorted by their Return on Invested Capital (ROIC), which is essentially a proxy for quality. The top chart shows the correlation of stocks to the direction of the VIX over the last 25 years. The highest ROIC quintile has the strongest relation to a move in the VIX. If the VIX is expected to rise, higher-quality stocks might be expected to behave more favorably than low-quality stocks. Similarly, the bottom charts show the relative performance of stocks in the Russell 3000 Index over the last two periods (1994–1998 and 2007–2008) of higher volatility, again sorted by ROIC quintile. High-ROIC (quality) stocks in both instances provided superior relative returns.

Many participants who have not experienced a bear market, either in stocks or in bonds, may find a market environment like the one described above unfamiliar ground. The virtues of a long-term perspective, of building portfolios based on fundamental research from the bottom up, and above all, of having an appreciation for the need to protect capital—even at the expense of foregoing what could be short-lived opportunities—may be attributes the broader markets may come to prize as much as we do.

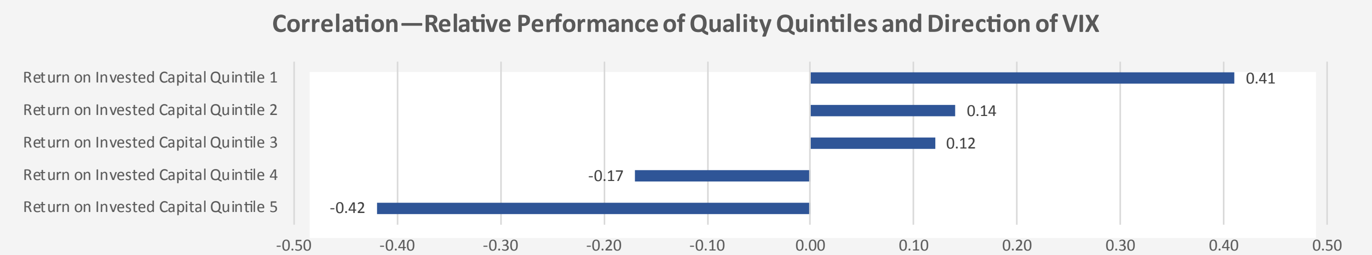
EXHIBIT 3: YIELD CURVE AS A RISK PREDICTOR



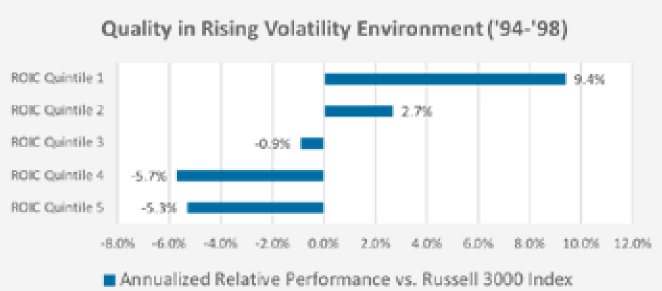
A steepening yield curve can be reflective of rising growth expectations and less risk aversion by investors, which in turn can suppress market volatility. On the other hand, a flattening curve can signal declining growth and rising risk aversion, often leading to escalated market volatility.

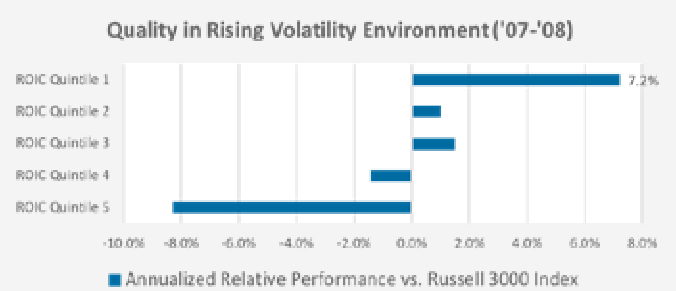
Source: FactSet, CBOE
Data as of Sept. 30, 2018. Past performance is no indication of future results.

EXHIBIT 4: QUALITY (MEASURED BY ROIC) IN PERIODS OF VOLATILITY



The chart above depicts the correlation between the relative performance of quality ranges—as measured by Return on Invested Capital (ROIC)—to the direction of the VIX (using rolling 12-month data going back 25 years).

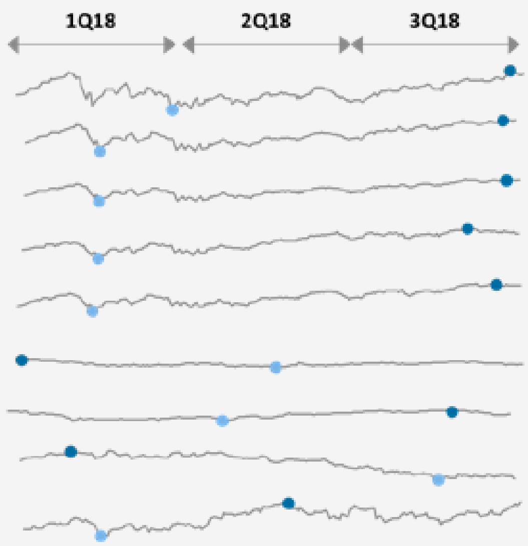




In periods of rising market volatility and investor uncertainty, high-quality stocks have historically outperformed the broader market.

Source: FactSet, CBOE, Bloomberg, Russell
Data as of Sept. 30, 2018. Past performance is no indication of future results.

MARKET BAROMETERS
AS OF SEPTEMBER 30, 2018



	Dec. 31, 2017	Sept. 30, 2018	Low	High
Dow Jones Industrial Index	24,719.22	26,458.31	23,533.20	26,743.50
S&P 500 Index	2,673.61	2,913.98	2,581.00	2,930.75
Russell 3000 Stock Index	1,582.77	1,726.52	1,525.26	1,737.97
Russell 2000 Stock Index	1,535.51	1,696.57	1,463.79	1,740.75
Russell Midcap Growth Index	970.34	1,092.20	942.42	1,103.90
Barclays Aggregate Index	2,036.91	2,004.36	1,976.98	2,036.91
Barclays Muni Bond Index	1,201.59	1,196.80	1,181.76	1,205.33
Gold (Price/Oz) London AM Fix	1,296.50	1,183.50	1,176.70	1,360.25
Goldman Commodity Index	2,556.71	2,859.44	2,474.59	2,861.85

Source: Bloomberg

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