SEGALL BRYANT & HAMILL

3RD QUARTER 2018

SBH NEWSLETTER

Thoughts on the Current Environment

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"History doesn't repeat itself, but it rhymes."

-Attributed to Mark Twain

The oft-repeated phrase, "History doesn't repeat itself, but it rhymes," is frequently attributed to Mark Twain. Whether or not these are his words, the essence of the thought can be seen in the ninth year of each decade. In more than half of the last 10 decades, the ninth year has proven to be a challenge for financial assets. There is no rational basis in economics for this to be the case, but the fact remains that serious stresses have played out as the decades have come to a close. Since we are coming up to one of those occasions soon, it seems worth reviewing the history to see if there are some common themes we can pull out of the record and some courses of action to consider.

1929: The end of the boom of the 1920s and the onset of the Great Depression are all neatly summarized simply in the number, "1929." In retrospect, the root causes of the Depression were several years in the making and largely due to major policy mistakes by global central bankers. Almost everyone loses sight of the fact that the stock market nearly recovered its losses by 1930, only to suffer a more devastating decline between then and 1933. Nonetheless, the moment between boom and bust is sharply etched into the public consciousness with the events of October 1929.

1969: The decade of the 1960s was the culmination of the postwar recovery and the end of a long bull market. Belief in the government's ability to control a modern economy reached its peak with the notion that Guns and Butter (i.e., simultaneously fighting in Vietnam and implementing the Great Society) could be sustained without consequence was finally challenged with the realization that inflation had become a chronic problem. The stock market declined significantly in 1969, with the S&P 500 Index falling from 103 to 92, having begun the decade at 60.[1]

1979: The appointment of Paul Volcker in 1977 as Chairman of the U.S. Federal Reserve (Fed) marked the beginning of a policy era to fight inflation with higher interest rates. By the end of the 1970s, the federal funds rate (the intra-bank overnight lending rate, directly controlled by the Fed) was at 13.75% and the yield on the 10-year Treasury note was similarly in double-digits, at 10.75%. Both would continue to rise for another year or so, but the inversion of the curve by the late 1970s (meaning that short-term interest rates were higher than longer-term rates) heralded a recession that was short and nasty. This was quickly followed by a return to recession in 1982. The stock market was down modestly in 1979, but the decline that ensued when the economy went into recession the second time led to the end of a 40-year bear market in interest rates, followed by a subsequent bull market in stocks that ran from 1982 to late 2008.

1989: The stock market had no end-of-decade swoon in the 1980s. The same could not be said, however, about the Savings and Loan (S&L) industry, which essentially imploded in the last two years of the 1980s. Fully one-third of the S&Ls in the U.S. in 1989 (1,043 out of 3,234) were shuttered by the time the crisis sputtered to a close in the early 1990s.[2] While a number of factors, including incomplete deregulation of interest rate differentials and inept-to-outright-incompetent S&L management played a big role, the spark was the decision by the Fed to raise short-term interest rates in 1989 from 9.75% to 12.0%. The S&L business model, which called for borrowing (via deposit gathering) at short-term rates and lending (via making 30-year mortgages) at long-term rates, turned upside down almost overnight (with the cost of borrowing for S&Ls far exceeding their return on lending). As a result, many institutions simply went insolvent, requiring federal bailout assistance to prevent depositors' losses. While housing prices, primarily in California and Texas, stumbled in the late 1980s as a result of the S&L crisis, the decline proved transitory, helping to build the myth that "housing prices in the U.S. could never go down for long."

1999: The decade of the 1990s produced a strong run in the financial markets, culminating in the infamous Tech Bubble of 1999. The introduction by Microsoft of Windows 95 revolutionized the widespread use of desktop computers across society. The advent of the age of the World Wide Web (the internet) promised dramatic changes to the ways information could be disseminated. The democratization of information promised radical changes, and promotors of internet investment opportunities found that only their imagination constrained them. As 1999 proceeded, the Fed became highly concerned about "Y2K"—the impact of the change in the century digits (from 19xx to 20xx) and its potential effects on the global computer system. (Quaint, huh? But a real worry back then.) Dire stories about the risks of widespread system failures, including/especially banking, led the Fed to flood the system with money right up to year-end. Soaring animal spirits and unlimited liquidity produced a heady brew, which led to a terrible hangover that began in the first quarter of 2000. The NASDAQ Index, home to many internet companies, fell by 41% by mid-2000.[3]

2009: The great bubble in residential real estate burst with a fury in late 2008 and into 2009. Wall Street has always had an infinite capacity to take sound ideas and drive them to an absurd conclusion. In this instance, the myth about the durability of housing prices rationalized the acceptance of increasingly lower borrower credit standards. Because housing prices "could never go down," the idea was that the collateral backing loans was sufficient even if a borrower's ability to pay wasn't. The bubble began to leak as early as 2007 and burst into crisis in the housing market and stock market, which then reached into the banking system. The so-called "Great Recession" was the most serious downturn since the Great Depression. The complete seizing up of the banking system was avoided only by extreme measures by global central banks, up through and including driving short-term interest rates to zero. From peak to trough, the S&P 500 Index fell about 60%.[4]

Common Threads in the "Nines"

Several common elements run through all of these episodes. First, an underlying economic theme or trend becomes accepted by many participants in the markets and economy as "the way things should be." This shared belief system results in valuations of an asset class becoming unmoored from its historical ranges. New theories of why it is different this time are developed to validate these higher prices. Price gains beget further confidence, which begets

[1] Source: FactSet
[2] Source: FDIC Banking Review, Volume 13: No. 2, June 2, 2000.
[3] Source: FactSet
[4] Source: FactSet

further price gains as a positive feedback loop becomes self-perpetuating. Second, at about the same time, the Fed begins to raise interest rates for reasons that may or may not be directly related to the shared theme or belief. Whatever the reason, higher interest rates inevitably produce stress on the weakest link in the economy. Depending on the cycle, it might be a subprime mortgage lender or an emerging market economy. Then, some development comes along to upset the conventional wisdom. The fragility of the market or sector in which fundamentals have changed is revealed, and "people who have gone mad collectively begin to regain their senses one by one," to quote a great line from the 1841 book, *Extraordinary Popular Delusions and the Madness of Crowds*.[5] A vicious price cycle downward ensues in the rush to sell. Although significant amounts of wealth are destroyed, when the dust settles in the beginning of the next decade, the opportunity for a new round of the game is ready to be dealt.

Our Current Decade

If we ask ourselves what is the excess as the decade of the "Teens" concludes, one would have to say that the leading candidate is the mountain of debt that has been created by global central banks in an almost decade-long struggle to kickstart economic growth. Quantitative easing (QE), a term brought to popularity during the Great Recession, has led to unparalleled growth in the holdings of public and private debt in the hands of the global central banks. Such a large burden of debt ought to overwhelm the income available to service it, but artificially low rates have masked that risk. In the U.S., monetary authorities have begun to slowly shrink their balance sheet, allowing the debt to roll off. This has been accompanied by slow but steady increases in the short-term lending rate in the U.S. Since neither the European Central Bank (ECB) nor the Bank of Japan (BoJ) have followed suit, the U.S. dollar has strengthened as a result. This is no doubt creating consternation in emerging markets, where substantial amounts of debt have been borrowed, denominated in dollars as opposed to local currencies. Why? Because "everyone knew" the dollar would inevitably decline. Throw in the unexpected risk of significant disruptions to global trade and conditions could get problematic quickly.

In times of stress, there is historically a flight to quality by investors as they seek to hold what they perceive to be the strongest investments in the asset class based on the ability to maintain its income-generating ability, be that a dividend or an interest payment. Cash becomes king, as liquidity evaporates in the fear of the moment. To the question of what to do in reaction to all this, our answer is: Not Much. There are no dramatic actions we think necessary. Our bottom-up approach to investing focuses on security selection, with heavy emphasis on quality or factors associated with quality. Historical experience suggests that our strategies tend to have good "downside capture" ratios relative to their benchmarks. ("Downside capture" refers to the degree to which a portfolio declines relative to its benchmark.) Equally as important, understanding the time horizon of a portfolio and the role of various asset classes in building that portfolio, the truly essential work to do is yet to come: determining what will rise from the ashes of the downturn and where the next set of opportunities lie.

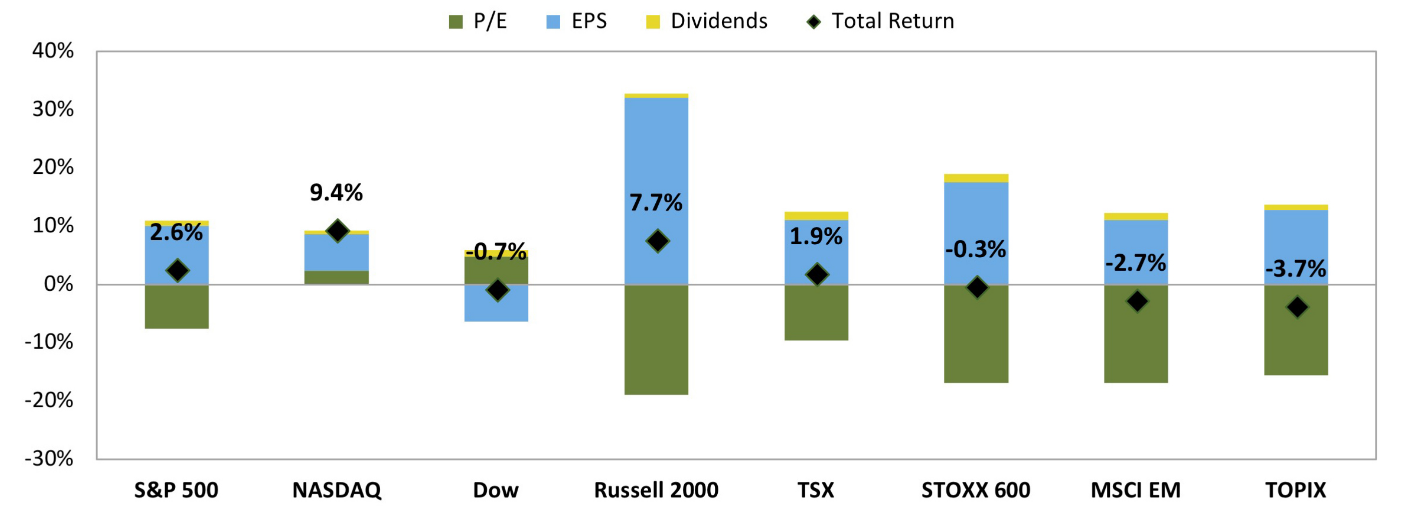
Meanwhile, Back at The Ranch...

Although the stock market rallied in the second quarter, the theme we advanced late last year appears to be playing out: Last year was Wall Street's year, but this year belongs to Main Street. The real economy is chugging along in fine fettle. Unemployment levels are at new lows as more and more people can find work. Wage gains may be modest, and inflation remains under control. Nonetheless, as we talk to the companies we invest in, we are hearing more concerns about the ability to find labor and the cost of such labor. If small businesses have any complaint, it is that input costs are rising more than they expected, but they correspondingly indicate they can pass those costs along to their customers—unless they are selling to the consumer, in which case price increases are proving harder to come by. In all, both small businesses and consumers are showing increasing levels of confidence, largely as the beneficial effects of the tax bill from late December continue to roll out and percolate through the economy.

As for the stock market, while we remain confident that the growth rate of earnings in 2018 and 2019 will stay strong, we believe the effect of those higher earnings will be partly undercut by rises in interest rates. Outside of the tech sector, gains in earnings have been more than offset by lowered valuation levels. The Fed, for its part, continues its program of weaning the economy of zero interest rates and QE. Higher interest rates are having the same kind of effect on financial assets as lower interest rates did, just in the opposite direction. As a result, higher earnings are not being matched by higher stock prices, and some parts of the financial markets, especially at the riskier end, are feeling stress.

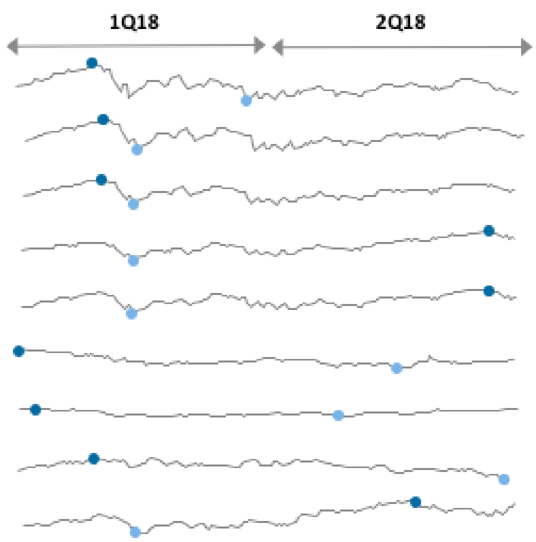
[5] Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds*. Originally published in 1841 by Richard Bentley, London.

GLOBAL TOTAL RETURN DECOMPOSITION (YTD)



Source: FactSet, Bloomberg. Data through June 2018

MARKET BAROMETERS
AS OF JUNE 30, 2018



	Dec. 31, 2017	June 30, 2018	Low	High
Dow Jones Industrial Index	24,719.22	24,271.41	23,533.20	26,616.71
S&P 500 Index	2,673.61	2,718.37	2,581.00	2,872.87
Russell 3000 Stock Index	1,582.77	1,618.99	1,525.26	1,694.23
Russell 2000 Stock Index	1,535.51	1,643.07	1,463.79	1,706.99
Russell Midcap Growth Index	970.34	1,017.40	942.42	1,057.92
Barclays Aggregate Index	2,036.91	2,003.97	1,976.98	2,036.91
Barclays Muni Bond Index	1,201.59	1,198.61	1,181.76	1,202.57
Gold (Price/Oz) London AM Fix	1,296.50	1,250.55	1,250.50	1,360.25
Goldman Commodity Index	2,556.71	2,821.65	2,474.59	2,861.85

Source: Bloomberg

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