Q3 2018
Investment Perspectives

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- **ALL-TIME HIGHS:** US equity markets fully recovered from their Q1 swoon and made new all-time highs during the quarter. The benchmark S&P 500 Index posted its biggest quarterly advance since Q4 2013. This came against a backdrop of heightened trade tensions between the US and China as well as growing concerns about the impact of rising interest rates.
- **GLOBAL TRADE CONCERNS LINGER:** Despite reaching an agreement in principle on NAFTA 2.0 shortly after the end of Q3, investors remained concerned about the potential impact of a protracted, global trade war. In particular, emerging markets continued to be punished by investors over fears that their export-driven economies would be at risk.
- **THE FED HIKES AGAIN:** The Fed stuck to its plan during Q3 and delivered another 25 basis point hike to the Fed Funds rate. Bond investors were again forced to re-calibrate expectations in response to a more hawkish Fed outlook, leading to higher interest rates and a flat quarter for core bonds.

Market Recap

The US reasserted itself as a leader in the global economy during Q3 as corporate earnings and economic data held firm against a backdrop of slowing global growth. US stocks responded accordingly, advancing by over 7% during the quarter thanks to improving investor enthusiasm. Non-US stocks, on the other hand, struggled to advance during Q3 as a variety of concerns weighed on share prices.

Bond returns—outside of high yield—were lackluster once more as investors continued to adjust interest rate expectations upward in response to a more hawkish Fed outlook. The Barclays Aggregate Bond Index finished the quarter -1.6% for the year, threatening to post a negative calendar-year return for the first time since 2013 and only the second time in 20 years.

continued on page 2

FIXED INCOME

	USD Total Return (%)	
Index	**Q3 2018**	**YTD**
Barclays 1-10 Yr Muni	-0.1%	0.0%
Barclays US Agg. Bond	0.0%	-1.6%
BofA/ML HY Master II	2.4%	2.5%

EQUITIES

	USD Total Return (%)	
Index	**Q3 2018**	**YTD**
Russell 3000	7.1%	10.6%
S&P 500	7.7%	10.6%
Russell 2000	3.6%	11.5%
MSCI All Country World	4.3%	3.8%
MSCI EAFE	1.4%	-1.4%
MSCI Emerging Mkts	-1.1%	-7.7%

Source: Bloomberg (Data as of 9/30/18)

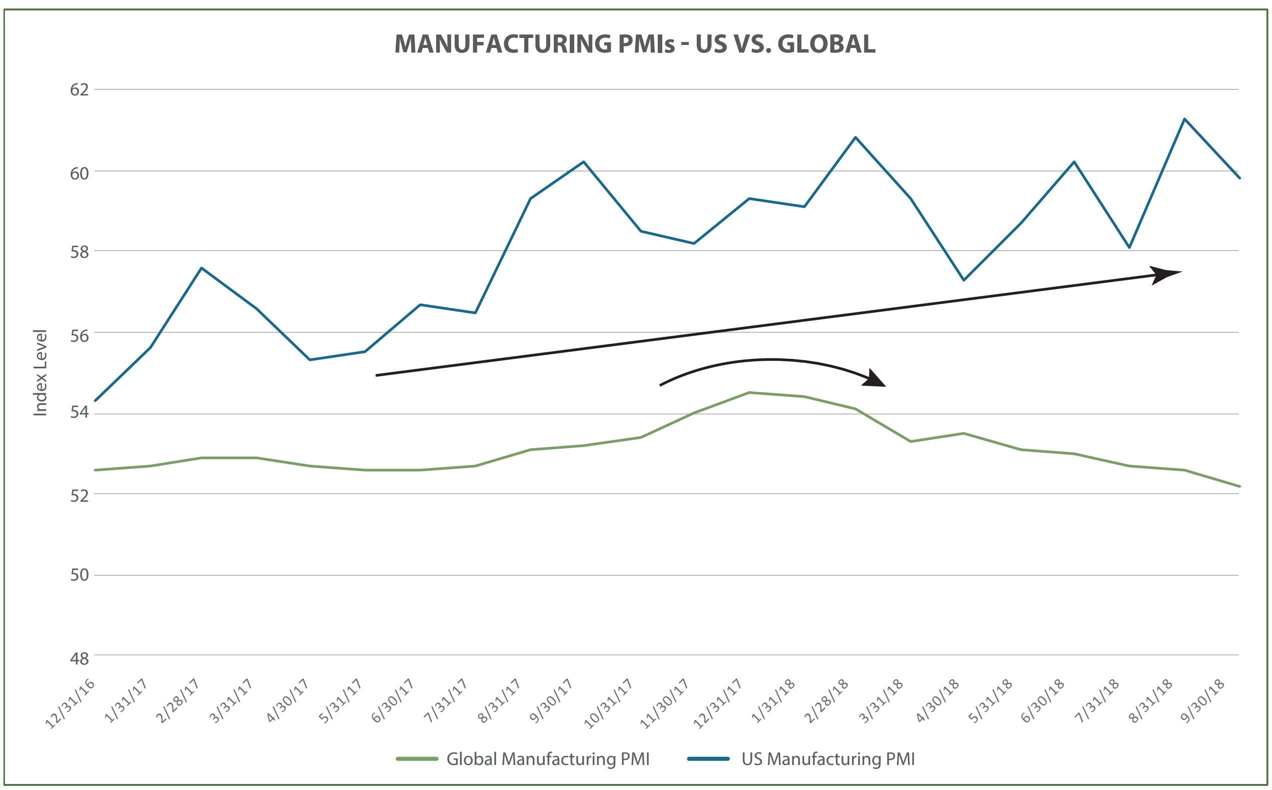
ONE OF THESE THINGS IS NOT LIKE THE OTHERS

Investors reviewing year-to-date returns across major asset classes will notice one major anomaly: as indicated on the performance chart on page one, the US equity market is dramatically outperforming global stocks and bonds—by a wide margin. Notwithstanding crude oil's year-to-date return of over 20% (an anomaly in and of itself within the commodity complex), US stocks are the only asset class to post double-digit returns, and most other major asset classes range from flat to negative. In our experience, in such an intertwined global economy, these types of significant dispersions tend not to persist. The question will be how the convergence occurs—e.g., via a US sell-off or a non-US rally.

THE SYNCHRONIZED GROWTH STORY COMES TO AN END

After a multi-quarter run of synchronized global expansion, economic data from non-US countries unequivocally rolled over in Q3. The chart below illustrates the trajectory of the Purchasing Managers Index (PMI) that tracks manufacturing activity in the US and the world more broadly since the beginning of 2017. The PMI is a "diffusion" index, reflecting the level of acceleration or deceleration around a neutral level of 50.

While the global economy has clearly been slowing, US manufacturing and industrial production data has remained firm—likely a key underpinning for the US market's outperformance. Non-US markets that are more levered to cyclical sectors that thrive when growth is broadly accelerating have been especially hard hit—e.g., China, Korea—with protectionist trade rhetoric only serving as an accelerant for the sell-off.



Source: Bloomberg (Data as of 9/30/2018)

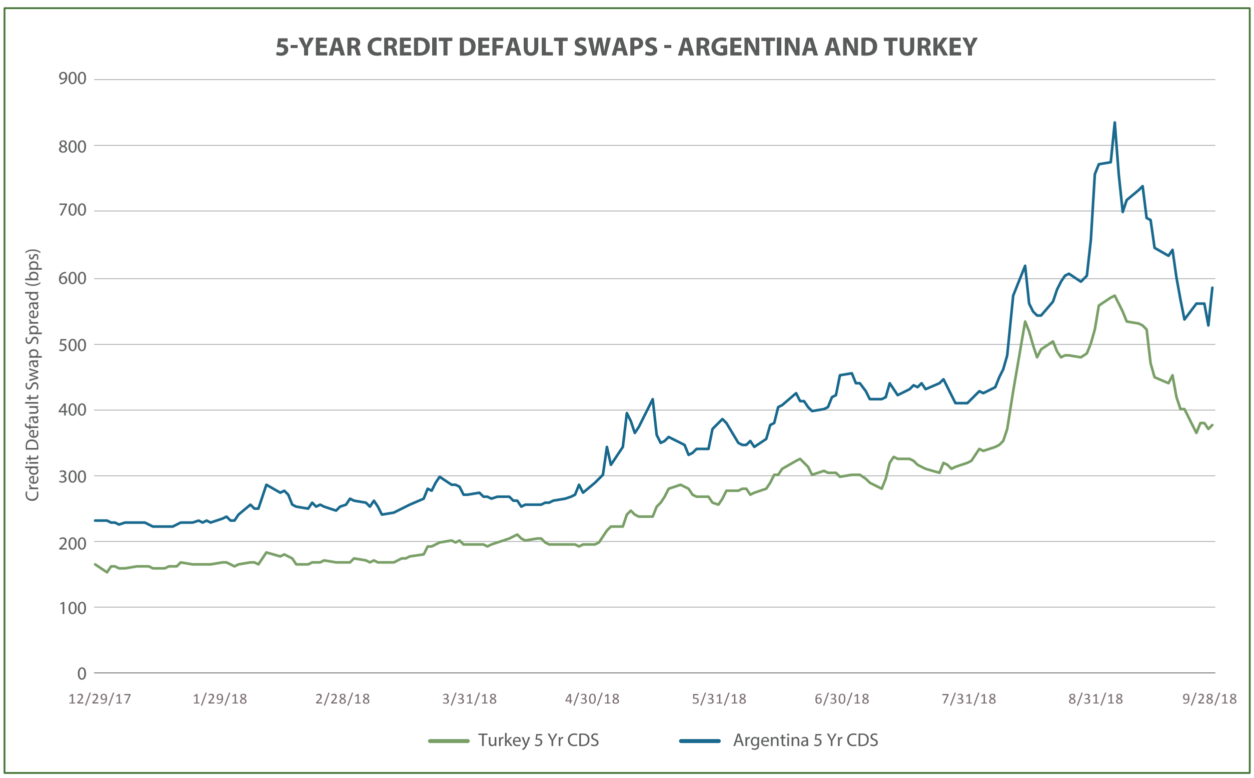
continued on page 3

NARROWING MARKET LEADERSHIP

A frequent feature of late cycle markets is narrowing leadership; in other words, market gains being driven by an increasingly concentrated group of companies or industries. With that in mind, consider the following: Despite the S&P 500 being up roughly 10.6% for the year, only three of the S&P 500's eleven sectors outperformed the index for the first nine months of the year. Technology and consumer discretionary stocks led the way with returns of roughly 20.3% each, and healthcare advanced 16.2%. Amazon, Apple, and Netflix—members of the oft-cited "FAANG" stocks (Facebook, Apple, Amazon, Netflix, and Google/Alphabet)—along with Microsoft have accounted for over 4% of the S&P 500's 10.6% gain. On the other side of the coin, four S&P 500 sectors posted negative returns through Q3—financials, telecom, materials, and consumer staples. For broadly-diversified strategies that did not hold meaningful positions in the aforementioned stocks, it has been a difficult year to match the performance of the index.

CONTAGION CONCERNS IN EMERGING MARKETS

As the US dollar strengthened to its highest levels of the year in Q3, investors grew increasingly concerned about emerging market countries reliant on dollar funding sources. In particular, the quarter saw fresh concerns emerge about Turkey and Argentina—two nations that are heavily reliant on foreign funding and susceptible to shocks stemming from a stronger dollar. Both currencies, the lira and peso, weakened dramatically, and the debt of both countries came under selling pressure. The chart below shows the cost to insure Turkish and Argentinian 5-year bonds against a default slowly becoming more expensive, then spiking higher in August and September.



Source: Bloomberg (Data as of 9/30/2018)

continued on page 4

The big concern within emerging markets is the so-called contagion effect, whereby the problems seemingly confined to a smaller number of countries begin to spill over into similarly-situated countries, causing global repercussions. At this point, the Turkish and Argentine issues appear to be contained, but contagion risk remains a key concern for developing markets.

RATE HIKE REALITES

For a third consecutive quarter, the bond market was behind the curve relative to the trajectory of Fed interest rate hikes. Market participants had been discounting the likelihood that the Fed would stick to its guidance of one rate hike per quarter in 2018. As the Fed's guidance became increasingly credible, bond yields had to adjust to reflect the reality of the situation. As bond yields move higher, bond prices go lower, leading to negative returns for core fixed income indices in 2018.

The concern going forward is that investors continue to underestimate the likelihood of the Fed raising rates more than two times over the coming 12 months. At the end of Q3, the market-implied probabilities were for 2.2 rate hikes over the next year. With a December rate hike seeming like a near certainty based on the Fed's commentary, if the Fed opts to raise rates more than one time in 2019, the bond markets will likely be in for more pain as expectations once again play catch-up with reality.

OIL AT AN INFLECTION POINT

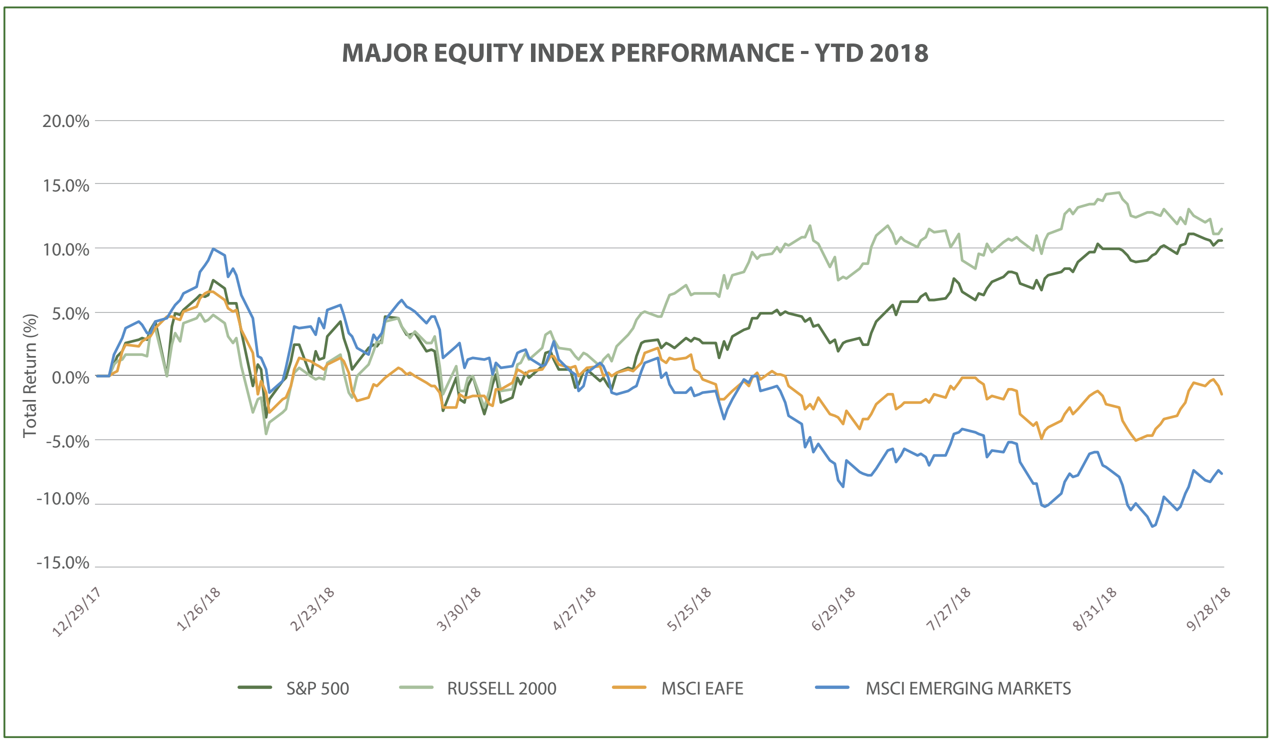
After President Trump opted to abandon the Iran nuclear deal and reintroduce sanctions on Iran in August, oil prices moved meaningfully higher into quarter-end. Concerns that removing supply from the market would squeeze already tight markets for crude oil pushed West Texas Intermediate prices to roughly $73 dollars per barrel. A number of energy experts have made the case that the world simply does not have enough spare capacity to meet the growing demand for oil, which could lead to a spike in prices over the coming months.

The impact of oil prices on the global economy is incredibly complex. On the one hand, higher oil prices are generally helpful to commodity producers around the world and are reflective of a healthy global economy that requires hydrocarbons to manufacture and transport goods. Specific to the US, the shale oil boom created a significant number of jobs and a large amount of wealth. On the other hand, as oil prices rise too high, corporate margins are squeezed because of higher input costs, and consumers have to allocate more of their budget to energy expenses. At over $70 per barrel, oil is approaching an inflection point whereby another material increase in prices may shift from being economically productive to deleterious. ●

Chart of the Quarter

This month's "Chart of the Quarter" is a simple depiction of the 2018 performance of two major US stock indices—the S&P 500 and Russell 2000—and the major non-US indices—the MSCI EAFE and MSCI Emerging Markets. The chart distills myriad narratives into a single picture. Among the key storylines for 2018:

- The global growth story was largely intact until the beginning of Q2, then a bifurcation started to occur along the lines of US versus non-US.
- Emerging markets started the year as investor darlings once again after posting the best returns among major asset classes in 2017. Then, the US dollar started to strengthen as interest rates moved higher, trade war rhetoric heated up, and EM stocks fell out of favor.
- Small cap US stocks—as measured by the Russell 2000—thrived in Q2 as investors sought more domestically-oriented businesses that would be less impacted by global trade protectionism.



Source: Bloomberg (Data as of 9/30/18)

As we begin to look toward 2019, the chart also elicits some key questions:

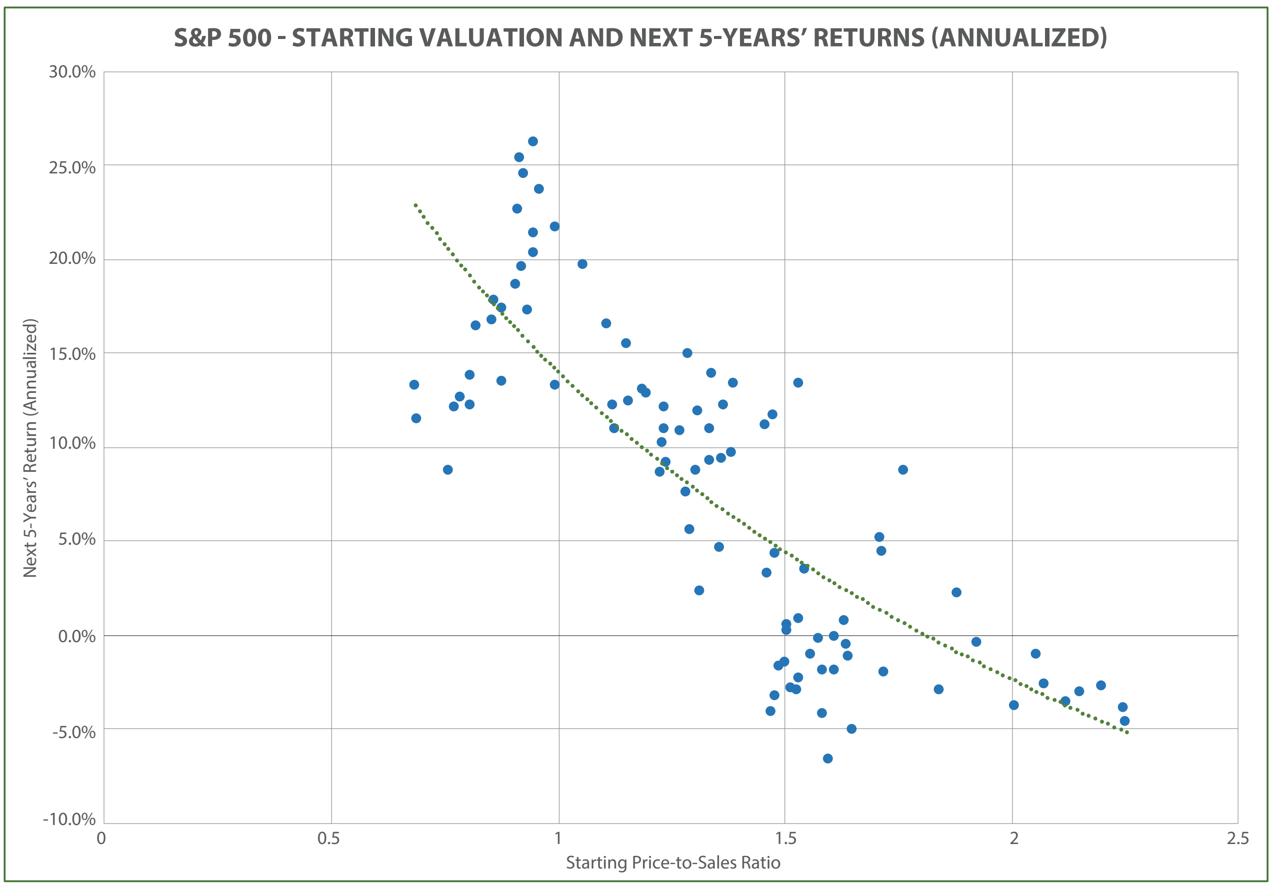
- Will the US growth story prove to be robust despite a weakening global economy?
- Will there be any progress toward a resolution of the trade wars—particularly between the US and China—which would improve investor sentiment toward EM stocks?
- Can small cap stocks continue to outperform large caps despite relatively expensive valuations?
- Will US/non-US performance converge?

Q4 will likely start to offer answers to these questions with markets having had time to digest the impact of the shifting fundamental landscape.

Why Does Valuation Matter?

Even if you only loosely follow the stock market, you are probably familiar with references to "PE ratios" or more general discussions about valuation. A PE ratio, or price-to-earnings multiple, is a common way of assessing the relative cheapness or expensiveness of a stock by dividing a company's stock price by its earnings—most frequently, either the last 12 months of actual earnings or the consensus expectations for the next 12 months' earnings. All things being equal, the higher the PE ratio, the more expensive the stock. Invert the price-to-earnings ratio and you have the earnings yield. For instance, a 20x PE ratio would be a 5% earnings yield, which is useful to think about relative to high quality bond yields; if a risk-free Treasury bond is yielding roughly 3%, does a 2% expected return premium provide sufficient compensation for the extra risk?

There are countless other metrics to compare stock valuations—price-to-sales, price-to-book, enterprise value-to-EBITDA (earnings before interest, tax, depreciation, and amortization), etc. Some measures are more or less relevant for different industries or types of businesses, and some are more susceptible to spurious readings caused by extraordinary factors. To that end, one of our preferred data points is price-to-sales. Unlike earnings that can be impacted by temporary expenses and/or creative accounting maneuvers, top line sales figures are more difficult to manipulate. Particularly in a historical context—across different interest rate environments, tax regimes, etc.—it is perhaps the most useful way of standardizing valuations.



Source: Bloomberg (Data as of 9/30/2018)

Now to the central question: Why does valuation matter? The short answer is that your starting valuation has traditionally been a strong predictor of your future returns. The chart on the previous page shows the historical relationship between the starting price-to-sales multiple for the S&P 500 and the next five year's returns going back to 1990 (observed quarterly). As the starting valuation is more expensive (the horizontal axis), the future rate of return is lower (the vertical axis). The line of best fit has an r-squared of 0.64, or in plain English, the relationship between the two variables is quite strong.

To be sure, valuations do not tell us much about the near-term direction of markets, nor is the price-to-sales multiple a one-size-fits-all indicator. But, at today's high valuations, it does argue for a more cautious approach going forward, and it certainly suggests that investors should have more measured expectations about future returns. ●

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