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Eyes Wide Open — Maintaining A Longer Term Perspective

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Stocks continued their heavy decline as more technical selling pushed market indices down further. Volatility spiked and all eleven sectors exhibited additional drawdowns. NASDAQ officially entered into correction territory with a decline of at least 10 percent from its 12 month high. The most recent fierce weakness triggered more of a flight to quality versus earlier in the week. Gold and the Japanese yen rallied while longer term Treasury yields declined.

We advise investors to take a longer-term perspective. We would take advantage of the negative volatility once it subsides and use the extreme weakness to increase exposure to equities with high-quality balance sheets, strong free cash flow, solid dividend growth commitments and that are priced at an attractive valuation. Investment managers that have a long-term history of allocating to these types of investments should take advantage of the large-scale re-price that is occurring in the market, in our view.

WHY ARE WE EXPERIENCING FURTHER SELLING IN EQUITIES?

Even though interest rates were widely expected to rise throughout the year, as economic growth gathered momentum, market participants waited until yields reached cycle-high levels, U.S. equity valuations became so over-stretched in the high growth areas of the market, and U.S. indices climbed to historically wide levels relative to the rest of the world, before de-risking their portfolios in an aggressive fashion.

The selling did not occur due to any one event or an economic or financial indicator rolling over. Rather, the sharp rise in risk aversion occurred due to the concern that rising rates are going to eventually pressure the consumer, increase financing rates for corporate and government debt, and significantly slow down the above-trend economic growth we have been experiencing.

As this realization filtered into the market in the past week, and as negative volume gathered momentum, technical price levels came under pressure, which resulted in additional liquidations. In some cases, de-risking a portfolio involves lowering equity allocations by multi-asset institutional investors. In other cases, it involves forced selling when an investment model is breached and there is an automatic, non-emotional sell trigger. This can occur in both stocks and bonds as well as in currencies, commodities and derivatives. When this happens it can feed on itself and cause more "domino effects" across various types of programs. At this point, asset class correlations tend to quickly rise together.

Moreover, we are in the fourth quarter, a period when technical selling by short-term programs sometimes leads to portfolio re-positioning in the longer term segment of the market—in particular, the fund manager. When quick downdrafts of this magnitude occur, it can cause fund managers to evaluate their positioning and lock in the gains they have made, since we are now later in the year. This is one of the reasons October has historically been one of the weaker months in terms of performance.

Since growth stocks, momentum stocks, and sectors such as Technology have far outpaced many other segments of the marketplace, these areas tend to be the ones in which fund managers take profits and lower their allocation all the way back to "normal" strategic benchmark levels. Other sectors,

such as Financials, Energy, and Industrials, are sold due to concerns that more cyclical industry groups are going to succumb to a much lower growth environment. If very few investors are willing to "buy on the initial dips," the overall market can exhale to lower levels in a short period of time, particularly prior to earnings periods in which there is a dearth of fundamental news.

This type of activity (and linkage) is not new. This has happened numerous times throughout various business cycles. However, since there are more model- and machine-based programs involved in the markets nowadays, coupled with the ease of buying and selling passive investments, such as Exchanged-Traded Funds (ETFs) and Index-based investments, drawdowns like those we have experienced recently can occur in a shorter time frame and perhaps with greater magnitude than previous periods. We call this "episodic volatility." That is, volatility that stays dormant for a long period of time throughout the year then quickly spikes in a short time frame before settling back down as economic fundamentals take over from the technical activity.

Market episodes that produce a higher level of fear, particularly ones that involve more short-term model-based investment programs, tend to produce significant gyrations in day to day activity as many investors begin to analyze key technical price levels in the markets. They analyze these price levels to test whether or not new investors are going to support the market and whether existing investors are going to protect gains or protect against further losses by de-risking.

In periods of extreme volatility it's important to step back and assess the economic fundamentals, to determine if the broader economy is still producing the level of growth (in both economic and corporate earnings) needed to support the level of interest rates. Business cycles can often produce mixed signals, particularly cycles that have included a record level of central bank liquidity and ones that have lasted as long as the current cycle.

WHAT'S OUR VIEW?

At present, we view this extended sell-off as a re-pricing of risk and a correction of the excess built up in the high growth areas of the market. This, in our opinion, is more of a technical, shorter term de-risking event that is likely to push valuations down to more acceptable levels, rather than a major change in the direction of the broader economy. Economic and earnings growth may slow down in 2019 relative to this year, interest rates may rise further, and central bank liquidity should continue to decline. But we do not believe the potential slowdown is going to push the economy far below trend at the same time as the Federal Reserve creates significantly restrictive conditions by raising overnight rates above the neutral level.

As growth slows, we do expect equity multiples to stabilize at a level that is more appropriate given the higher interest rates. Therefore, equity returns are likely to be closer to the level of corporate earnings growth (6-7 percent) or slightly below long term historical returns. We still expect stocks to outperform bonds and do not believe the end of the full cycle is imminent. If the yield curve begins to invert where short rates rise above long rates, or if oil prices move sharply higher toward $100 a barrel, or if yield spreads widen out dramatically, we would lower our risk budgets and re-position portfolios more defensively. Market timing is not only very difficult, it is also not a particularly successful strategy, in our opinion.

Periods that contain macroeconomic pivot points, such as a transition from a low yield, low growth environment to a higher yield, higher growth one like today's, can produce a number of mixed signals and could create a push-pull atmosphere as portfolios are re-balanced. We would focus on the full Treasury yield curve, credit spreads, and whether or not earnings have peaked, to determine if the stocks to bonds ratio is transitioning more in favor of bonds or other defensive assets.

At this stage, where fear is high and short-term traders are creating a backdraft (volatility spikes), investors should maintain a high level of diversification across and within asset classes. This can help you stay on track with your pre-determined long-term objectives without trying to move in and out of the market in the short-term.

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