CAPITAL
ADVISORS

Overview

April 2019

Key Points

- The stock market rallied sharply during the first quarter after the Federal Reserve (Fed) communicated its intention to stop raising interest rates for the foreseeable future.
- More recently, investors have been digesting the potential impact of an "inverted yield curve," an unusual condition where long-term interest rates drop below short-term rates.[1]
- This development makes investors nervous because every U.S. recession since 1956 was preceded by an inverted yield curve (although not every inversion led to a recession…there were two exceptions).[2]
- Importantly, the timing between yield curve inversions and subsequent recessions has varied widely in the past, making it far from perfect as a driver of investment decisions.
- Fortunately, there has always been a lag of at least a few months before the economy or the stock market rolled over (when it did), and stocks have tended to perform reasonably well for a time after inversions.
- We believe investors have time to be thoughtful about responding to the recent inversion.
- Although we are acutely aware of the ominous history of yield curve inversions, we do <u>not</u> expect a recession to follow this time.
- We are watching two variables in particular to track the credibility of our viewpoint – corporate earnings estimates and credit spreads.
- If earnings estimates hold up through the coming earnings reporting season, and credit spreads remain stable, we suspect stocks can build upon their gains from the first quarter.
- We do <u>not</u> recommend that investors "lock in" the recent advance in the stock market by reducing their equity holdings *unless the downturn in the fourth quarter alerted them to a mismatch between their risk tolerance and their portfolio design.*
- If our relatively optimistic outlook turns out to be wrong, we would not expect the resulting downturn in the stock market to be any worse than the fourth quarter of 2018 in either magnitude, or duration…unnerving, but not the end of the world.

[1] The "yield curve" describes the term structure of interest rates on bonds with maturities ranging from a few months out to 30 years. Most of the time the slope of the yield curve is positive, meaning short-term yields are lower than longer-term yields. When shorter-term yields are higher than long-term yields, the curve is said to be "inverted."

[2] The source for all recession references in this section is National Bureau of Economic Research (NBER) and Bloomberg

Is it Time to Sell?

Since 1956 the stock market has peaked six times following the start of a yield curve inversion, while a recession has followed on seven occasions. An inverted yield curve has only signaled a false-alarm twice in the past seven decades.[3] With this correlation in mind, it's no surprise that investors began to question the durability of the stock market rally when the yield curve inverted in late-March.

Although we believe an inverted yield curve is important, we do not believe it is necessary for investors to react aggressively in the near-term for several reasons:

a) There should be time to be thoughtful. Historically, stocks have continued to perform reasonably well in the immediate aftermath of an inversion, even when the economy eventually slipped into recession.
b) Not all yield curve inversions led to recession – exceptions occurred in the late-1980s and late-1990s.
c) Although the yield curve has been a reliable predictor of recessions in the U.S., the same has not been true in other countries.
d) While it is always dangerous to assume "it's different this time," 10+ years of emergency monetary policies throughout the world makes many things different about today vs. history.
e) As of this writing, the yield curve has only been inverted for one week based upon a single approach to measuring it (three-month U.S. Treasury Bills vs. 10-Year U.S. Treasuries). Another common metric for defining the state of the yield curve – 2-Year vs. 10-Year Treasuries – has not inverted thus far.

The Likely Meaning of the Inverted Yield Curve

We believe the most important message from the current shape of the yield curve is that the global economy is slowing. Importantly, this is <u>not</u> new information. Indeed, we suspect the primary driver of the stock market downturn in the fourth quarter was the Fed's insistence – at the time – that it planned to continue hiking interest rates in 2019, despite increasingly squishy economic data that *everyone but the Fed* seemed to notice at the time.

In early January the Fed executed an abrupt pivot when it declared a pause in its campaign to raise interest rates. The stock market rallied sharply in reaction to this development, appropriately so, in our opinion. We believe the Fed's pause removed a major risk factor from global asset markets – that an overzealous Fed might tighten monetary policy too far.

[3] Source: Investopedia

Today's Interest Rate Level Would Normally Be Celebrated

With the Fed on hold for now, it is important to acknowledge that interest rates are incredibly low by historical standards. Moreover, inflation data has not been threatening anywhere in the developed world, so there is little reason to expect interest rates to move materially higher for the foreseeable future. Against this backdrop, we believe the stock market can continue to perform reasonably well *as long as corporate profits remain healthy*.

There is an important reason to believe corporate profits *can* remain healthy due in large part to low interest rates. We suspect the most important (and least discussed) distinction between today's inverted yield curve and examples from the past is the relationship between the cost of capital and return on capital for domestic businesses. Specifically, companies can still earn a comfortably positive spread over their cost of capital today, regardless of whether they borrow short-term or long-term, because rates have settled at such a low level for this point in the monetary policy cycle.

This was not the case during past yield curve inversions when the Fed pushed short-term rates high enough to squeeze the margin of safety out of potential business investment opportunities, causing companies to delay, or cancel projects. Unlike past yield curve inversions, there is no dis-incentive today for companies to continue to invest in their facilities, equipment and people. We believe they will.

How Will We Know if We Are Wrong?

The first sign post we will use to assess the credibility of our outlook is first quarter "earnings season," which kicks-off in mid-April. Consensus expectations are low for the first quarter, with companies in the *S&P 500 Index* expected to report a year-over-year decline of roughly 3.5%.[4] If actual corporate profits come in at, or above consensus estimates (they almost always do), and earnings guidance for the remainder of 2019 does not surprise to the downside, we suspect investors' concerns about the economic outlook might mellow a bit.

The other indicator we watch on a regular basis is credit spreads, or the difference in yield between corporate bonds, which carry the risk of default, and U.S. Treasuries, which do not. When credit conditions in the economy deteriorate, it usually reflects itself in widening credit spreads, particularly among companies with lower credit ratings (i.e. "junk bonds").

Credit spreads remained well behaved throughout the first quarter, including the last two weeks of the quarter when the yield curve inverted. This is an encouraging signal, in our opinion.

[4] Source: Bloomberg

What's the Upside?

At its closing price on March 31st the *S&P 500 Index* was trading at a forward price-to-earnings ratio (P/E) of approximately 17.1.[5] With interest rates expected to remain anchored at very low levels for the foreseeable future, a P/E ratio in the 18-19 range seems easily justified by historical experience and economic principles.

In addition to potential P/E multiple expansion, corporate profits are also expected to keep growing. The recent consensus estimate for 2020 calls for year-over-year growth of approximately 11% vs. 2019.[6] Even if the 2020 earnings estimate drifts lower over time, as out-year estimates typically do, we believe the combination of earnings growth potential, plus P/E multiple expansion, can allow the stock market to build upon its first quarter advance by year-end. To be sure, lingering risks surrounding the economy, geopolitics, and U.S.-China trade relations could trigger a pull-back at any time. However, provided the macro worries of the moment – and there are always plenty – can resolve themselves in a better-than-worst-case manner, we suspect investors who stay-the-course in the stock market will be glad they did.

Current Design of Our Investment Strategies[7]

The remainder of this report addresses the current positioning of each of our investment strategies. To the extent possible within the structure of each strategy, we have positioned these portfolios for the following broad perspectives:

1) Many risks remain unresolved, but our base case outlook assumes the economy will not enter recession for the foreseeable future – despite the inverted yield curve – and stocks can perform reasonably well through year-end.
2) We do not recommend that investors "lock-in" recent gains in the stock market by selling down their equity exposure.
3) The only possible exception to point #2 is any investor who learned that the downside volatility of their portfolio was out of sync with their risk tolerance during the fourth quarter downturn.
4) If our relative optimism is misplaced, we would not expect the resulting downside in the stock market to be materially worse than the fourth quarter in either magnitude, or duration. Investors who endured that experience with tolerable anxiety seem well suited for the full range of most likely outcomes over the next 12-18 months.
5) Principal areas we are watching closely for negative surprises include earnings estimates, credit spreads, trade policy, and the behavior of international markets, particularly China.

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[5] Source: Bloomberg

[6] Source: Standard & Poor's; Bloomberg

[7] The portfolio strategy discussions in this section are supplemental to a compliant presentation. A complete list of Capital Advisors' portfolio models and compliant presentations are available by contacting Capital Advisors.

Managed Equity Strategies

The Stock Market is Still Cooking the Same Recipe – Is it Using a Timer?

During the past three years the *S&P 500 Index* has risen a bit over 10% annually, on average. During the past six years, a bit above 11% annually - during the past 10 years, over 11%.[8]

The following ingredients have been essential to this successful recipe:

1) Low interest rates (globally)
2) A supportive central bank (globally)
3) Low but stable economic growth (no recession in the U.S.)

We believe all three of these variables remain in place today, with the first two having been strengthened recently. Most in question may be #3. The economic growth outlook has been the variable most a risk of faltering throughout the bull market, but we suspect a constructive outlook can remain in place through the upcoming earnings season, at a minimum.

Risk Management – Steps We Have Already Taken

Near- and longer-term economic scenarios are key to our risk management process. As discussed, we do not expect a recession. Even so, we recognize that financial markets can change quickly. With this in mind, we have taken several steps to tilt the risk profile of our Managed Equity strategies lower, as follows:

- We have been actively managing the stock weightings in each strategy for new money purchases to avoid over-committing to individual stocks that are close to our near-term price targets;
- We have rotated the stocks in both strategies towards higher-quality balance sheets. For instance, we added two companies to the *Dividend* strategy that have a blended average dividend yield of 5.5%, three-year dividend growth rate of 4%, and an average credit rating of A- (upper tier)[9].
- We have further diversified both strategies to help avoid over concentration to any single valuation factor. For instance, within *Growth*, we trimmed certain outperforming Technology and Health Care positions, while redeploying those funds into a more diversified range of value drivers.

[8] Source: Bloomberg. Compound annual growth rate, assumes gains are reinvested
[9] Source: Bloomberg

Focus on Sustainable Leaders of the Most Attractive Markets

We seek to focus the Managed Equity strategies on mega-trends that seem likely to create significant value in the global economy. Within these mega-trends we seek to identify leading companies that help to shape the trend's development. We believe this is an important feature of active investment management because the leading companies and industries of tomorrow are frequently different from the past.

Top-10 S&P 500 Members

1980	2017	
1. IBM	1. Apple	
2. AT&T	2. Microsoft	*Indices heavily weight yesterday's trends*
3. Exxon	3. Alphabet	
4. Standard Oil of Indiana	4. Amazon	
5. Schlumberger	5. Facebook	*Only one company made the transition from 1980 to 2017*
6. Shell Oil	6. Berkshire Hathaway	
7. Mobil	7. JP Morgan	
8. Standard Oil of California	8. Johnson & Johnson	
9. Atlantic Richfield	*9. Exxon Mobil*	
10. General Electric	10. Bank of America	
7 of 10 were Oil companies	**Top-5 are Tech companies**	

Source: Standard & Poor's. As of December 31 in the year shown

For example, the *Managed Equity Growth* strategy currently includes dedicated exposure to the following mega-trends:

Robotics: The next leg of the Industrial Revolution's use of machines to make tasks more efficient. At present, we view Medical Robotics as the highest-value segment.

Artificial Intelligence: The next leg of the Computing Revolution, including data analytics, self-driving cars, intelligent homes, smart utility grids.

Cloud Services: Involves businesses shifting their technology and information assets to the cloud for better capture and analytics...technology is not Wal-Mart's core competency; retailing is.

Biotechnology: At the center in the fight against suffering and death - the knowledge, equipment and treatments that are sparking advances in cancer, heart disease, diabetes, arthritis…

- **Gene & Cell Therapy:** Treating DNA strands and cells to eliminate or treat the root cause of diseases.
- **Immuno-Oncology:** Supercharging the body's immune system to fight cancer.

Electronic-Payments: The shift from cash to card to button. E-payments can enable new business models and help make established ones more efficient.

New Retail: Technology is transforming the shopping experience. Use a phone (or ask Alexa) to have food delivered to your doorstep in two hours; select items and check out of a store without stopping at the cashier; try on a blue item at a store and order a red one from the online kiosk...we believe technology has just scratched the surface of its potential impact on the shopping experience and profitability of "new retail" companies.

Social Change: The aging global population, the impact of connectivity technologies, the rise of two-income families, increasing financial power among women, changing generational expectations....

Emerging Consumer: In Asia alone, 525 million have already joined the middle class - more than the total population of the European Union (EU). Over the next 20 years the middle class could expand by another 3 billion people, almost exclusively from the emerging world.[10]

Fixed Income

The Fed has increased its borrowing rate from ~1.0% in mid-2017 to ~2.5% today. At this point, we believe they are very close to, or are already done with their current tightening program, and we expect the Fed to remain on the sidelines for the foreseeable future.

By structuring bond portfolios in a "ladder" with maturities typically contained within the 1-to-10-year range, the cost of being wrong should be minimal unless rates rise significantly. Conversely, if rates stay lower for longer as we currently expect, we can be thankful for the extra income provided by the longer bonds in the portfolios.

Our individually managed taxable (corporate focus) and tax-exempt (municipal focus) bond portfolios are customized according to three broad priorities – Liquidity, Income or an Aggregate of the two. A Liquidity portfolio invests exclusively in high credit quality securities and short-term maturities to ensure stability of principal and ready access to capital. An Income portfolio extends further out on the yield curve and includes a broader range of credit quality to generate a higher level of income. The Aggregate approach incorporates elements of both designs for a "core" exposure to the fixed income asset class. We continue to prefer an "up-in-quality" bias across all bond portfolios.

Within our ETF bond models, we continue to emphasize "defined maturity" ETFs. These funds include all of the features of a traditional fixed income ETF with one important difference: a specific maturity date. These funds are populated with bonds that all mature in the same calendar year. During that year, the ETF terminates, and the fund's net assets are distributed to shareholders as cash, similar to what happens when an individual bond matures. During the first quarter we took advantage of higher yields following December's Fed rate hike to increase the income profile in both strategies through maturity extensions.

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[10] Ernst & Young, "Middle class growth in emerging markets: Hitting The Sweet Spot," April 23, 2015

Looking forward, we believe capital allocated to the fixed income market can continue to earn a respectable cash flow after nearly a decade of paltry yields anchored to zero. Consider that the recent yield-to-maturity for the *Barclays U.S. Intermediate Credit Bond Index* is 3.16%, while the tax equivalent yield to maturity for the *Barclays Municipal Bond 10-Year Index* sits at 3.40%[11] (for investors in the top income tax bracket).

This is significant because the starting yield for a laddered bond portfolio (like the indexes above) accounts for the vast majority of its expected return over the subsequent 4-6 years. This happens because the staggered maturity schedule of a bond "ladder" creates periodic liquidity events that allow the portfolio to adjust to changing market conditions.

If interest rates rise the ability to reinvest bond maturities into a higher rate environment helps to offset the negative price change among the longer term bonds in the ladder (over time….not month-to-month). When interest rates trend lower, price gains at the long end of the ladder serve to offset the lower reinvestment rate from maturing bonds.

The table below illustrates the resilience of "bond math" for laddered portfolio structures. Note how the starting yield of the index correlates with its subsequent 5-year total return. This dynamic held true regardless of the subsequent path of interest rates over each 5-year measurement period:

Barclays Aggregate Bond Index
Starting Yield vs. Subsequent 5-Year Return
Dec. 31, 1990 to Mar. 31, 2019

Start Date	**Beginning Yield**	**Subsequent 5-Yr. Return**
12-31-90	8.52%	9.48%
12-31-95	6.01	6.46
12-31-00	6.43	5.87
12-31-05	5.08	5.80
12-31-10	2.97	3.25
12-31-15	2.71	2.82 (3.3 Years to 3-31-19)
3-31-19	2.93	??

Source: Barclays, Bloomberg

It is not possible to invest directly in the index

[11] Source: Bloomberg; Barclays; The Barclays U.S. Intermediate Credit Bond Index measures the yield and return of a diversified basket of investment grade corporate bonds with maturities in the 1 to 10 year range; The Barclays Municipal Bond 10-Year Index measures the yield and return of a diversified basket of investment grade municipal bonds with an average maturity of 10 years.

We seek to enhance the benefit of the laddered portfolio structure with active management. By deliberately emphasizing certain maturities, and diversifying across different sub-sectors and credit profiles, we hope to optimize the risk and return profile of our fixed income strategies. In all cases we will not reach for yield unless the merits of the underlying strategy prove worthwhile relative to the risk.

Tactical Dynamic Allocation

The *Tactical Dynamic Allocation* strategy is designed to be highly responsive to changing market conditions. By systematically responding to a quantitative indicator called a "moving average," this strategy is likely to be mostly exposed to risk assets when the recent trend in these markets has been positive, and mostly out when the recent trend has been negative.

This strategy was very helpful in 2018 due to several timely shifts out of risk markets throughout the year, resulting in a *much* shallower drawdown during the fourth quarter compared to benchmarks like the *S&P 500 Index,* or the *MSCI World Index.*[12] The process of re-entering the risk markets has been slower than we would have liked during the first quarter, but the process is well underway, nonetheless. Emerging markets were first to return in mid-February, followed by real estate one week later, and domestic equities in mid-March. As of quarter-end the strategy model held 65% of its assets in risk markets, with the balance in short-term Treasuries and cash reserves.

Tactical Global Growth

The *Tactical Global Growth* strategy participates in the long-term growth of the world equity markets by spreading investments among 10 broad sectors of the global asset markets using ETFs for each market sector. A discipline of systematically tilting the sector weightings toward relative strength incorporates a momentum effect into the portfolio. This strategy can serve as a core position for investors seeking global diversification within the equity portion of their portfolio.

This strategy got off to a strong start in 2019 due to the broad recovery in virtually all risk markets worldwide during the first quarter. An over-weight position in the domestic large-cap growth sector was particularly helpful during the first quarter. For the upcoming quarterly holding period the strategy will include over-weight positions in the domestic large-cap growth, large-cap value, and real estate sectors, while international equities, emerging markets and international small-cap will be under-weighted.

[12] The S&P 500 Index measures the price and yield performance of the leading companies in the U.S. stock market. The index is maintained by Standard & Poor's. The MSCI World Index measures the price and yield performance of stocks throughout the world, including the U.S. market.

International Focus

The *International Focus* strategy delivers broad exposure to the global equity markets outside the United States. The strategy seeks to capture a return premium relative to common international equity benchmarks through disciplined exposure to three market factors that have demonstrated a long-term history of producing attractive risk-reward characteristics – value, momentum and low market capitalization, or "small-cap."

The portfolio model is strategically diversified across four ETFs that provide exposure to international stocks and emerging markets. One of the four ETFs uses a quantitative discipline to overweight securities that exhibit characteristics of value such as low price-to-book, low price-to-earnings or low price-to-sales. One ETF applies a quantitative process to overweight securities that demonstrate recent price momentum. The other two ETFs focus on emerging markets and small-cap companies, respectively.

International equity markets rebounded strongly in the first quarter, enabling this strategy to deliver a solid start to the year. If our expectations for the U.S. economy turn out to be more right than wrong, we suspect international equity markets can have a constructive year. International equities have under-performed the U.S. stock market for the vast majority of the post-financial crisis period. At this point there is a fairly wide valuation gap between the two global regions, implying a potential catch-up opportunity for international equities if optimism can improve for the global economy in general.

April 2, 2019

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The **MSCI Emerging Markets Index** seeks to track the price and yield performance of emerging market equities, as determined by MSCI. The index is calculated on a total return basis with dividends reinvested and is not assessed a management fee.
The **Barclays U.S. Intermediate Credit Bond Index** measures the yield and return of a diversified basket of investment grade corporate bonds with maturities in the 1 to 10 year range.
The **Barclays Municipal Bond 10-Year** Index measures the yield and return of a diversified basket of investment grade municipal bonds with an average maturity of 10 years.
The **Barclays Aggregate Bond Index** is a broad base index, maintained by Barclays Capital, which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States.
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The information provided is supplemental to a fully compliant presentation. A complete list of Capital Advisor's portfolio models and compliant presentations are available by contacting Capital Advisors at the number listed below. The actual return and value of an account fluctuate and, at any time, the account may be worth more or less than the amount invested.

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