CLEARWATER CAPITAL

Thought · Leadership

THINK18

November 2018

Private Client Letter

The Beginning of the End ??

October was a difficult month for investors. Concerns that the U.S. economy could be overheating has prompted the Federal Reserve (FED) to raise interest rates three times this year, with another rate hike largely expected in December. Separately, equity investors began to fear slowing economic growth next year and the related risks to corporate profits.

Ironically, market participants somehow arrived at the conclusion economic activity could be at once too robust and possibly stagnating. Thus, these seemingly contradictory fears triggered a painful correction in equities.

The S&P 500 fell over 6% in October, its worst month in more than eight years. Shares in Europe haven't fared much better, with the Stoxx Europe 600 declining nearly 6%. Several major indexes in Asia are down in the double digits this month, one of the worst being Japan's Nikkei, which is on pace for its biggest monthly pullback since 2010. With losses mounting, the MSCI world equal-weighted index (23 countries) is down more than 15% from its closing high in late January (Wall Street Journal).

Making matters worse for investors, traditional safe haven holdings such as bonds have also come under pressure. With interest rates rising to multi-year highs, annualized losses among U.S. Treasury bonds and investment-grade bonds are at 9.7% and 4%, respectively, the third-steepest declines since 1970 (Bank of America).

The list of concerns shaking investor confidence has grown to include rising protectionism, tighter monetary policy, peak earnings growth, the mid-term elections, and deteriorating confidence. These issues intensified in a notoriously volatile month to produce considerable market disruption. Below I will comment on these worries and offer our current assessment of each.

Trade negotiations between the U.S. and China appear to be on hold pending the results of the mid-term elections. Although the outcome of the elections remains too close to call, we are not expecting a dramatic shift of mpolitical leverage coming from the mid-term cycle. Accordingly, we believe the stage will be set for further talks, and potential progress, between the U.S. and China on trade issues later this year.

Likewise, we do not believe that any shift in the domestic legislative environment following the mid-term elections would be significant enough to disrupt the pro-growth policies that have given a boost to the economy. Concerns that the mid-term results could materially alter the trajectory of the U.S. economy in 2019 appear unwarranted from our perspective.

As for monetary policy, our original *Outlook 2018* report called for 3-4 Fed rate hikes and a 10-year Treasury rate climbing to 3.25%. Accordingly, we

John E. Chapman

John is the Chief Executive Officer at Clearwater Capital Partners and serves as the firm's Managing Partner. With thirty four years of Wall Street experience, John directs all wealth management and advisory services for the firm. He also serves as the firm's Chief Investment Strategist and chairs the firm's Investment Policy Committee.

Key Takeaways

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- October was a difficult month for investors.
- The S&P 500 fell over 6% in October, its worst month in more than eight years.
- Annualized losses among U.S. Treasury bonds and investment-grade bonds are at 9.7% and 4%, respectively, the third-steepest declines since 1970.
- We believe the stage will be set for further talks, and potential progress, between the U.S. and China on trade issues later this year.
- We are not surprised by higher interest rates.
- Earnings trends have never been stronger.
- Business optimism remains strong and profits are still rising.
- Despite turmoil in the stock market this month, U.S. consumers remain optimistic.
- There will come a time when we will become more defensive, we just don't believe we have at this point in time just yet.
- Serious investors with extended planning horizons are best served by staying focused on their long-term goals.
- Stay focused, stay invested. Our best days are still ahead.

are not surprised by higher interest rates. However, we have taken note of the rapid pace by which longer-term rates have moved and the hawkish language found in the Fed's comments. The potential for monetary policy mistakes has increased in recent weeks and we will be watching future developments carefully.

Earnings trends, meanwhile, have never been stronger. A record 60% of Russell 1000 companies beat consensus earnings expectations by at least one standard deviation in the third quarter. While current results have been record breaking, investors are beginning to worry about future profits.

With the unemployment rate at 50-year lows, the labor markets have become much tighter and labor costs for many companies are rising. Other input costs have risen and margins are expected to come under pressure in 2019. How much of these higher costs can be passed along to consumers remains an unanswered question.

Clearly earnings growth for U.S. corporations will come down next year as the savings from corporate tax reform have been realized. Apart from the recent tax cuts however, business optimism remains strong and profits are still rising. We think we will see solid corporate earnings results for at least the next 18 to 24 months.

Despite turmoil in the stock market this month, U.S. consumers remain optimistic. In the Conference Board's read of consumer sentiment for the month of October, the headline index came in higher than expected, rising from 135.3 (revised from initial reading of 138.4) to 137.9 compared to expectations for a reading of 135.9.

As shown in the chart above, October's level is the highest since September 2000. Given strong consumer balance sheets, 50-year low unemployment and rising wages, we believe consumer confidence is warranted. We also conclude that confidence will remain high along with continued gains in employment data.

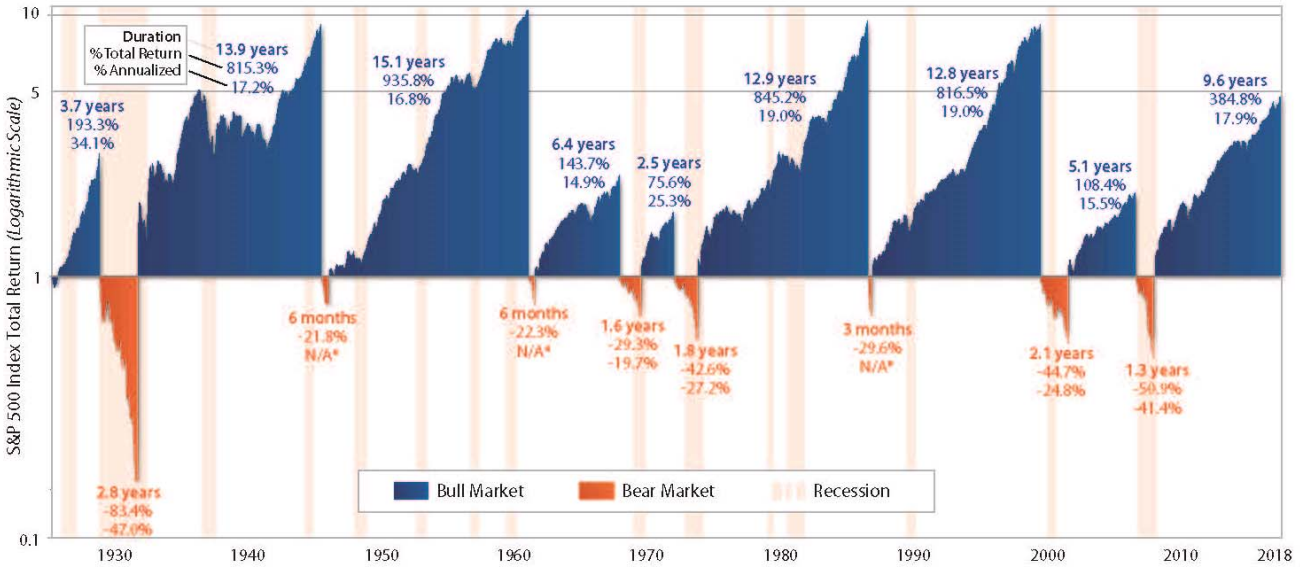
We at Clearwater Capital Partners remain constructive on stock prices going into 2019. The landscape for investors however, is shifting. In our 2018 Spring Symposium we concluded the presentation with the observation that things would soon become "complicated" with volatility moving higher as we moved toward the latter stages of this economic cycle.

While we recognize the risks, we remain confident that the stock prices will eventually rebound. There will come a time when we will become more defensive in our portfolio strategies; we just don't believe we have at this point in time yet.

Our view is that those investors who have been selling into weakness in October are too early in their calculation that the end of the economic cycle is upon us. Accordingly, we see the recent sell-off as overdone. Economic fundamentals and corporate profitability remain strong and should support a rebound in equity prices in the coming weeks and months.

We acknowledge that higher interest rates and tightening financial conditions represent a headwind for equity prices going forward. We are likely to see a rotation from growth stocks to value stocks as money continues to move towards quality and away from high valuations. Companies with strong balance sheets and solid margins can be expected to perform well in such an environment.

Investors are understandably nervous when difficult months like this past October occur. While a spike in volatility can greatly impact the short-term speculator, serious investors with extended planning horizons are best served by staying focused on their long-term goals.



First Trust, Morningstar

One of our favorite illustrations of long-term equity market returns comes from First Trust (above). Using data from Morningstar, this graphic demonstrates that the U.S. stock market has been growing steadily for the past 90+ years with only occasional set-backs. Investors who attempt to time short-term swings in the markets run a real risk of missing out on future gains.

This chart intentionally resets each individual bull and bear market to a baseline. Bear markets are shown in orange and bull markets are shown in blue. Both are plotted on a logarithmic scale. According to First Trust, the average bull market period lasted 9.1 years and enjoyed an average cumulative return of 476%. Conversely, the average bear market period lasted 1.4 years with an average cumulative loss of -41%. While we do not believe a new bear market is about to begin anytime soon, the perspective is helpful.

The beginning of the end? No. I remind readers that a couple of times each year we are reminded that corrections, like the one we are currently experiencing, happen about twice a year. The last painful correction occurred this past February. I concluded my March *Private Client Letter* the following:

"Stay focused, stay invested. Our best days are still ahead."

I believe this is as true today as it was just 8 months ago. Thank you for your continued trust and confidence.

John E. Chapman
November 2018

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interest payments.

The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index.

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