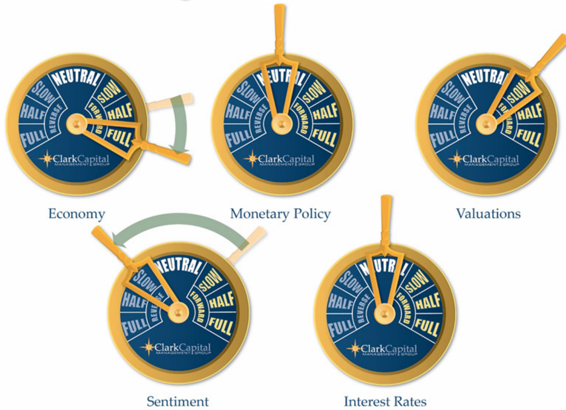
Economic Review & Outlook

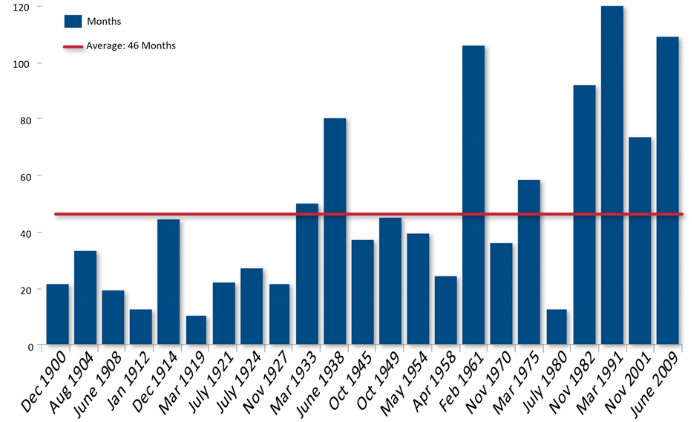
Video Transcript | Third Quarter 2018

Thanks for joining me for a recap of the latest economic and capital market developments, as well as what we're seeing heading into the final quarter of 2018. So let's begin.

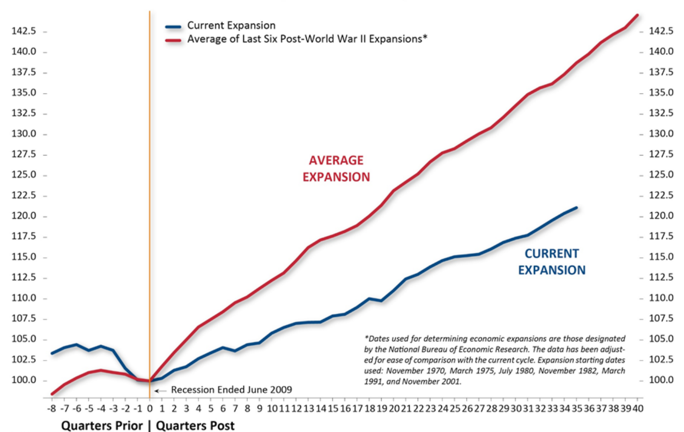


These gauges represent the five major areas that help shape our view for the overall economic environment, which in turn drives our expectations for the stock market. As a reminder, 12:00 is neutral. Anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative. We made two adjustments this quarter, improving the economy gauge to its strongest level, while shifting back the sentiment gauge from a slight positive to a slight negative. So, we currently have two gauges that are positive, two that are neutral and one that is negative.

First let's discuss the U.S. economy. The current U.S. economic expansion has now lasted over nine years making it the second longest expansion since 1949, surpassed only by the expansion from 1991 to 2000.

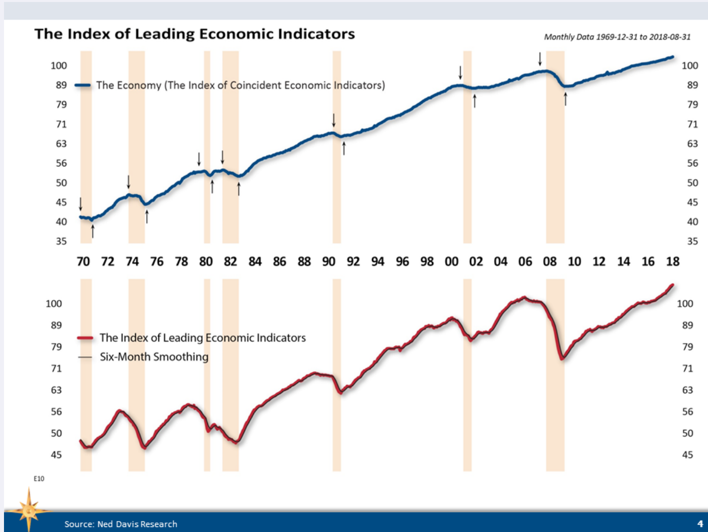


We have previously discussed that despite the length of this economic expansion, it has been one of the weakest expansions as well, averaging only a 2.3% annualized growth rate. However, we now want to acknowledge the pickup in growth we have seen over the last several quarters. This stronger growth culminated in a 4.2% annualized growth rate enjoyed in the second quarter of this year. This was the strongest growth rate since Q3 of 2014. Furthermore, economic indicators on the front

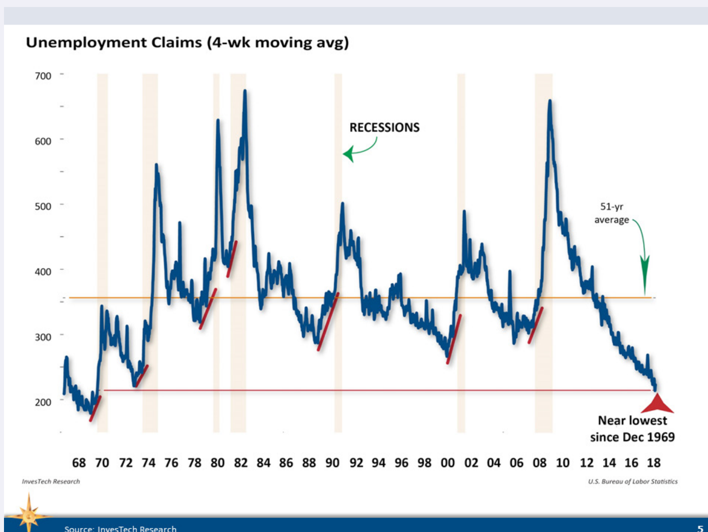


end of the economy continue to reflect ongoing economic strength and are not signaling pending economic weakness.

The Conference Board's Leading Economic Indicators index (the red line on the bottom of this chart) continued to hit new highs and shows no signs of rolling over, which it has historically done about 11 months prior to a recession.



Weekly initial jobless claims continue to hover near their lowest levels since the late 1960's reflecting strength in the job market, which is critical for our consumption led economy. Layoffs, which would be reflected in this reading, tend to turn up six to 12 months before a recession and those indications are not present at this time.

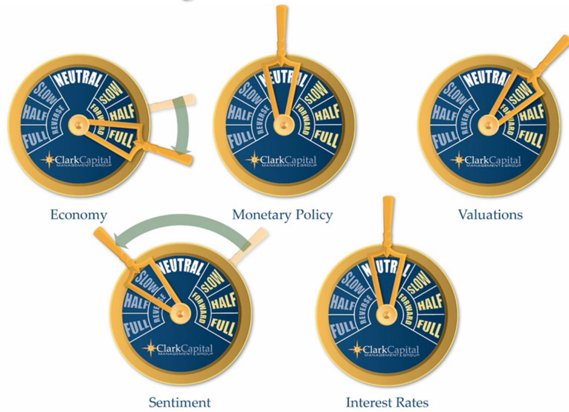


The yield curve, while flattening, remains positively sloped. The yield curve has become inverted prior to every recession since the late 1960s and, if anything, some of the recent moves higher in interest rates in early October have helped the yield curve steepen somewhat. At this point, we remain positive on the U.S. economy and expect the economic expansion to continue into 2019. As a result, we've increased the economy gauge to reflect this strong overall economic backdrop. Unemployment is low, consumer confidence is high, earnings are strong, inflation is stable, and corporate America is benefitting from tax cuts. Interest rates are increasing, but not to the point where we believe they will hinder economic growth.

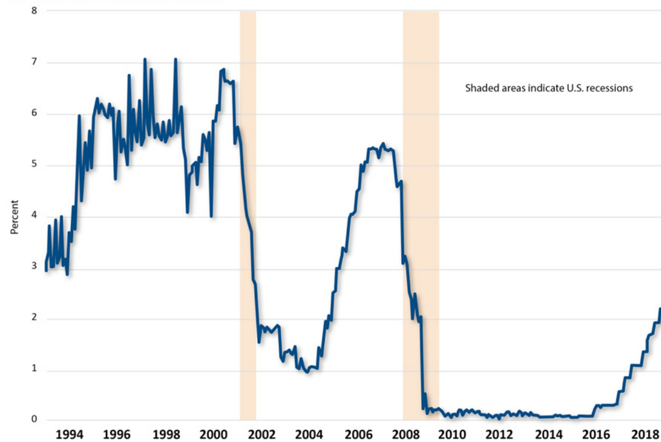
Yield Curve Leading Up to Recessions

	Yield Curve (bps)	
Start of Recession	At Start of Recession	52-Week Low
12/31/1969	-13	-45
11/30/1973	-61	-187
01/31/1980	-87	-208
07/31/1981	-20	-373
07/31/1990	61	-16
04/02/2001	72	-99
12/31/2007	79	-60
Current	86	71

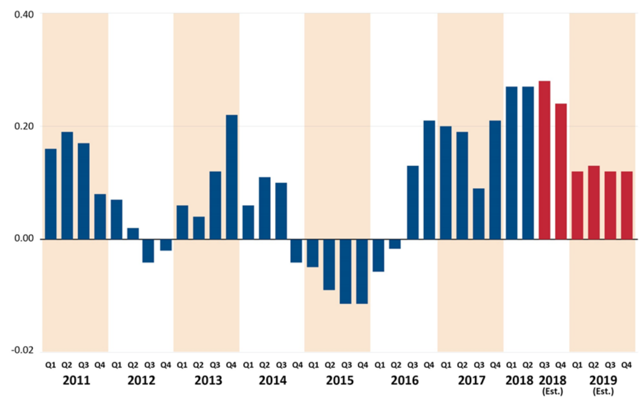
Source: InvesTech Research 6



The next gauge is Monetary Policy. As we all know, the Fed is in a rate-tightening cycle, but we have kept this gauge in a neutral position as the Fed has stayed largely in line with market expectations. We are now eight rate hikes into this tightening cycle that began in December 2015. We believe this a Fed trying to normalize policy rates from the near zero interest rate policy from the credit crisis period and acknowledge improved economic conditions. The Fed has come under increased scrutiny in recent weeks from the President and financial commentators alike for raising rates too aggressively. However, we maintain a neutral gauge believing these moves have been scripted out and expected by the market.

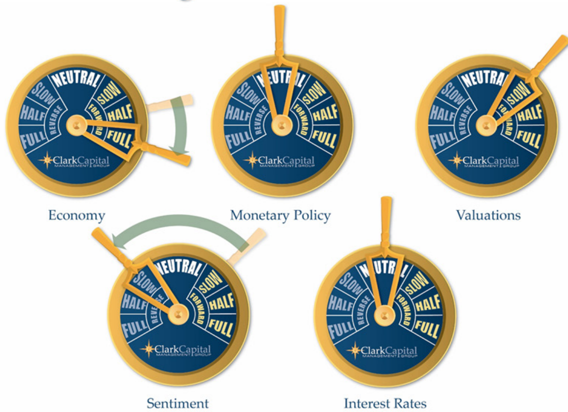


Next are valuations, which moved from one of our areas of greatest concern in 2017 to one of our positive gauges during 2018. The Price to Earnings or P/E ratio moved well above historical averages in 2017, but 2018 ushered in tax cuts, which, along with stock buybacks and a strong economy, caused actual and expected corporate earnings to surge.



The price of stocks or the "P" has increased this year, but the pace of stock price appreciation has paled in comparison to actual and expected earnings (the "E") in 2018. This chart shows actual and expected earnings growth in the mid-20% range and this situation, coupled with a modestly increasing P has led to a better valuation environment. Corporations meeting or exceeding these lofty earnings goals will be key to maintaining this positive valuation environment, and the pace of earnings growth will likely moderate in 2019. So far, companies have largely delivered in 2018.

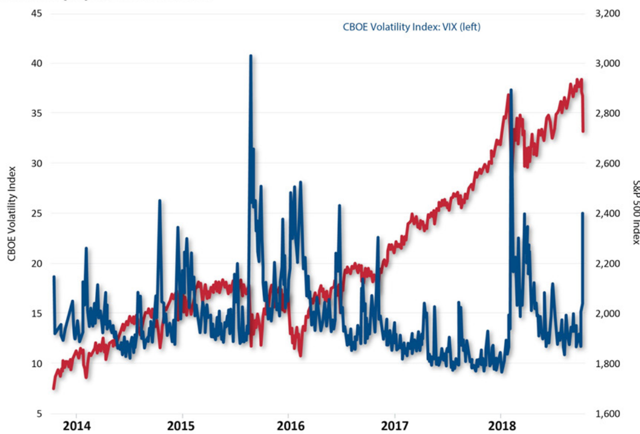
Economic Gauges



The gauges reflect the degree of Clark Capital's positive (forward) or negative (reverse) outlook on the corresponding economic factors. 1

The next gauge is Sentiment, which can be thought of as a measure of speculation. We are shifting this indicator from a slight positive to a slight negative moving into the fourth quarter as optimism readings have picked up as of late and point to higher levels of speculation in the market. Moving into the fourth quarter, there seemed to be some underappreciation of volatility that might take place leading up to the mid-term elections and complacency seems to have set in after a steady

Volatility Spikes From Lows



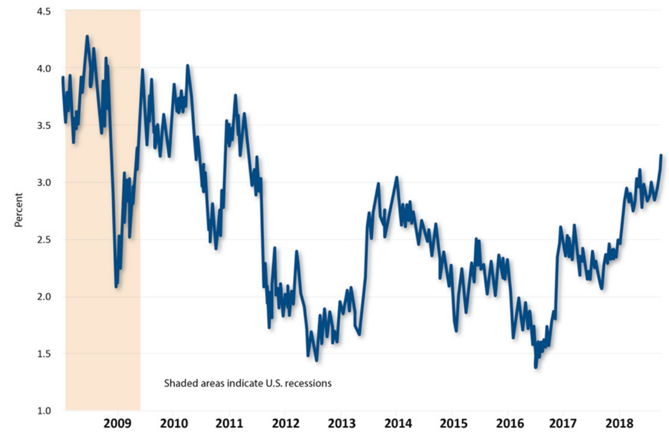
Source: Board of Governors of the Federal Reserve System (US) 11

couple of months of equity market progress. We have seen volatility soar back into the market to begin the fourth quarter as stocks came under significant pressure in early October.

Our final gauge is interest rates, which we have left in a neutral position.

The yield on the 10-year U.S. Treasury has taken some pretty

10-Year Treasury Constant Maturity Rate



Source: Board of Governors of the Federal Reserve System (US) 13

big rides in 2018, starting the year streaking higher in January and February, declining to its lowest level of 2018 in early April, and then hopping around until a rather definitive move higher beginning in late August, which propelled the yield to 3.25% in

10-Year Treasury Constant Maturity Rate

Source: Board of Governors of the Federal Reserve System (US) 14

early October—its highest level since 2011. Other spots along the yield curve have hit multi-year highs as well.

From a longer-term perspective, rates remain low and we believe the level of interest rates is having a neutral effect on the U.S. economy at this point and the Fed will continue to be measured in its rate-hike timing. The slope of the yield curve remains positive (a historically good omen), and some modest steepening has occurred of late with interest rates moving higher.

Moving to the capital markets, the third quarter began with strong gains in July and August as the historically slow summer months proved to be a great time for equity market gains. Most major U.S. averages posted all-time highs and the momentum in stocks picked up pace during these months. September proved to be strong for large cap stocks, but mid- and small cap stocks struggled and moved lower in the final month of the third quarter. Overall, equity market volatility subsided in the third quarter and equity markets put in gains.

The nature of the equity market gains is worth reviewing. Digging into performance, the third quarter, and really much of 2018, has been marked by a narrow, low-quality rally. Only three sectors— Technology, Consumer Discretionary, and Health Care contributed over 90% of the price return of the S&P 500. In fact, just four stocks, Apple, Microsoft, Amazon and Google accounted for over half of the S&P 500 returns. Stocks with the highest P/E ratios, lowest quality ratings, and lowest dividend yields performed the best for the first nine months of the year.

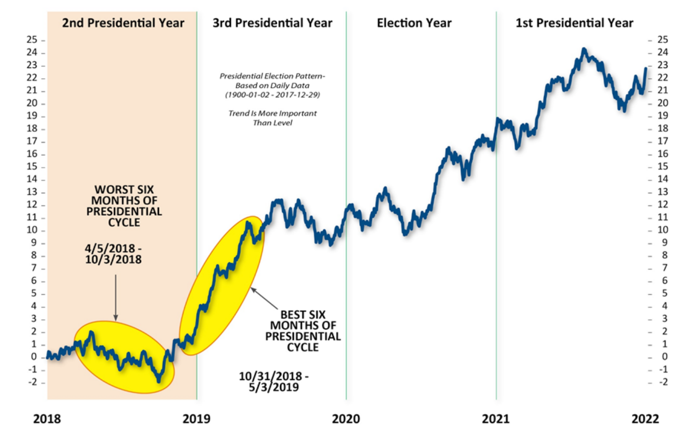
Equity Factor Performance Across Best (1) and Worst (5) Quintiles

Through September 30, 2018	QUINTILES				
	1	2	3	4	5
Projected Growth Rate	20.3	8.1	6.6	5.6	7.4
Quality Rating	8.7	5.2	6.3	10.3	12.3
Operating Earnings Yield	5.2	5.8	6.7	12.8	17.5
Dividend Yield	5.1	5.8	6.2	16.4	14.3
P/E Ratio Using Normal EPS	5.1	6.8	6.3	8.2	21.9
Price/Value Ratio	5.0	6.0	8.4	9.3	19.5

Source: Ford Equity Research 15

The early days of the fourth quarter have been another story with volatility picking up and rather sharp declines in equities due in part to higher interest rates and lingering trade concerns. Some of these lower quality stocks have come under particular pressure and small cap companies, as measured by the Russell 2000 index, have experienced a "correction" defined as a decline of at least 10% from its high. We believe our investment approach, focused on higher quality stocks should serve our clients well in this more volatile environment.

Despite this recent weakness in equity markets, we are entering a historically strong period for stocks in the fourth quarter and furthermore are entering the strongest six-month period historically for stocks of the four-year Presidential Cycle. Clearly, history does not need to repeat itself, but volatility heading toward the mid-term elections is not unexpected.



Turning to bonds, high yield bonds were the clear outperformer through the first three quarters of 2018, which is consistent with our belief that credit exposure is currently more desirable than interest rate exposure. Most other pockets of fixed income have struggled with the rising rate environment and should the broad bond benchmark, the Bloomberg Barclays Aggregate Bond Index not rally in the fourth quarter, 2018

might mark only the fourth year of negative returns for this index since 1976.

We continue to expect interest rates to gradually move higher and for the yield curve to flatten. As a result, we continue to favor credit exposure in our bond portfolios over pure interest rate risk and believe active bond management should also be able to add value over passive, laddered bond portfolios in this type of environment.

Putting this all together, we continue to favor stocks over bonds, and we believe the long-term secular bull market is intact driven by a strong economic backdrop. Our forecast this year for the S&P 500 continues to be 2,900, or about an 8.5% increase driven by strong earnings growth. While already experienced in early October, we maintain our expectation of higher capital market volatility moving toward the mid-term election. However, we also acknowledge that the fourth quarter is a historically strong period for the market, coupled with the historically strongest six-month period of the presidential cycle beginning in the fourth quarter as well, which will take us through the first several months of 2019.

There are always risks to an outlook while trade concerns still linger, but progress has been made between the U.S., Europe, Mexico and Canada, while China continues to be a significant hold out. Ultimately, however, we think that fundamentals are what matter in the long run and the current fundamentals are positive. During these periods of elevated volatility, we believe it is imperative for investors to stay focused on their long-term goals and not let short-term swings in the market derail them from their longer-term objectives. Please contact your Investment Consultant to discuss how we can support your client reviews and how we can help you deliver successful outcomes to your clients. Thanks for watching.

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