Stock Market Volatility in Context

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We've come a long way and have every reason for a pause.

As of this writing, Thursday, December 6 2018, global stocks have sold off for the entire week, leaving most indices negative for the year and US markets essentially flat. Every day we hear a new reason for the sell-off, and each of these small data points seem to be a part of a larger whole—one that needs to be put in context.

This week's inter-related stock market drivers:

- The arrest of Huawei's CFO adds doubt to the outlook for trade talks between US and China.
- Signs that the global economy is slowing, in part on uncertainties surrounding trade.
- Oil prices have fallen as meetings among OPEC Members and Russia fail to agree to production cuts.
- The US Treasury Yield Curve has finally inverted (somewhat). Some see this is a sign of recession in the US.
- Political Drama in the US signals more uncertainty and possible inertia.

The most recent news being blamed for today's rout is the arrest and possible deportation of Huawei Technologies CFO, Wanzhou Meng. Meng is facing charges stating that the company sold technology to Iran in violation of sanctions against exports to that country.

This is only important because it risks the trade talks between the US and China, as Meng is requesting to be released from custody on the same day President Xi and President Trump are scheduled to renew discussions. Last week, markets were pleased when the G-20 summit in Argentina resulted in a 90-day truce in which the Trump Administration offered to refrain from increasing tariff rates on Chinese goods while talks continue. The new development threatens to derail this headway and rekindle the trade war.

The trade war, while an important issue on its own, is of greater market focus in light of recent data that

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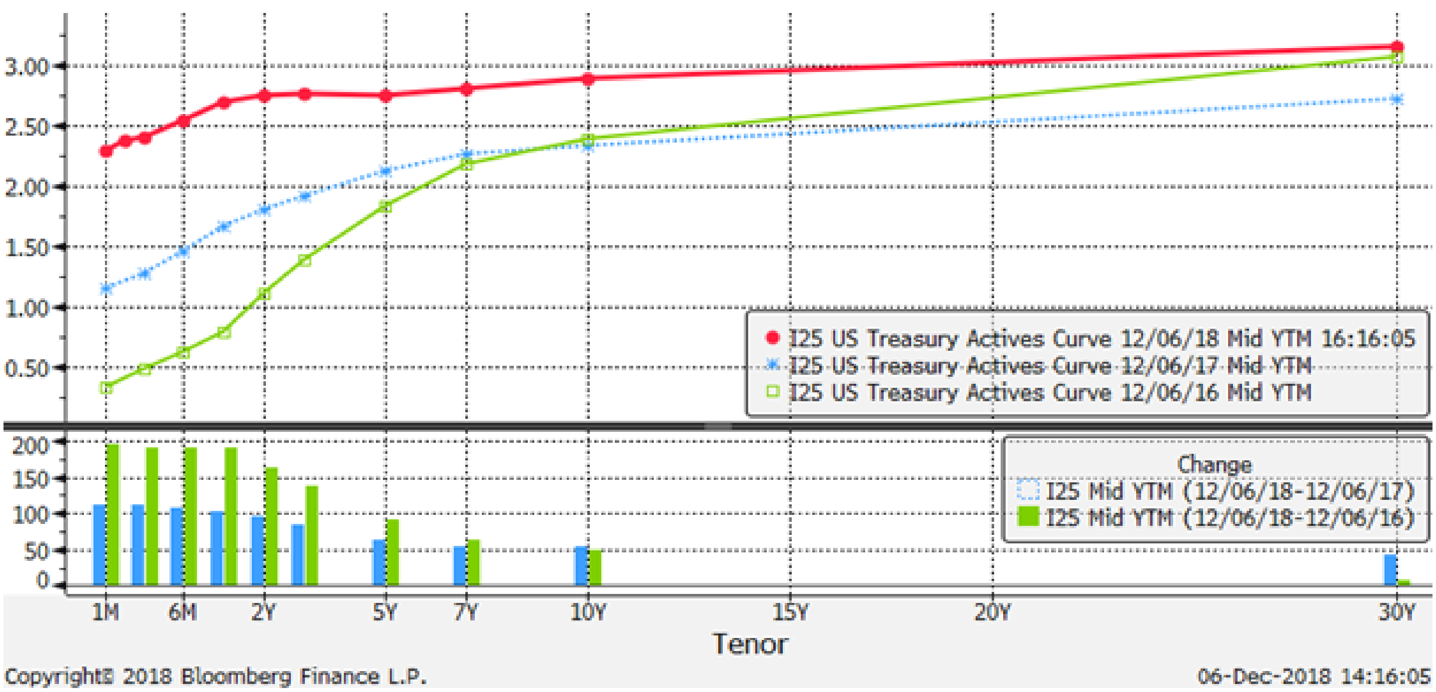
China and Europe are slowing, threatening a more global slowdown. This negative news has been exacerbated by the deepening woes surrounding Brexit where the May Government's agreement with the EU has faced sharp opposition in the UK Parliament, even among her own party, risking a hard exit of the UK without a deal. There has been a growing chorus in favor of a new referendum, but the government seems determined to pursue Brexit with or without a deal, risking the UK economic outlook.

Prospects of a slower world have impacted energy markets where oil prices have slumped with West Texas Intermediate Crude (the US benchmark price) falling to $50/bbl at one point. Oil price weakness has been exacerbated by the failure of OPEC+ talks this week, which were aimed at production costs. This was the first time in 5 years that the organization could not reach some agreement on the matter with non-member Russia. The latter appears unwilling to agree to cuts. While Saudi Arabia dominates OPEC output, it has relied on Russia to help stabilize markets. News that small member Qatar is quitting the organization as of January has done nothing to improve the mood.

With the backdrop of a global slowdown on the aforementioned drivers, the pending gridlock in the US on divided government does the outlook no favors. Some observers believe that the growth impulse from tax reform and deregulation is set to fade within the coming year, advancing the recession risk. This has helped prompt the inversion of the yield curve where 2-year and 3-year US Treasuries now yield more than 5-year ones. While not a true inversion—where short rates exceed long ones—it's close enough to have spooked the markets. In any event, the curve is very flat.

US YIELD CURVE OVER THE PAST 3-YEARS



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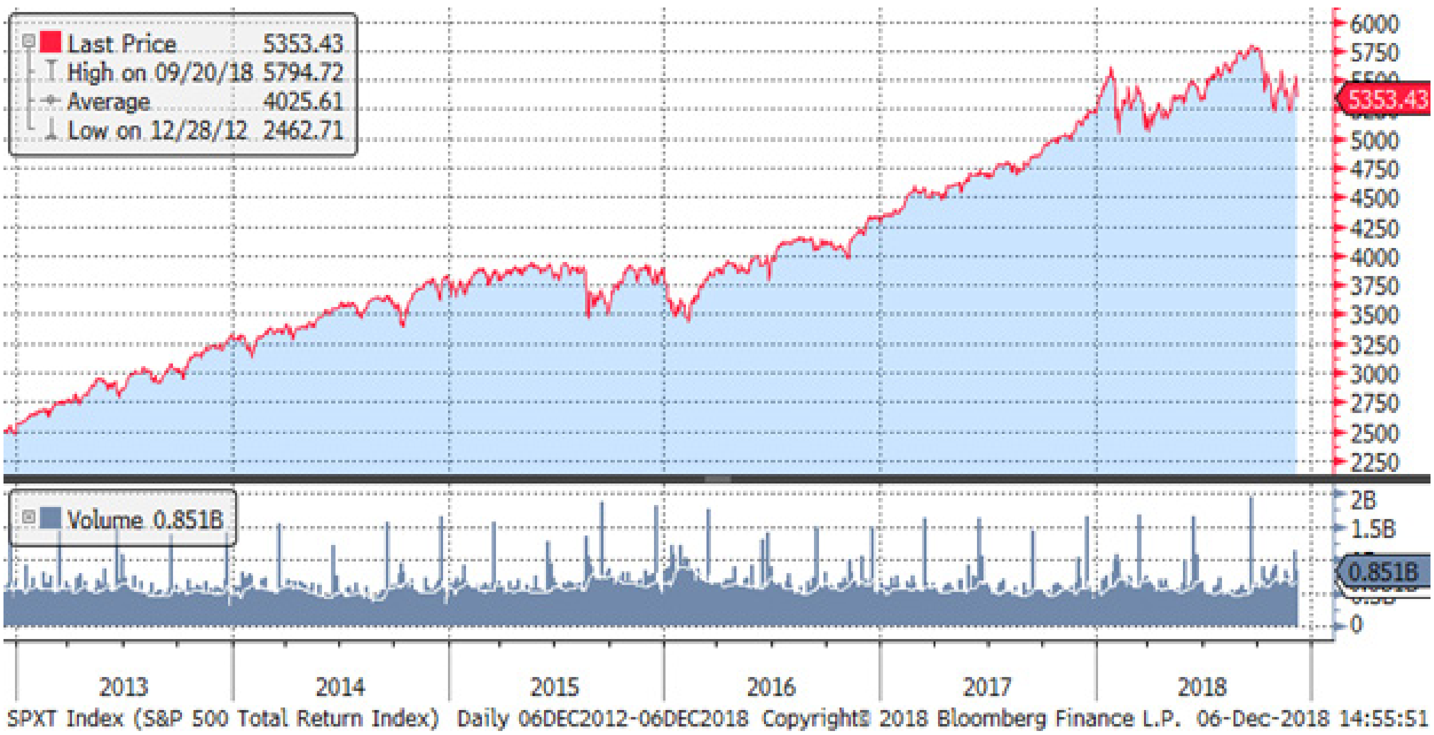
So, what to make of it?

Over the past 6 years, the US Stock market, as measured by the S&P 500, has returned 116% in total return, or almost 14% per annum, a rate that is well above the long-term average. In 2018 alone, that index has returned 2.7% so far. While not a stellar performance, it has out-performed most others globally and has beaten bonds by a mile as interest rates have adjusted higher. That we should have a pause, even a correction, would be the most natural thing, especially given the economic and political backdrop. But the recent volatility might slow the pace of Federal Reserve rate hikes.

Market participants are already doubting that there will be as many hikes in 2019 as previously forecast, and the once certain December 19 hike has come into doubt. For those concerned most about the Fed being too hawkish, a delay on rate hikes would be a very welcome development. On a more positive note, as much as some observers believe the tax cut and fiscal spending bump is a fading impulse, others believe the impact will support the economy through 2019 and into 2020.

S&P 500 TOTAL RETURN SINCE 2012



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The US economy has been strong and US companies have seen excellent revenue numbers, strong dividends and in many case, have conducted stock buybacks. The tax reform and deregulation has contributed significantly to these developments and appear poised to propel them further into the future. That there should be a pause in equity returns, or even a correction, is part of the natural cycle. But there is no reason to believe that a crisis is brewing that would cause one to not stay invested for the long run.

Even if there is a shallow recession over the coming two years, it is unlikely to be very deep or long-lasting as there are no large imbalances in the economy similar to a decade ago. Bank balance sheets are in excellent shape and the consumer is better off than they have been in recent memory with assets well in excess over liabilities. From an investment standpoint, this is exactly the environment where value will outperform growth, thus validating our investment thesis where our focus on those companies affording and growing dividends will stand out against the peer group. In terms of fixed income, we continue to be defensive, but are pleased to be growing our income stream as rates rise. The fixed income benchmarks may all be in the red, but we've remained in the black. Broadly, there are interesting opportunities developing in international markets, and recent volatility will also create dislocations in alternative strategies. Maintaining an appropriate asset allocation and diversified portfolio is essential during these periods of high volatility and over the long run. In short, there is no reason to panic about the recent moves in the market, if one sticks with their investment discipline, the future will right itself.

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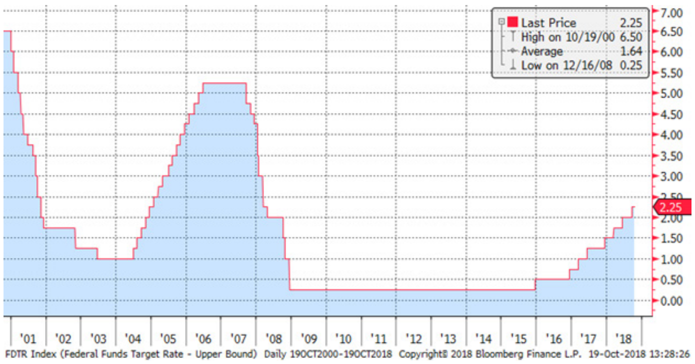
will be as many hikes in 2019 as previously forecast and the once certain December 19 hike has come into doubt. For those concerned most about the Fed being too hawkish and engineering a recession through too-tight monetary policy that would be a very welcome development. On a more positive note, as much as some observers believe the tax cut and fiscal spending bump is a fading impulse,

FEDERAL RESERVE'S RED FUNDS POLICY INTEREST RATE (UPPER BOUND)



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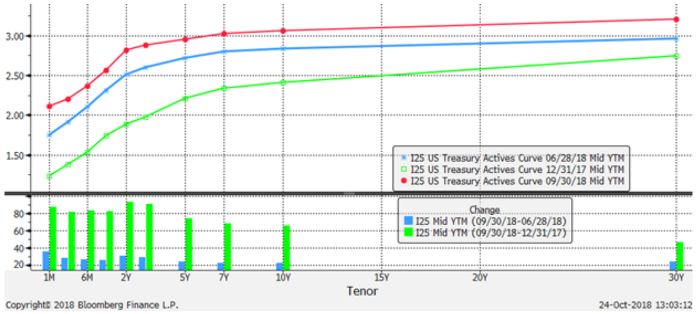
US TREASURY YIELD CURVE FROM YEAR END 2017 TO PRESENT



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