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Q1 2019 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to

On the Fridge

Utilities

In what was a dismal quarter for stocks, it's no surprise that the defensive utilities sector came out on top, rising 1.4% while all other sectors fell.

Redhat (RHT)

Redhat rose 32% in the otherwise tough quarter, nearly doubling the next best member of the S&P 500 (Starbucks +16.5%).

Government Bonds

Again, like utilities, it is no surprise to see Government Bonds (+2.5%) outperform all other classes in a quarter where risk assets sold off. Although it is nice to see that the

In the Dog House

US Stocks

In what has been a real rarity in the last decade, US stocks were the worst performing asset class in the sector, falling -13.7%.

Energy Sector

The energy sector, whose fate is so closely tied with oil prices (down -26% in the quarter), fell –23.8% in the quarter, good for last place.

Nvidia (NVDA)

In the wake of disappointing earnings results, semiconductor manufacturer Nvidia shed over half its value, falling –53.8% in the fourth quarter alone. That makes it the worst performer in the S&P 500, although it had plenty of company as no fewer than 50 companies managed to shed 30% or more in the quarter.

SPECTRUM
STRATEGIC CAPITAL MANAGEMENT, LLC

4949 Meadows Road, Suite 475
Lake Oswego, OR 97035
Phone: (503)746-9666
Fax: (503)343-9539

Big Picture

Well, we just suffered through a historic quarter. The December sell-off was the worst since the Great Depression, while stocks sold off -14%, turning what would have been a great year into the first down year in a decade and arguably marking the end of the bull market we've enjoying since the 2008 financial crisis. The two threats I've been writing about all year (and one that I haven't been) finally boiled over. Trump ramped up trade tensions at the same time the Fed began altering their message and oil prices dropped on oversupply fears. Together the three forces caused quite a panic in the stock market.

Beyond just the fear of an expanding trade war, a government shutdown, or an inverted yield curve, earnings expectations for the fourth quarter were revised down from 16.7% to 11.4%. While that would mark the fifth straight quarter of double-digit growth, it is still a substantial downward revision from just three months ago. On the other hand, throughout the pullback third quarter earnings were coming in stronger than expected, rising 26%. Early in the 4th quarter, the IMF issued its World Economic Outlook where it revised its global growth expectation down to 3.7% citing "recently announced trade measures" including the tariffs imposed on $200 billion of US imports from China. However, within the US specifically, strong consumer spending figures throughout the quarter gave a boost to fourth quarter GDP estimates. So, while trade tensions and Fed actions will undoubtedly have (and already are having) material effects on economic activity, we have, for the most part, yet to see the damage flow through to economic indicators.

Looking Ahead

Along with trade tensions and Fed actions, increased tariffs and the government shutdown will have negative economic effects that have yet to manifest themselves in economic reports. However, one major cloud hanging over equity investors appears to have been temporarily lifted as the Fed seems to have indicated they are adopting a more dovish stance, pausing rate hikes and hinting that they may pause their balance sheet run-off as well. However, the Fed is citing "cross currents and conflicting signals" in the global economy, so not entirely good news.

Still, the number of potentially cataclysmic disrupters to the equity market has been, for the time being, cut in half. Now, the largest threat to stocks is the risk of a nasty trade war between the US and China. It is still near impossible to predict how Trump will guide the US through trade negotiations. He may be content to settle largely for a tweaking and rebranding of our existing trade relationship á la USMCA, or he may dig his heels in and pursue a war of attrition á la his wall-budget strategy. Either way, if we ignore politics for a moment we are already seeing a slowdown in the Chines economy and downward earnings revisions in the US. With interest rates off their lows, the Fed preaching patience, and global growth expectations falling, it is hard to make a case for significantly higher rates in the near term and investors that have been avoiding long duration for years may view this as an attractive opportunity to re-enter the fixed income space.

Links and Articles

- **Bloomberg's 2018 Jealousy List**
  An annual list of journalism so good they wish they had written it themselves.
- **Fed Leaves Rates Unchanged**
  Reuters reviews the latest Fed decision to hold rates steady despite a strong economy.
- **Factory Job Openings are Booming**
  Bloomberg highlights record job openings at US factories.
- **Companies Affected by Shutdown?**
  FactSet's John Butters reviews the impact of the government as reported by CEOs.

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February 2019 Q1 Newsletter

Performance

While the US stock market fell –13.7% in the fourth quarter, S&P 500 earnings actually rose 13.25%. Even more incongruous, the Energy sector performed the worst falling –23.8% while their earnings have risen 98%. Perhaps not as surprising when reminded that oil prices also fell –26% in the quarter. Earnings reports look backward, while the market looks forward, after all. Altogether, strong earnings growth and falling prices has now brought the forward P/E on the S&P 500 down to 14.4x, half a standard deviation below the 25yr average of 16.1x. Interest rates have risen considerably since their 2016 lows, yet the recent pullback in stocks left the earnings yield spread (inverse of P/E ratio minus the yield of BBB rated bonds) at 1.8%, the 25yr average is –0.1%, by this measure stocks are unusually cheap compared to bonds at the moment.

	Benchmark Index	Q4 2018	2018	LTM	3yr	5yr	10yr
Cash	**BBgBarc US Treasury Bill 1-3 Mon TR USD**	0.6%	1.8%	1.8%	1.0%	0.6%	0.3%
Fixed Income	**BBgBarc Global Aggregate TR USD**	1.2%	-1.2%	-1.2%	2.7%	1.1%	2.5%
Blend	BBgBarc Global Aggregate TR USD	1.2%	-1.2%	-1.2%	2.7%	1.1%	2.5%
Government	BBgBarc US Government TR USD	2.5%	0.9%	0.9%	1.4%	2.0%	2.1%
Inflation Protected	BBgBarc US Treasury US TIPS TR USD	-0.4%	-1.3%	-1.3%	2.1%	1.7%	3.6%
Municipal	BBgBarc Municipal TR USD	1.7%	1.3%	1.3%	2.3%	3.8%	4.9%
Floating Rate	BBgBarc US Trsy Floating Rate TR USD	0.5%	1.9%	1.9%	1.2%	0.0%	0.0%
Corporate	BBgBarc US Corp Bond TR USD	-0.2%	-2.5%	-2.5%	3.3%	3.3%	5.9%
High Yield	BBgBarc US Corporate High Yield TR USD	-4.5%	-2.1%	-2.1%	7.2%	3.8%	11.1%
International	BBgBarc Gbl Agg Ex USD TR USD	0.9%	-2.1%	-2.1%	3.1%	0.0%	1.7%
Equity	**MSCI ACWI GR USD**	-12.7%	-8.9%	-8.9%	7.2%	4.8%	10.0%
Blend	MSCI ACWI GR USD	-12.7%	-8.9%	-8.9%	7.2%	4.8%	10.0%
US Equity	MSCI USA GR USD	-13.7%	-4.5%	-4.5%	9.1%	8.3%	13.2%
Developed Markets	MSCI World ex USA GR USD	-12.7%	-13.6%	-13.6%	3.6%	0.8%	6.8%
Emerging/Frontier	MSCI EM GR USD	-7.4%	-14.2%	-14.3%	9.6%	2.0%	8.4%
Alternatives	**Wilshire Liquid Alternative TR USD**	-3.7%	-4.3%	-4.3%	1.0%	0.2%	2.3%
Blend	Wilshire Liquid Alternative TR USD	-3.7%	-4.3%	-4.3%	1.0%	0.2%	2.3%

	Q4 2018	6mo	1yr	3yr	5yr	10yr
Information Technology	-17.3%	-10.1%	-0.3%	16.4%	14.9%	18.4%
Financials	-13.1%	-9.3%	-13.0%	9.3%	8.2%	10.9%
Health Care	-8.7%	4.6%	6.5%	8.1%	11.1%	14.7%
Consumer Discretionary	-16.4%	-9.6%	0.8%	9.5%	9.7%	18.3%
Consumer Staples	-5.2%	0.2%	-8.4%	3.1%	6.3%	11.0%
Industrials	-17.3%	-9.0%	-13.3%	7.6%	6.0%	12.7%
Energy	-23.8%	-23.3%	-18.1%	1.1%	-5.6%	3.5%
Utilities	1.4%	3.8%	4.1%	10.7%	10.7%	10.5%
Materials	-12.3%	-12.0%	-14.7%	7.2%	3.8%	11.1%
Communication Services	-13.2%	-4.6%	-12.5%	2.2%	2.6%	7.5%
Real Estate	-3.8%	-3.0%	-2.2%	3.9%	8.8%	13.3%

*All returns over 12mo are annualized

Breaking down US equity, small cap value stocks ended the year at the largest discount to their historical P/E, trading at 12.6x vs a 20yr average of 16x. While small growth stocks ended the year trading exactly at their 20yr average of 29.2x.

For the full year, 2018, US stocks lost –4.5%, but within the category, large cap growth stocks performed the best, falling just –1.5%. On the opposite end of the spectrum, small cap value stocks performed the worst falling –12.9%. In fact, growth outperformed value across large, mid, and small stocks and size outperformed with large stocks beating mid caps and mid caps beating small caps.

Disclosures: Past performance is no guarantee of future results. This newsletter is being provided for informational purposes only and should not be considered investment advice, a solicitation of advisory services, or a recommendation to buy or sell any types of securities. No investment decisions should be made solely based on the information in this newsletter. There is a risk of loss when investing in securities, including the risk of loss of principal. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for a particular investor's financial situation or risk tolerance. Asset allocation and portfolio diversification cannot assure or guarantee better performance and cannot eliminate the risk of investment losses. The opinions contained herein reflect Spectrum Strategic Capital's views as of the date of this newsletter and are subject to change without notice. Spectrum Strategic Capital obtained most of the information from third party sources, which are believed to be reliable but are not guaranteed.

Asset Class	Benchmark	Description
Cash	BBgBarc US Treasury Bill 1-3 Mon TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	BBgBarc Global Aggregate TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	BBgBarc US Government TR USD	The Bloomberg Barclays US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Corporate Bonds	BBgBarc US Corp IG TR USD	The Bloomberg Barclays US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	BBgBarc US Corporate High Yield TR USD	The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	BBgBarc Gbl Agg Ex USD TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.