PCM
PEAK CAPITAL MANAGEMENT

Navigating Choppy Seas

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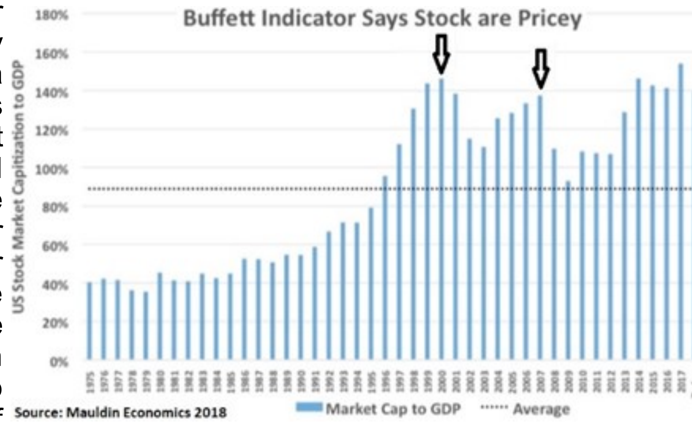
Brian Lockhart, CFP®

"To reach a port we must set sail -
Sail, not tie at anchor
Sail, not drift."
— Franklin D. Roosevelt

The spike in volatility and market rout in October is once again giving investors a myopic view of the markets and creating sizeable uncertainty. There are obvious reasons for concern: valuations are elevated, yields are rising, the Fed is shrinking its balance sheet, and geopolitical uncertainty is moving sharply higher. The reality for investors, however, is that to achieve their long-term financial goals you have to be able to remain invested even when the water becomes choppy; staying in port or dropping anchor simply is not an option.

To set sail in the equity markets does not mean buy and hold, far from it. One must have the ability to allocate their capital in a disciplined manner that considers the risk/reward continuum. At market inflection points, which I believe we are facing, there are divergences in investor behavior that is worth taking note of. For example, individual investors were pouring money into stocks at the fastest pace in nearly 15 years in September. According to Schwab data, cash as a percentage of assets fell by 10.3% in September to the lowest level since 2004 and TD Ameritrade reported trading volume increased 70% from the prior year. Hedge funds and large pension plans, conversely, were massive sellers of equities in September and were large buyers of long duration Treasuries in a risk-off positioning (WSJ Data).



As we focus on the horizon, very little has changed in terms of fundamentals. The labor market is incredibly strong, and GDP is forecasted to continue well above the trend of the last decade. I believe the recent volatility is risk being re-priced in the market at the end of an extremely complacent period. Market corrections that are driven by re-pricing risk tend to be sharp and short-lived compared to corrections that occur in advance of the next recession.

We are focused on key leading indicators of an economic slowdown that could lead to a recession such as the yield curve. The 1-year Treasury is currently only 50 basis points below the 10-year Treasury which is worrisome having dropped from a spread of 1.56% in early 2017. If the spread remains below .50% it has historically signaled a recession approximately 6 months later. Economic and political commentator Niall Ferguson has highlighted the current risk in the Chinese shadow banking system where bad debt is currently 14 times the value of high-quality loans as a systemic risk to the global economy.

Most investors today cannot afford to drift and take a passive approach to investing. According to Pew Institute and the Social Security Administration there are 10,000 Baby Boomers turning 65 years old every day and that will continue into the 2030's. The median retirement savings for people age 65 is shockingly only $126,000 suggesting most retirees will continue to hold growth portfolios in lieu of income portfolios. The challenge these, and all, investors face is the likelihood of minimal returns over the next decade. Research Affiliates publishes extensive data to forecast asset class returns for a 10-year forward period that have historically been very accurate. Their current forecast suggests the real return on U.S. Large Company stocks to be 0% for 10 years with an annual volatility of 15%. U.S. Small Company stocks are even less attractive with slightly negative real returns over the next 10 years with annual volatility of 20%. If Research Affiliates is even close to being accurate months like October could become more the norm than the exception.

We continue to believe that maintaining non-correlated assets in a diversified portfolio is key to successfully navigating whatever the future holds. This also explains why hedge funds and pension funds are accumulating positions in long duration Treasury bonds very similar to our Dynamic Risk Hedging (DRH) process. The good news for investors is that they do not need to switch to investment vehicles with high management and performance fees as strategies like DRH can be delivered at attractive management costs. Finding the balance between remaining invested and managing risk through a disciplined process will continue to be the best approach to navigating market storms.

"Most investors today cannot afford to drift and take a passive approach to investing."

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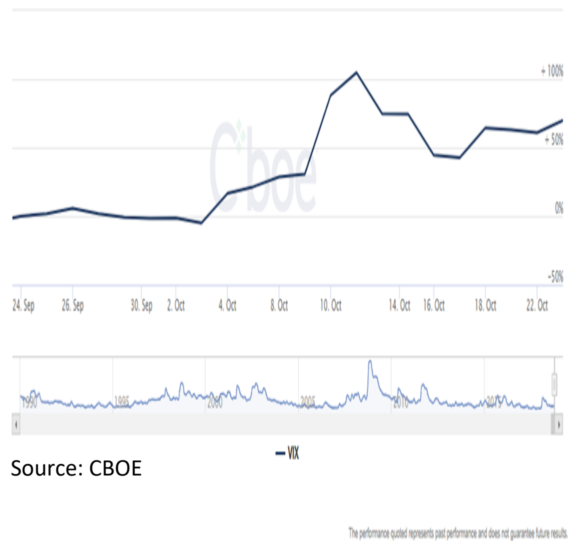
Builders Getting Crushed

It has been a difficult year for Homebuilders as the S&P Homebuilders Index has fallen 25% as of late October compared to a flat year so far on the S&P 500. The situation is even more grim when you consider the index has fallen almost 50% from the highs established in June 2017 although it still represents giving back a large part of the 76% gain in the 2017 calendar year. Hurricane Florence negatively impacted housing permits particularly in the South that showed housing starts at the lowest level in over 3 years. The slowdown is unlikely to derail the economy overall as housings share of GDP is roughly one-half of what it was in 2007 even though it has risen from a low of 2.25% of GDP to 4% today.

- The average rate on a 30-year conforming mortgage has risen to 5%, the highest rate since 2011. The higher cost of financing is largely responsible for the slowdown in both new and existing home sales (WSJ).
- Housing affordability has improved slightly in some of the markets that were overheated but remain at very high levels and will require a larger fall in prices to compensate for higher financing costs.
- Multi-family construction has suffered the most with the most recent data showing new permits falling 7.6% and multi-family starts plunging 15.2% in September (Reuters).

October Volatility Spike



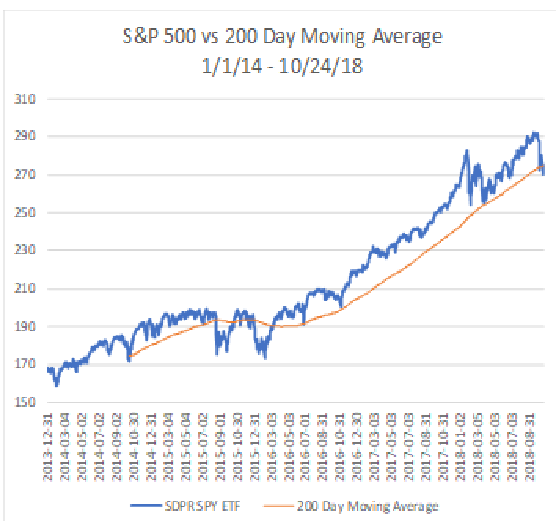
Source: CBOE

Among market enthusiasts, October is a month often viewed with trepidation because history serves as a reminder of significant price swings consistently occurring over the course of the month. 2018 has been no exception. The S&P 500 index had not moved more than 1% in either direction for 74 continuous trading days until October 10th when the index dropped 3.29% in a single day (Schwab). Despite positive earnings reports and strong GDP results, volatility may be a product of the Fed's commitment to raising rates, market anticipating November midterm election results, a drop in home sales, weakness in Chinese equities, possible contagion stemming from the collapsing Italian bond market, trade wars, and geopolitical risk. Spikes in volatility is likely to continue until the market prices in the tug of war between the headwinds and the tailwinds.

- The VIX Index reflects investors' consensus view of 30 day future expected stock market volatility (CBOE).
- October 10, 2018, was the single largest drop in value for the S&P 500 index since February 2, 2018 (Schwab).
- The CBOE VIX Index has remained around 20 over the course of the month of October, maintaining elevated levels relative to the preceding months.
- The CBOE chart below shows the VIX Index results from September 24-October 24, 2018, showing an increase of over 50% for the time period.

Finding A Bottom

Source: YCharts



The recent uptick in volatility has sent the S&P 500 Index lower, which in turn has tested support levels as measured by the Index's 200-day moving average. In the chart below, we illustrate the price of the SPDR S&P 500 Index Fund (SPY) in blue and its 200-day moving average in orange. As the graph shows, we have crossed the 200-day moving average with this month's pullback (upper right). Crossing the 200-day average is noteworthy as it is a technical measure used by many traders that signals an official "correction". Once the Index crosses the 200-day moving average, market volatility tends to increase as investors reevaluate their expectations.

- SPY had traded above its 200-day moving average since June 2016, or roughly 570 trading days. Historically, trading above the 200-day moving average for this length of time is quite extreme. In contrast, SPY crossed below its 200-day moving average multiple times in 2016 and 2015.
- Last year, 2017, was quite unusual in that the equity markets experienced relatively no volatility. The markets crescendoed in late January and then converged to the 200-day average in February and March, but did not cross. The market is trying to form a new bottom, for what will hopefully be a new leg up to end the year.

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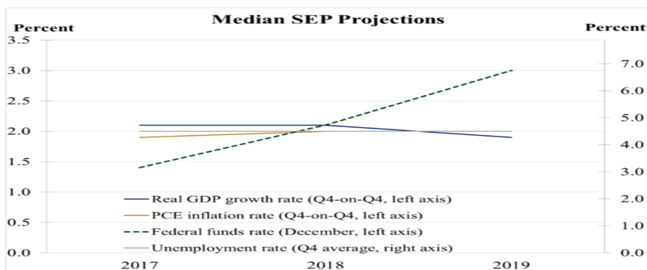
Macro View – Rose Colored Glasses

James Bullard, St. Louis Fed President, recently spoke at an event in Singapore providing a glimpse at how the Fed views the economy and their subsequent stance on steady rate increases. The title of the presentation was "Some Consequences of the U.S. Growth Surprise". Bullard pointed out that the US economy measured by real GDP growth surpassed the FOMC's Summary of Economic Projections (SEP) for 2017 and likely 2018. He stated, "The U.S. growth surprise has been a factor in allowing the FOMC to normalize its policy rate along a projected path, with attendant consequences for global financial markets," continuing to point out that the continuation of the U.S. growth surprise likely requires faster U.S. productivity growth (St Louis Fed). Many contend that the growth in GDP is the result of historically low unemployment. Bullard pointed out three consequences to the outpaced growth: the FOMC staying the course in rate hikes, appreciating US equity prices, and a strengthening dollar. Economic expansion at a 3-4% rate may likely depend on productivity growth increasing.



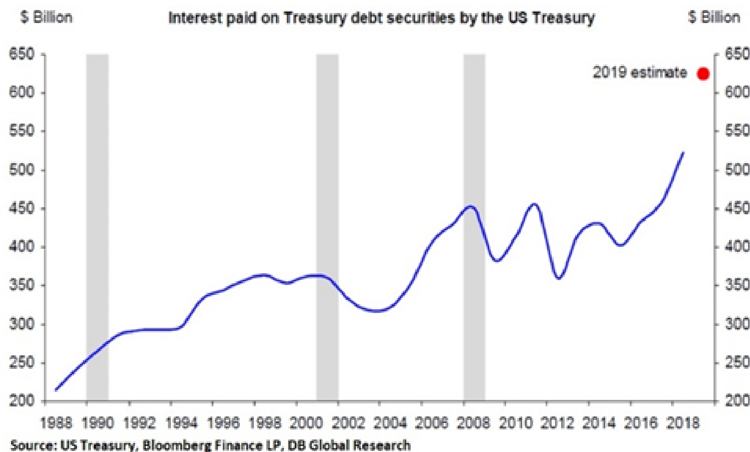
Source: Federal Reserve Board, March 2017 SEP.

Taking Stock – Buybacks Second Wind

Share repurchases by S&P 500 companies continued to climb in 2018, reaching the highest level since the recession in 2008, offering some potentially good news for US equities. 2018 buybacks have eclipsed $175 Billion (S&P Dow Jones Indices). As companies buy back their own shares, it often lifts share price. There is a relationship between the number of shares available to buyback and trading volume per SEC regulation. A company's buyback on a given day cannot exceed 25% of the ticker's daily trading volume over the previous four weeks. Further, most company's restrict buybacks during their earnings reporting period. Reviewing the top holdings of the NASDAQ US Buyback Achievers Index and Invesco BuyBack Achievers ETF (PKW) offers companies that are dedicated to share buybacks. Top holdings as of October 24th, 2018, include Proctor and Gamble, Disney, American Express, Citigroup, and Goldman Sachs. The ETF was down 5.8% Year to date as of October 24th (Invesco). The chart below shows 3 year performance of PKW.

Fixed Income - Cost of Borrowing

As interest rates continue their upward path the cost of servicing the debt is increasing as the chart shows. The U.S. currently spends about $1.5 billion every day in interest payments on the debt. This figure is projected to rise to $2 billion over the next few years taking an even larger percentage of Federal spending. Debt service equates to 7.4% of spending in FY 2018 but that is expected to climb to over 12%, an increase of 60% from current levels. There is a conflation of forces that suggest rates will go higher: increased supply of Treasury bonds, the Fed selling bonds on its balance sheet, and the high cost of currency hedging making foreign ownership less attractive. If the economy remains on track to grow at above trend levels expect to see the Fed continue to hike rates and yields rise.



Technical - The Lows Have It

For the stock market to remain in an uptrend over a long period of time it typically requires strong breadth or participation by most of the stocks in the index. This is measured by the number of stocks hitting new 50-week highs versus the number hitting a 52-week low. The market breadth data in October was nothing short of abysmal as seen in the $NYHL (NYSE New High New Low index). According to Barchart.com, there were an average of 18 new highs and 400 new lows in October. When new lows exceed highs by a 2-1 margin that is a warning sign. When lows exceed highs by a 20-1 margin it feels like the sky is falling. You cannot read too much into a single month of data but the technical picture of the markets is deteriorating rapidly if we do not see a turn-around very soon.

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Market Overview

Clint Pekrul, CFA

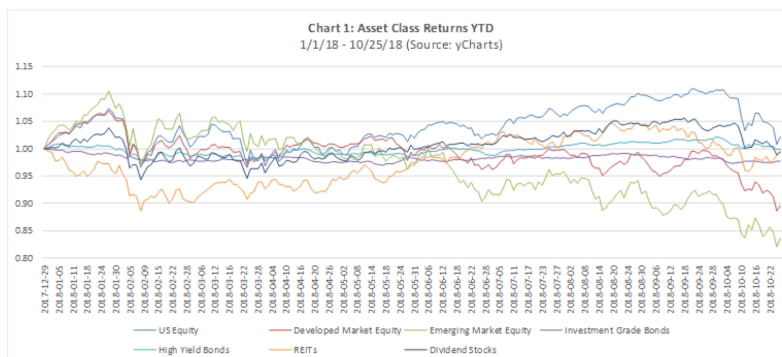
As we write this (October 25th), the S&P 500 Index is down by roughly 8% from it's all-time high is August. From a historical perspective, a pullback like this is not that uncommon. The price-to-earnings ratio (P/E) of the S&P 500 Index was well over 20x prior to the current correction, driven mainly by the technology sector. The long-term average P/E for U.S. equities is roughly 15x, so we could argue that valuations were a bit frothy. Equity prices tend to revert to the mean (average) over time.

At the end of the third quarter, momentum and small cap stocks had advanced for the year by roughly 16% and 10%, respectively. Not surprisingly, during this month's sell off, momentum and small cap stocks have taken the brunt of the decline, falling roughly 12% and 13%, respectively. Conversely, value and low volatility stocks were higher by only roughly 5% for the year through the end of the third quarter, but are down only 7% and 3%, respectively, so far in October.

In 2017, emerging markets soared roughly 35%. This year tells a different story as emerging markets are off roughly -25% from their yearly highs back in January. But this type of volatility in emerging markets is not unusual. The asset class is subject not only to geopolitical and currency risk, but also sovereign risk. However, over time, emerging markets can complement an allocation to developed markets, such as the U.S. While not down as much as emerging markets, developed markets are lower by roughly -10% for the year. As of the writing of this report, GDP growth overseas, particularly in Europe, is weaker than in the U.S. From a valuation standpoint, however, overseas markets in general might be more attractive then domestic markets going forward.

With rising yields, the fixed income markets have come under pressure this year. Investment grade bonds in general are lower by roughly -2% for the year. Mortgage backed bonds and corporate bonds are lower by roughly -2% and -5%, respectively, for the year. However, high yield bonds, which have less interest rate risk than investment grade bonds, are more-or-less flat for the year. Dividend paying equities are modestly lower for the year by roughly -2%, while REITs have been more-or-less flat for the same period.

In Chart 1 below, we provide a visual representation of asset class returns for the year. The primary takeaway is the relative stability of fixed income assets (investment grade and high yield bonds) compared to equities. From a portfolio standpoint, holding a mixture of equities and fixed income assets provided some stability of returns, particularly in October.



In Table 1 below, we provide the volatilities and correlations of asset class returns for the year. The volatility is stated in percentages, while the correlations are highlighted in red (positive) and green (negative). The takeaway is that investment grade bonds have been a diversifying asset class to equities for the year, given that bond returns have been negatively correlated to equity returns. Emerging markets have the highest variability of returns at 21%, while investment grade bonds have the lowest variability of returns at 3%. Not surprisingly, equity returns across the U.S., developed and emerging markets have been highly correlated.

Table 1: Asset Class Volatility and Correlations (1/1/18 - 10/25/18) Source: yCharts

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
US EQTY (1)	15%						
DEV MKT EQTY (2)	0.85	14%					
EMG MKT EQTY (3)	0.80	0.84	21%				
INV GRADE BOND (4)	-0.14	-0.18	-0.08	3%			
HIGH YIELD (5)	0.73	0.70	0.68	0.12	4%		
REITS (6)	0.55	0.43	0.41	0.27	0.42	14%	
DIV EQTY (7)	0.87	0.72	0.63	-0.01	0.62	0.69	12%

While the recent sell off has been challenging, we continue to be believe that diversifying across asset classes and keeping a close eye on correlations and volatilities is the key to long-term success.

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Q: Could a new middle-class tax cut impact the mid-term elections?

The White House economic team seemed surprised by an apparent announcement by the President of a new 10% tax cut for the middle class in stump speeches in Nevada and Texas in late October. He was certainly playing to his base with the announcement but there does not seem to be any definitive plan in place to deliver on the promise. With Democrats likelihood of taking control of the House rising to 65% according to most polls (Real Clear Politics) the likelihood of getting a tax cut passed in the House would be remote considering most Democrats are making campaign promises to reverse the tax cuts passed last year. Political promises are not uncommon at this stage of the election cycle as desperation sets in on both sides. My observation is that the "undecided" vote going into the final weeks of the campaign is much smaller this year than in previous years with both sides doing everything possible to sway the small swing vote. Mid-term House elections are typically driven by local issues and candidate popularity but there is a growing sense that this election is more of a referendum on Trump and his policies. Because of how divided the country seems to be, I do not expect a 9th inning appeal for tax cuts will impact the results in either direction.

The more I read into this, the more I think the promise of a 10% middle-class tax cut was an off-the-cuff remark from President Trump to rally support from the Republican base. The reason is that outside of the White House, few in Congress know much about the details. At first, the President stated that the tax cuts would come in the next few weeks, or before the mid-term elections. But then the President backtracked and said than Congress would pass the tax cuts after the mid-term elections.

Which means, in order for the tax cuts to come to fruition, voters must turn out in November so the Republicans can keep control of both the House and Senate. It's quite clever on Trump's part. It's like the carrot and the stick. Vote Republican and you get a nice 10% tax-cut, but if the blue wave ripples through Congress, Trump will simply blame the Democrats for not cutting taxes. By the way, Trump will then use this rhetoric against the Democrats in the 2020 presidential election. Ultimately, I think there will be an impact come November that might surprise the Democrats. If Republicans keep both houses of Congress, the equity markets could move meaningfully higher to close out the year.

Q: Will panic in Italy lead to contagion?

The risk of contagion is certainly high at this time but ECB Chair Mario Draghi has shown he is not out of bullets quite yet and as long as his mandate allows him to buy virtually any asset in Europe contagion can likely be avoided. Italy's problems are as much political as they are financial. The populist government in Italy is effectively refusing to abide by the rules established by the EU rules on spending and borrowing. Their budget deficit of 2.4% of GDP is likely to increase even as threats from Brussels increase. Their economy is ultimately going to pay the price as the yield on 10-year Italian bonds spiked from 2.8% to 3.4% in less than a month and the spread over German Bunds is approaching 3%. Italy remains Europe's 3rd largest economy so it is not likely to become the next Greece at this point. You do need to pay attention to the capitalization of Italian banks in terms of risk. Italian banks are the largest holders of government issued debt so when the debt is downgraded it impairs their balance sheets and may force them to raise capital at the most inopportune time. So far the troubles in Italy have not impact neighbors like Spain or Portugal but that can change quickly if downgrades do come.

It's hard to tell at this point, but when I look at the spreads on Italian bonds (i.e. the difference in yield between Italian sovereign debt and German bunds), it's certainly widened in recent months. Which reminds me of what occurred roughly seven years ago during the European Debt Crisis. Back then, debt problems in countries like Greece quickly spread to Portugal, Italy, Ireland and Spain (the so called PIIGS). That episode caused major disruptions in the global equity markets, especially in the Eurozone, as investors feared economies would begin to default on their sovereign debt and send interest rates skyrocketing.

Today, economic conditions in the Eurozone are somewhat improved. Back in 2011 and 2012 the EU GDP growth rate was negative, while today it's positive. Meanwhile, the debt-to-GDP ratio in the EU is modestly lower now than seven years ago. But still, the pace at which Italian bond yields rose is alarming and shows how quickly investor sentiment can change. I doubt the U.S. markets would be completely immune to a major disruption in the EU debt markets.

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All weights as of October 26, 2018

Income	
Mortgage Backed Bond	29.00%
Investment Grade Credit	13.24%
High Yield Bonds	22.74%
Preferred Stock	11.66%
US Dividend Equities	6.57%
US REITs	9.78%
Short (Inverse) Treasury Bond	7.00%

Balanced Income	
US Dividend Equities	15.97%
International Dividend Equities	15.56%
US REITs	11.38%
High Yield Bonds	44.45%
Long Term Treasuries	7.19%
Short (Inverse) US Equity	5.00%

US Growth	
Low Volatility Factor	20.31%
High Quality Factor	15.65%
Small Cap Factor	13.40%
Value Factor	21.26%
Momentum Factor	12.44%
Long Term Treasuries	16.94%

Global Growth	
Low Volatility Factor	12.98%
High Quality Factor	8.62%
Small Cap Factor	8.54%
Value Factor	11.38%
Momentum Factor	6.83%
Developed Market Equity	19.47%
Emerging Market Equity	12.32%
Long Term Treasuries	19.87%

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