Global Market Outlook

Q1 2019

Slowdown Ahead? – Navagating Volatility

MAJOR THEMES

We agree with the World Bank's most recent economic report that global growth should slow in 2019 and into 2020. This along with heightened political uncertainty is expected to drive volatility higher.

- ***Synchronized slowdown?*** – Rising debt burdens, lower than expected personal consumption expenditures and lower corporate earnings, suggest an economic slowdown.
- ***How to Navigate Market Volatility*** – The disconnect between consensus expectations & actual economic and investment fundamental continues to widen suggesting continued volatility.

The U.S. economy has been growing at a healthy pace with nearly full employment. At the same time inflation has remained dormant and interest rate levels attractive for borrowers. That's the view on the surface. Underlying this view, real growth has been slowing around the globe. Even in the U.S. Many say the sugar high from the Trump tax cuts have already been discounted in the market. We believe there is much more to the story and that economic growth will likely move lower from current levels.

If stock price behavior is a leading indicator, then it surely suggests a slowdown sooner than later. Equity earnings are falling and earnings estimates are quickly being revised lower. We may have seen the peak in earnings growth, margin expansion and revenue growth. Trade tensions and political warfare in Washington have also added to the uncertainty of the capital markets. Investors have become more risk averse and have fled equities in favor of cash. Debt levels continue to rise in most sectors of the economy, with interest payments representing a larger proportion of net income at a time when real wages have barely nudged higher.

The consensus forecast for stock returns remains excessively high in our view. Both buy and sell side analysts are predicting returns of 12%-14% for 2019. We do not have a specific point forecast for the 12 months ending in 2019, but do believe that 7+ annual returns going forward for stocks will be in a range from 4.5 to 5.5%. This estimate is based on current yields, the expected change of valuations over the period and expected earnings growth rates. We do see aggregate bond returns in the 3.0% to 4.0% range with continued diversification benefits relative to equities.

Looking out into the next decade we generally expect lower than average returns for equities, fixed income, commodities and many alternative investment strategies. At the same time we would expect higher risk for all individual asset classes and lower correlations between asset classes. We continue to be strong believers in transparency and the ability to manage controllable elements in the investment process, such as fees and taxes where appropriate. We are also proponents for integrating ESG factors into the investment process and investing in innovation across all global economic sectors.

ASSET CLASS VIEWS

Below is a summary of our outlook for the major asset classes:

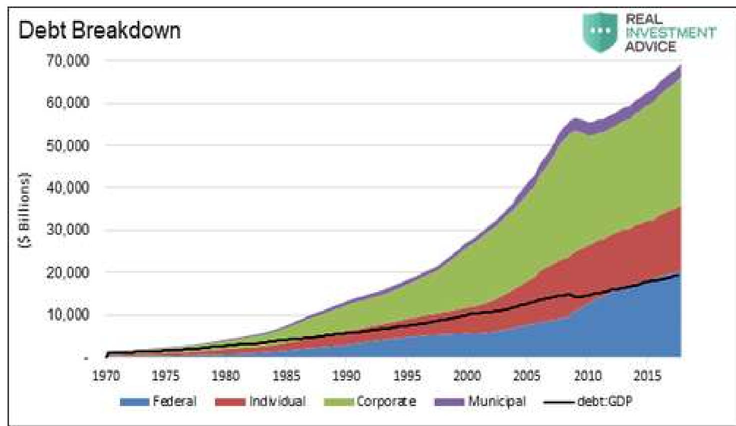
Asset Class	Current View				
	Bullish		Neutral		Bearish
Equities	Stock market volatility, correlations and valuations are elevated and dispersion remains at low levels suggesting lower returns lie ahead and a less than favorable market for stock pickers				
U.S. Large Cap	☐	☐	☐	■	☐
U.S. Small Cap	☐	☐	☐	■	☐
International	☐	☐	■	☐	☐
Emerging Markets	☐	☐	■	☐	☐
Fixed Income	Market expectations for higher interest rates have dampened, which is in line with our view as we do not see signs of permanent higher rates of inflation. We have become more cautious on credit as the business cycle matures.				
U.S. Aggregate	☐	☐	■	☐	☐
U.S. Government	☐	☐	■	☐	☐
U.S. Corporate	☐	☐	■	☐	☐
U.S. High Yield	☐	☐	☐	■	☐
Non-U.S. Developed	☐	☐	☐	■	☐
Emg Market Debt	☐	☐	☐	☐	■
Alternatives	We would expect volatility to move higher across most assets with bonds trading above fair value and the potential for increased earnings risk in equities. We continue to favor alternative return sources with low correlation.				
REITs	☐	■	☐	☐	☐
Commodities	☐	☐	☐	☐	■
Managed Futures	☐	☐	☐	■	☐
Hedge Strategies	☐	■	☐	☐	☐

Growth Outlook and Market Returns

The U.S. economy has enjoyed a record bull market in equities and generally positive economic growth since the Great Recession in the U.S. The major difference with this long recovery is that it has fallen well short of the economic growth rates typically experienced following a recession. The rationale could be, that the economy is in new territory where central banks used an extraordinary level of quantitative easing to stimulate the economy (never done before) and now the backside of uncertainty is upon us where the central banks are “unwinding” this excessive liquidity injection. The global labor market has changed as well with cross border labor supply easily accessible coupled with rapid automation. This has weighed on real wage growth and growth output.

- The near term impediments to economic growth are many: aging demographics, rapid debt accumulation (especially in the emerging markets) and transition from traditional labor markets to one that employ’s fewer people.
- This along with low inflation could make it difficult in the short run for companies to raise revenue and maintain high profit margins, hence a drag on future equity prices.
- We believe a fundamental-driven top down allocation to equities, bonds and alternatives remains critical as well as actively managed exposures to common risk factors across asset that include valuation, momentum, quality, size and low volatility.

Runaway Debt = Low Growth



Source: Real Investment Advice

With lower expected returns, higher volatility ahead and everchanging correlations between asset classes, factors and common themes it is imperative to actively manage risk in total portfolios. Shorter term, many of these risks are affected by changing elements in the economic cycle (economic regime) and by irrational behavior from investors who follow the crowd and tend to buy high and sell low several times throughout a complete market cycle.

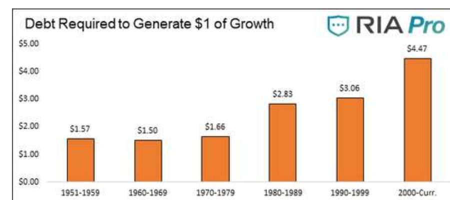
Evidence of Slowdown

- The “Great Disinflation” coined by the World Bank has meant a rise in economic well being across the globe, but at the same time has reduced output as pricing powers have waned. Both the World Bank and IMF have revised their growth and inflation forecasts lower at time when global debt has mushroomed to 320% of GDP, up from 225% of GDP in 2000.
- Debt growth has expanded the most quickly in the government sector where real budgets do not seem to apply. Corporate debt has grown appreciably as well, with a record amount of BBB corporate debt dominating the credit markets. The consumer balance sheet is also beginning to show some stress with credit card debt, auto loans and student debt moving higher.
- A slowdown has already occurred in the manufacturing sector and trade tensions remain high between major trading partners. The IMF recently lower its growth forecasts for advanced economies in 2019 and 2020 and in emerging countries for 2019.

World Economic Growth

Source: World Bank

Debt Burden – U.S.



Source: RIA Pro

Managing Volatility

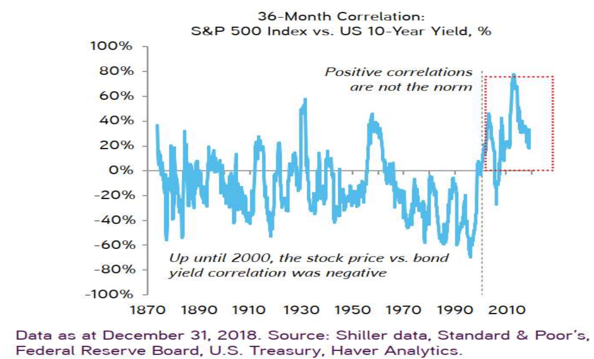
Market volatility is back. The VIX, a measure of expected stock market volatility, trended near 12 throughout much of 2018 only to spike over 35 in December. The VIX has now fallen back to a price level of 18.

- The recent volatility spikes in the global equity markets have spooked many investors, evidenced by asset flows out of equities into cash. Asset price volatility is nothing new, its just that we have witnessed record low equity market volatility over the last decade due to interest rate suppression by the central banks. This return to "normal" should be an opportunity for investors, as returns are only generated through taking on risk.
- Investors tend to forget that they are "investors". Daily, weekly and even monthly asset price swings may make investors nauseous, but should generally be ignored as they will have little relevance to future long term financial plans.
- Investors should stay focused on their long term financial plans, ignore the daily flow of investment news, stay well diversified across assets and common risk factors.

U.S. Stock Market Volatility - 2018

Source: Standard & Poor's Dow Jones, Chicago Board Options Exchange, Macrobond

Back to a Normal Risk Diversification Relationship?



Data as at December 31, 2018. Source: Shiller data, Standard & Poor's, Federal Reserve Board, U.S. Treasury, Haver Analytics.

The Case for Fundamental Investing & Active Risk Management

We have witnessed a plethora of momentum based investment strategies post the 2008 financial crisis and less so adherence to solid fundamental analysis. People tend to confuse quantitative methods for executing fundamental views with pure back testing (aka data mining). Active portfolio management requires understanding how assets are priced today and what are the factors that could influence those asset prices in the future.

1) Recently value has suffered at the hands of pure momentum strategies. Value is not dead, its just been neglected. We continue to believe that the price one pays for any quality asset may be the biggest determinant of its future return.

2) We believe that longer term, asset prices are largely influenced by valuation, momentum, quality, low volatility and size (in that order). Actively managing a good balance of these exposures, especially through different economic regimes, should result in superior results.

Consider equities and bonds in today's current market environment. Equities were on a roll until December of last year, where investors were used to double digit gains in equities and fairly positive returns in bonds. This also followed a period of unusually low interest rates and the desperate search for yield. A prudent approach to managing for the future is:

- **Equities –** the return elements for an equity security or group of securities is a combination of current yield, expected change in valuation and expected earnings growth. The risk around those estimates can be derived from a time weighted average of risk (higher weight given to recent periods) over a long period of time. Based on this approach we have estimated long-term returns (7+ years) for U.S, equities to fall in a range between 4.0%-5.5% ((dividend yield: 1.8% + change in valuation: -1.0% + growth: 3.5%)) and 5.5%-6.5% for non-U.S. equities. These compare to the consensus median forecast of 5.5% for U.S. equites and 6.5% for non-U.S. equities.
- **Bonds -** The elements of return for the bond market include current yield, impact of interest rate change over time and impact of credit downgrade and/or default. We believe, longer term that current yield and the impact of a secular change in interest rates dominates this equation. Based on this we would expect global bonds to return between 2.5% and 3.5% over the longer term. This compares to the median consensus forecast of bond returns slightly below 3%.
- **Risk and Diversification** – Over the last decade, investors witnessed record low levels of volatility in the equity markets and a lessor degree the fixed income markets. We expect a return to normal levels of volatility over the next cycle (50% jump from the previous decade) with normal correlations between stocks, bonds and certain alternatives.

Asset Class / Factor Outlook

When the correlation of asset prices across the broad spectrum of publicly traded securities moves toward one, the risk of a larger than average fall in prices increases (tail risk). In our view, most investors are typically risk averse and prefer to protect capital in times of financial market turbulence relative to outperforming the markets on the upside.

ASSET CLASS/FACTOR OUTLOOK

EQUITY	**Equity valuations remain slightly elevated in our view based on almost all accepted methods of valuation measurement. We do advocate a diversified factor weighted approach to overall equity exposure with an overweight to quality. Overall we believe this is a good time to be "de-risking" equity portfolios.**
U.S. Large Cap	*We continue to favor large cap over small cap and are slightly overweight non US equities relative to a global benchmark.*
U.S. Small Cap	*Smaller companies can enjoy faster growth rates and often have less exposure to currency effects and global competitors, but valuations are still high and we remain cautious.*
U.S. Value Factor	*We believe value has been neglected and expect a reversion to normal over the coming months.*
U.S. Momentum Factor	*We suggest an under weight position in momentum as the later stages of the cycle indicate better odds of a reversal.*
U.S. Quality Factor	*We favor well-established, profitable, and strong balance sheet companies that are poised to lead during the later stages of this bull market cycle.*
U.S. Size Factor	*Smaller companies typically lead early in economic expansions; the current one is late cycle.*
Non-U.S. Equities	*Selectivity of markets and companies is important given multiple challenges; we currently favor Europe and Asia ex Japan and slightly lower exposure to emerging markets.*
Non-U.S. Small Cap	*Valuations have improved and local companies are less exposed to global factors, but risk remains high.*
Emerging Markets	*Valuations are more attractive, but earnings sustainability is much less certain. We favor a risk managed, multi-factor approach.*
FIXED INCOME	**The yield curve continues to flatten with short term yields moving higher on Fed rate hike expectations and longer term yields trading in a narrow range due to low inflation expectations. With this, we believe duration risk is subordinate to credit risk.**
Cash	*Fed rate hikes have moved toward normalization with cash rates moving slightly higher, especially 2 Year Notes.*
Bonds - Total Return	*With low yields across the yield curve for both government and investment grade corporate there has been a pick-up in duration risk.*
Emerging Mkts Debt	*Valuations look attractive, but subject to turbulence from capital flow. In our view there is too much risk in the emerging markets debt space in the current environment.*
Bank Loans	*Near term concerns in the sector include the rapid pace of new issuance of "cov-lite" loans - a precursor to potential credit risk - and longer term inflation appears to be absent.*
GNMA	*In our view, a safe but modest yielding asset class; some opportunity exists in non-agency Mortgage-Backed Securities.*
High Yield	*Spreads have widened recently, while default risk remains low. We believe the risk of downgrade has increased.*
Int-term Treasury	*U.S. Treasury yields in the middle of the curve remain range-bound as market awaits clarity over growth, infrastructure and Fed moves.*
Short-term Credit	*Good expected risk/return tradeoff characteristics but with rising duration risk. One concern is the growing large market exposure to BBB credits.*
Short-term Treasury	*Rates have been moving higher based on Fed rate hike expectations.*
Sovereign Debt	*Negative yields have eased somewhat, but sovereigns remain significantly overvalued. Rising concern with higher yields in Japan and the rising cost required to service that debt.*
TIPs	*Current 10 year TIP yields have recently moved back below 1.0%as a lower growth outlook and falling oil prices has reduced inflation expectations.*
ALTERNATIVES / NON-FINANCIAL	**We continue to believe that exposure to lower cost liquid alternative risk premia alongside traditional equity risk premia is crucial as stock and bond market volatility moves higher traditional equity and bond premiums shrink.**
Global Macro	*With the move away from zero-bound monetary constraints opportunities for top-down global macro bets have improved.*
Long/Short Credit	*Opportunities to mitigate duration risk within a diversified bond portfolio; liquidity concerns require careful attention.*
Long/Short Equity	*Selective opportunities, but best to avoid high net equity beta strategies for hedging purposes.*
Debt & Merger Arbitrage	*Good portfolio diversifier and good play as consolidation continues in many industries.*
Managed Futures	*Trend-following strategies have recently struggled with systematic lower cost long/short approaches, and as a result there may better near term approaches to providing portfolio exposure to non-correlated risks.*
Event Driven	*Consolidation allows for additional opportunities in this space.*
Distressed Credit	*For patient investors, investments in mispriced assets with the catalyst for turnaround can be rewarding; consider illiquid options.*
U.S. Dollar	*Dollar has strengthened relative to other major currencies due to higher US growth prospects and higher short interest rates.*
Currency Carry	*Very difficult to estimate direction shorter term and spreads have narrowed.*
Gold	*A chaos and inflation hedge - very difficult to invest based on fundamentals; not currently held in any of our portfolios.*

Palladiem High Conviction Ideas

Segment	Comments
High Quality Defensive Equity	We believe companies with quality earnings, strong balance sheets, top-line revenue growth, and low levels of debt are well positioned to weather times of financial stress and typically lead during the later stages of the business cycle, therefore we would over weight this portion of investment portfolios.
Multi-factor Equity	In an environment of stretched valuations and modest growth, multi-factor equity exposure implemented globally may provide opportunities for enhanced return and reduced risk. We would advocate a balanced exposure between multi-factor risk exposures and market cap-weighted exposures.
Basket of Innovation	While global average growth rates are slow in historical terms, we see pockets of opportunity from innovation efforts in areas including cloud computing, 3D printing, biotechnology, gene therapy, immunotherapies, big data and machine learning, e-commerce, and clean technology.

About Palladiem, LLC

Palladiem LLC is an independent, employee-owned registered investment adviser that manages global, multi-asset class investment strategies, with an emphasis on alternative investments and active risk management. Palladiem's investment team has 30+ years experience working with high profile institutional clients in the public and corporate pension fund markets, as well as high-net-worth individuals.

The cornerstone of Palladiem's investment process was developed nearly 30 years ago. Refined and revised over time, this process has been implemented at both a major wire-house and managed account providers.

For more information contact us:

Palladiem, LLC
900 West Valley Rd, Suite 900
Wayne, PA 19807
610-304-6529
jwren@palladiem.com
www.palladiem.com

Important Disclosures

The statements contained herein are based upon the opinions of Palladiem LLC (Palladiem) and the data available at the time of publication and are subject to change at any time without notice. This communication does not constitute investment advice and is for informational purposes only, is not intended to meet the objectives or suitability requirements of any specific individual or account, and does not provide a guarantee that the investment objective of any model will be met. An investor should assess his/her own investment needs based on his/her own financial circumstances and investment objectives. Neither the information nor any opinions expressed herein should be construed as a solicitation or a recommendation by Palladiem or its affiliates to buy or sell any securities or investments or hire any specific manager.

Palladiem prepared this Update utilizing information from a variety of sources that it believes to be reliable that may include, but not be limited to, custodians, mutual fund companies, investment managers, Morningstar, Bloomberg, other third-party service providers and in some cases as directed by the client or their representative. Palladiem takes reasonable care to ensure the accuracy of such information but does not warrant that it is complete, accurate or adequate and it should not be relied upon as such.

It is important to remember that there are risks inherent in any investment and that there is no assurance that any investment, asset class, style or index will provide positive performance over time. Diversification and strategic asset allocation do not guarantee a profit or protect against a loss in a declining markets. Past performance is not a guarantee of future results. All investments are subject to risk, including the loss of principal. Portfolio positions referenced are subject to change at any time, your portfolio may not reflect the information referenced.

Palladiem has sole discretion to change allocations to styles and vehicles at any time without notice.

Palladiem, LLC is a Registered Investment Adviser.

For more information about Palladiem, as well as its products, fees and services, please refer to Palladiem's website, www.palladiem.com or call us at 610-304-6529