January 18, 2019
Intrinsic Value Team
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An Echo of 2016

Todd Asset Management US Market Commentary

	4Q 2018	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	-13.5%	-4.4%	9.3%	8.5%	12.7%	13.1%
Russell 1000 Value	-11.7%	-8.3%	7.0%	6.0%	11.0%	11.2%

* *Annualized Total Returns.*

The US stock market anticipated a recession in the second half of last year. The 20% decline from the S&P 500 peak in September to the trough in December is confirmation of that. The US bond market probably geared up for one as well, as the decline in bond yields seems to indicate. The odd thing about this is that the Federal Reserve and most economists do not expect one. Looking at performance for the last quarter, current fundamentals didn't matter, but geopolitics and Fed policy did. Investors are anticipating an economic contraction that we do not think will occur. This feels very much like an echo of a similar episode the US experienced in 2016, and our sense is it probably plays out the same way, i.e. no recession and a recovery in stocks with good fundamentals.

If you look at the correction of 2016, there are many similarities to the bear market of 2018, as you can see in the chart below.

We think the reasons for both of these declines trace their roots back to investor fear of another financial crisis. That fear prompts investors to anticipate the worst possible outcome in any period of uncertainty, and sell stocks.

TODD
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The worries investors are most focused on include:

- Recession concerns. – Investors have rewarded the traditionally defensive (and generally expensive) sectors of Staples, Utilities, REITs and Healthcare since June, despite the fact that they have some of the higher valuations and lower EPS growth rates within the S&P 500.
- Global growth concerns- Tariffs, Brexit, contentious trade conversations and commodity weakness have led to this.
- Fed Tightening- Higher rates *(and the stronger dollar they caused)* have led to worries ranging from Emerging Markets funding to concerns on the US housing and capital spending markets.
- Domestic politics- Shutdowns, investigations, divided government, and turnover in the cabinet have caused consternation.

Other factors indicate investors are worried about the economy as well. The yield curve has flattened, dividend yielders have been favored, and the cheaper economically sensitive names have lagged. There is a serious crisis of confidence that ignores several arguments that a recession is not imminent, including:

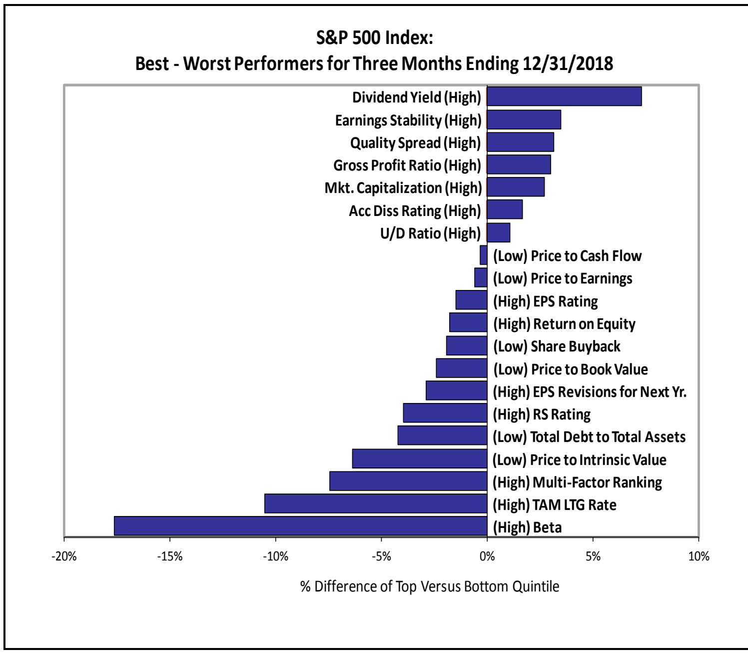
- Earnings growth has been robust. S&P earnings and sales estimates for 2018, 2019 and 2020 were increased between June and December.
- Tax cuts are likely to continue to be felt next year, supporting economic growth.
- Leading Indicators, Employment and Small Business Optimism all remain strong.
- The yield curve may be flatter, but normally it significantly inverts 6 to 18 months before a recession.

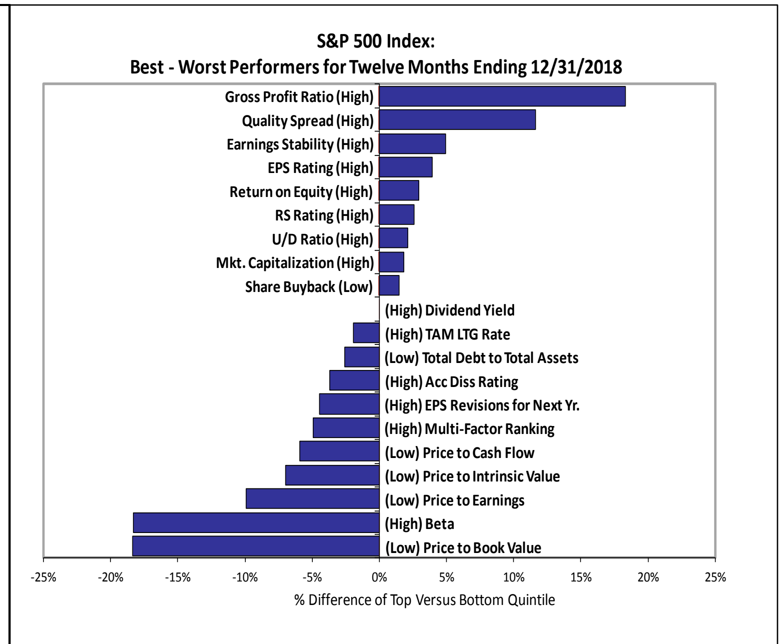
There are several potential developments that could reduce uncertainty, improve economic visibility and generally help confidence within markets. If we were to see these developments occur, we think the recent laggards would be a beneficiary. Those potential developments would include:

- Some resolution on trade and tariff concerns- The US is working on EU, UK and Japanese trade deals, and negotiations with China are beginning to yield small steps that indicate some progress.
- A Federal Reserve pause in hiking rates- The reaction to December's statement was poor, but Fed speakers have been sounding much more patient and data driven about continuing to raise rates.
- Oil Prices firming up- would indicate a reduction in current oversupply and better global growth outlooks.
- The dollar weakening- would indicate the markets are less concerned about a global growth slowdown.
- Continued good earnings growth and guidance from the S&P 500 stocks.

The good news for investors is that periods of fear are usually followed by recoveries. Looking at the chart above, 2017 and the first part of 2018 were great recoveries from the bottoms seen in 2016. We think another recovery like that is in store, but whether it begins now or later in 2019 remains a question. We are encouraged that the market put in the best 10 day period in the past 10 years after posting the worst December since 1930s.

Market Action





Source: Todd Asset Management, Bloomberg

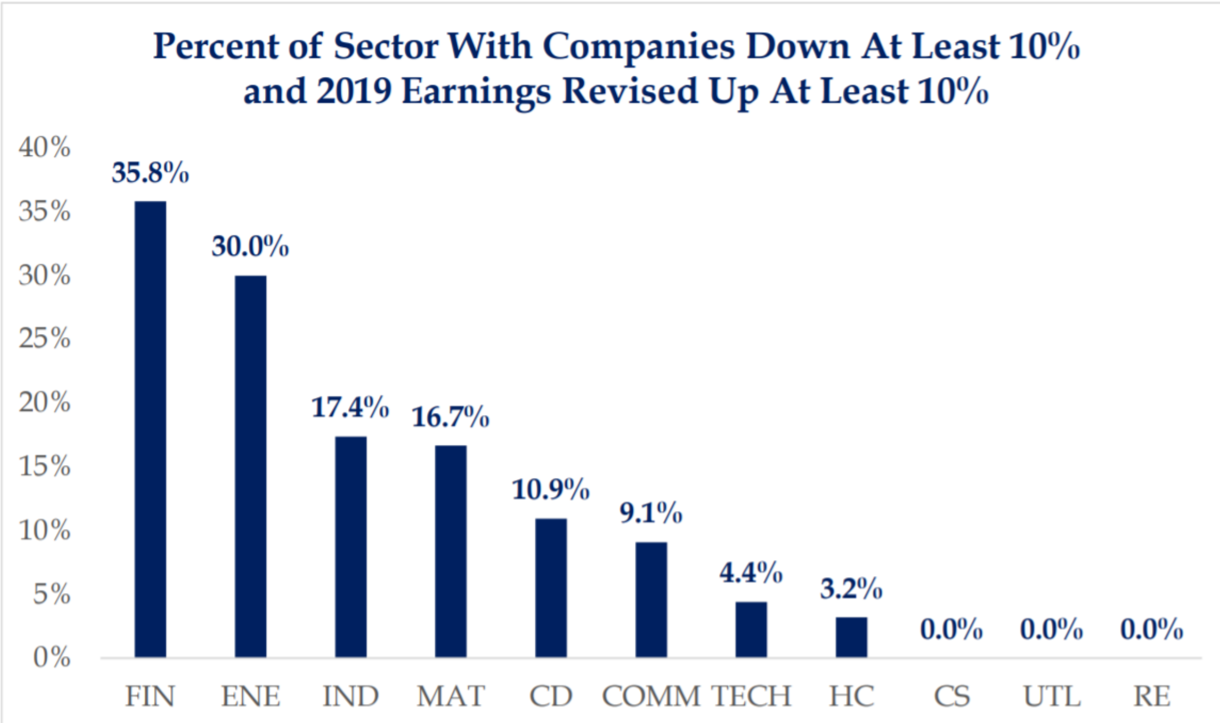
We present our customary factor analysis for the fourth quarter (chart left) and year to date (chart right) above. In general, the market has favored factors indicating higher stability and quality on the year to date and quarterly basis. Dividend Yield lead during the quarter, much like it did during the weak episode of 2016, more evidence of our echo theory. Earnings stability was also a favorite along with measures indicating financial quality. On the bottom of the list, cheap stocks offered little protection in the downdraft of Q4. Also, stocks with lower debt or positive earnings revisions for next year offered little refuge either.

Since June, the defensive sectors that are known for earnings stability and yield have been the best performers. They are also the most expensive sectors and have lower growth rates than most sectors that lagged, as can be seen in the chart below.

S&P Sector Returns 06-30-18 through 12-31-18

Source: Bloomberg, TAM

Interesting Charts We Saw During the Quarter



Source: Strategas

This chart illustrates what we mean when we say the market was ignoring fundamentals. It shows the percent of companies in a sector that were down at least 10%, while their 2019 earnings were revised up at least 10%. Clearly, it was not current results that had investors worried, but anxiety about future prospects **IF** any number of concerns come together to torpedo their prospects. Read the headlines and the concerns become apparent. What **IF** Brexit goes poorly, will a global recession follow? What **IF** US China relations deteriorate and companies need to rework supply chains, will a global recession follow? What **IF** the Fed makes a policy mistake, and raises rates more than the economy can handle, will a global recession follow? All of these concerns and many more gave investors fits, and caused some weakness in groups that showed fundamental earnings strength. The other culprit may well be algorhythmic traders (algos) that base their actions on inferred relationships between different asset classes. <u>When the market declines -2.7% on Christmas Eve (a notoriously quiet day) only to rebound nearly 5% on the day after Christmas (another notoriously quiet day) it makes fundamental investors ask if the inmates (the algos) are running the asylum.</u>

The charts on the following page illustrate two other salient points. First, the market does sometimes have a major decline without a recession following. Second, sentiment is poor enough that it may have marked a bottom in the market late last year. Time will tell.

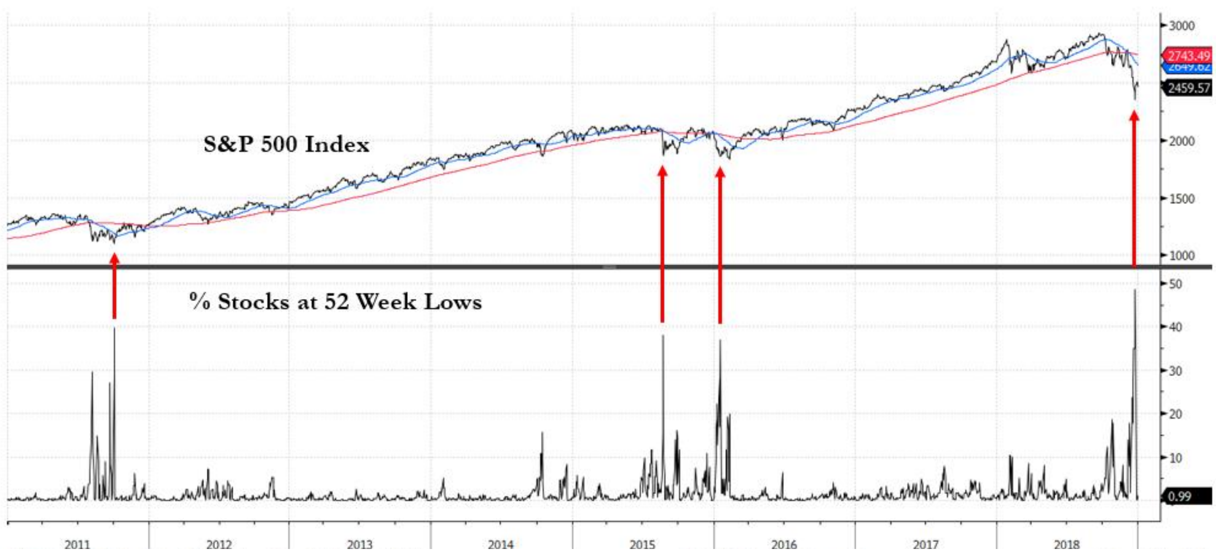
Major S&P Declines Without a Recession

1945 to Present

Start Date	End Date	% Decline	Recession?
5/20/2015	2/11/2016	-15.2%	*No*
5/2/2011	10/4/2011	-21.6%	*No*
7/20/1998	10/8/1998	-22.5%	*No*
8/25/1987	10/20/1987	-35.9%	*No*
9/21/1976	3/6/1978	-19.4%	*No*
2/9/1966	10/7/1966	-22.2%	*No*
12/12/1961	6/26/1962	-28.0%	*No*
5/29/1946	5/19/1947	-28.5%	*No*

Source: Strategas

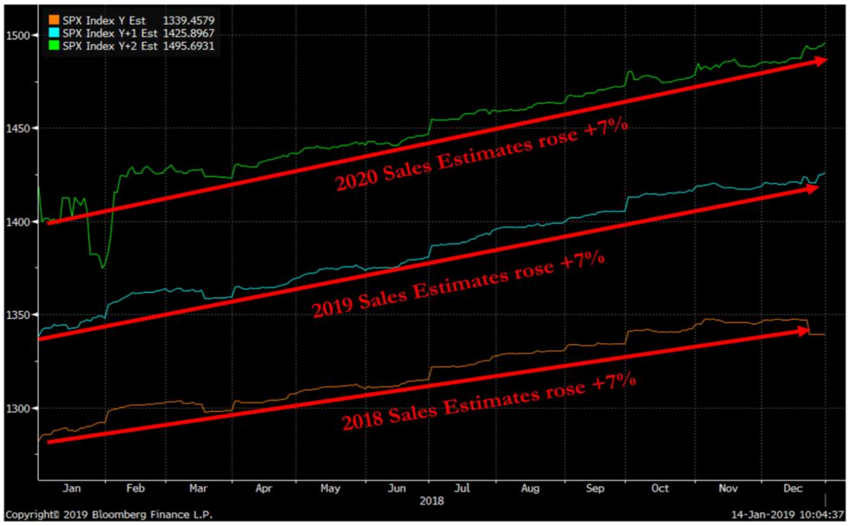
Sentiment: 52 Week Lows at Extreme



Spikes in new 52 Week Lows represent sentiment extremes that usually coincide with market bottoms.

Source: Bloomberg, MSCI and TAM

S&P 500 Sales/Share Estimates



Source: Bloomberg

Sales are a very pure measure of how companies are doing. Sales estimates have been extremely strong for the S&P 500, rising 7% for the 2018, 2019 and 2020 estimates over the past year. We think this bodes well for the economic outlook.

Summary

Most asset classes declined last year, and US stocks were no exception. The primary difference between the US and the rest of the world was that our markets were at new highs as recently as September and suffered a 20% peak to trough decline during the fourth quarter. Investors lost faith in the economy in dramatic fashion during the fourth quarter, leading cyclical stocks to underperform. This was probably exacerbated by algos and quantitative strategies.

The positive message is there's life after "Bear". Markets began a recovery after Christmas that appears to affirm that the US economy is on firmer ground than most worried. Now recoveries from bear markets usually have retests of the lows, so we may not be fully out of the woods, but the lows are likely in for US stocks for the time being. Leadership often changes after Bears, and the early portions of this cycle seem to affirm that. The spreads between growth and value stocks performance is at an extreme, and our sense is that markets will post better results in 2019 than 2018, and likely be led by value stocks.

As always, if you need any additional information, please feel free to contact any of us.

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1/18/19
S&P 500 – 2,669 (Intraday)
Russell 1000 Value – 1,165 (Intraday)

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

Disclosure

S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.