FUNDAMENTUM
INVESTMENT MANAGEMENT

The Home Stretch

With less than 30 trading days left in the year, we think it's useful to reflect on 2018 to consider what we "got right", what we missed, and most importantly, the remarkable change in sentiment that has occurred over the course of the year (especially October). Recall that the overriding narrative coming into 2018 was one of "synchronized global growth." We had just finished 2017, a year of record-low volatility where nearly every global asset class appreciated meaningfully, and in the U.S., we were expecting a year of strong economic activity and strong corporate profits on the heels of a very large cut in corporate tax rates. At Fundamentum, we were in print saying we were far less concerned with the "E" in the P/E equation this year for U.S. equities, but due to concerns over the potential for the economy to overheat, we were concerned about what investors were willing to pay for those earnings. On this point, we got it right, as the P/E ratio for U.S. equities have fallen from about 18.5x expectations of forward S&P 500 earnings earlier in the year, to about 15.5x today, resulting in market that is roughly flat, despite EPS growth that is expected to be over 20% this year[1].

While correct in that prediction, we were wrong about the cause of the valuation contraction, as concerns over overheating have given way to fears about the prospects for slowing global growth. Following economic disappointments throughout the year from the Eurozone, continued slowing growth in China, trade and currency-related pressures on Emerging Markets and Fed policy that has now tightened monetary conditions enough to have an impact on the real economy, investor sentiment has collapsed, far surpassing changes in the real economy. The result has been a record 90% of the 70 asset classes tracked by Deutsche Bank posting negative total returns so far in 2018, versus the previous high reached back in 1920 at 84%.[2] Clearly, there has been few places to hide this year. Equity markets that had reached peaks as recently as late-September, are now off by ~10%, the second "correction" seen in the S&P 500 Index in 2018, despite strong earnings and still only modest inflationary pressures. In fact, the current 4th quarter performance from the S&P 500 at -9.1% through Thanksgiving is the 3rd worst in the post-war history, despite well-documented tendencies for strong seasonal performance in the final quarter, especially in mid-term election years[3].

The Investment Committee at Fundamentum can't find reasons to argue from the current consensus regarding the prospect for recession – it is unlikely in 2019, though many indicators are trending in the wrong direction and are cause for concern. Still, financial conditions have tightened enough (through the Fed's actions and the rising U.S. Dollar) and corporate costs (wages and interest costs) have risen enough to expect a meaningful decline in the rate of earnings growth in 2019. But slowing growth is far different than what could be expected to occur in a recessionary environment. At the current reduced valuation level, a bullish case could be made for U.S. equities in 2019 should the economy and inflation cool enough to justify a "pause" in Federal Reserve monetary policy, as the current re-rating of markets likely discounts the slower outlook in 2019.

Our recent activity in our Tactical portfolios has been to nibble at U.S. equities with our elevated cash positions. We continue to think a seasonal year-end rally is possible, if not likely, and we're using last week's decline to modestly add to positions in our Global Individual Equity Portfolio, a portfolio that is outpacing its benchmark (S&P 100) YTD as the rotation into "value-oriented" stocks from momentum stocks has resulted in relative gains vs. the benchmark in the 4th quarter. Our Quantitative strategies have

also held up this quarter due to an underweight to equities as several momentum indicators we track have warranted.

For some time, we've been concerned about conditions being "as good as it gets", and recent market action is now reflecting the change in conditions we candidly expected in 2019. We've been more concerned with protecting downside risks than possibly missing upside gains, and that's still the case. Still, with the pullback and the change in sentiment and valuations, we are more constructive about the environment in 2019. For us, it's still too late in the cycle to be outright bullish, but conditions (sentiment and valuation) have changed enough to be less concerned about prolonged equity drawdowns. This requires conditions that cause interest rate and inflation pressures to moderate, while at the same time, for economic growth to continue, allowing for continued advances in earnings. This so-called "soft landing" scenario is one that could bring solid gains in U.S. equities in 2019. Missing (in either direction) is likely to result in another year of disappointing returns like those experienced in 2018. As we study the data that will determine this outcome in 2019, our highest conviction is that portfolio returns are likely to be modest over the coming years, and investors would be well-served to review their objectives, risk tolerance, time horizons and asset allocations regardless of the outcome for 2019.

As always, we appreciate your confidence in our team and are always available to assist however we can so please contact us with questions.

Fundamentum Investment Committee

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Sources:
[1] Factset Earnings Insights, November 23, 2018
[2] Wall Street Journal, November 26, 2018
[3] Strategas Technical Strategy, November 26, 2018

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