SEGALL BRYANT & HAMILL

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SBH NEWSLETTER

Thoughts on the Current Environment

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An optimist falls off a 10-story building. As he passes the sixth story, someone yells from the window, "How's it going?" The man yells back, "So far, so good!"

- Anonymous

In the March just past, the current bull market celebrated its 10th birthday. From the bottom on March 9, 2009, the stock market, using the S&P 500 Index as a reference, is up 417% on a total return basis, which includes dividends, even if the dividend yield is at a miserly low rate. This is one of the strongest bull markets ever recorded in the U.S., clearly the finest that the global central banks' money could buy. And a lot of the gain must be laid at the door of the central banks. Corporate profits, again using the earnings of the S&P 500 Index constituent companies as a reference point, are up only 217% in this period. The difference is due to an increase in the valuation put on those earnings by investors.

Ardent fans of the bull market will attribute the increase in valuation to much better business conditions in the aftermath of the Great Financial Crisis. For example, managements squeezed costs out of their operations, producing more efficient companies, while new innovations in technology led to greater demand for a host of new products and services. Some cynics in the crowd, no doubt spoilsports, will note that pinning interest rates at zero and keeping them there not only drove investors to take on more risk but actually encouraged speculation by providing an unspoken, but nevertheless real, commitment by the central banks to buy more financial assets when economic conditions appeared to be weakening.

Whatever the reason, it is no doubt fitting that the market celebrated this birthday with a rousing rally that has virtually reversed the dramatic decline of the 4th quarter of 2018, which now feels like a bad dream we would just as soon forget. All that said, the fact remains that since the beginning of 2018, stock markets around the world, and particularly in the U.S., are essentially flat. Indeed, if one looks at the S&P 500 Index on an equal-weighted basis (that is, taking the return of the 500 stocks in the index, adding them together, and dividing by 500), one can see that the index is up less than the index as it is commonly computed. Absent the strength of a diminishing number of larger capitalization companies, the broad stock market is wallowing in heavy waters.

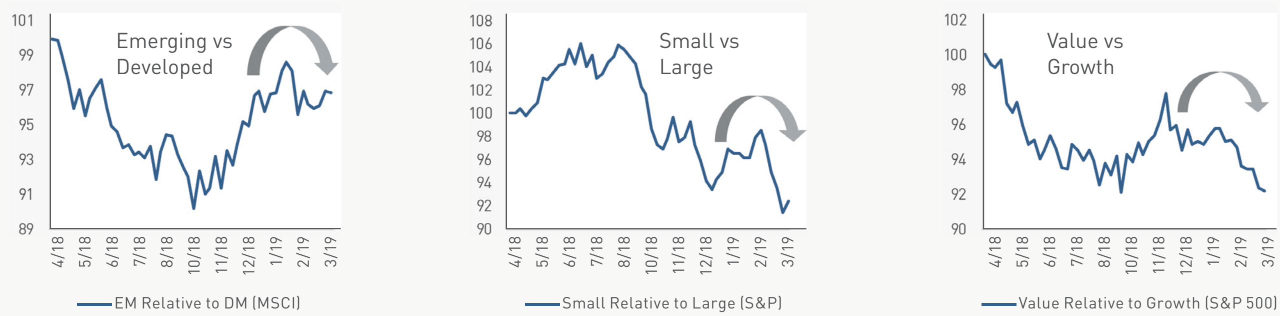
The markets may only be reflecting what seems to be a great deal of controversy about the economy. Are we in the eighth or ninth inning of an economic expansion that has run as long as the bull market in stocks? Employment continues to grow, but wage growth is not what it usually would be this late into a cycle. Inflation still runs stubbornly low—much to the consternation of the central bankers at the Fed, who appear willing to tolerate inflation at higher levels on the grounds that it would somehow be helpful. (Note to self: A good topic for a future *Quarterly Review* would be to consider why a central banker would want to deliberately debase the value of their own raw material—their country's currency.) For our part, we continue to hew to the line about which we have previously written: We see no reason yet for the economy to slide into a downturn. No economic excess has appeared that needs to be reduced to keep things in balance. If the economy grows strongly enough to warrant it, the Fed (or the markets acting for it) will cause interest rates to go up. If not, rates will stay around current levels—and possibly move lower.

At quarter end and contrary to the view we just expressed, the prevailing mindset seems to expect interest rate cuts before the end of the year because of a growing perception that global growth prospects are fading. Many market observers, based on the experience of the last 10 years, would cheer interest rate cuts from here, seeing cuts as beneficial to the stock market. We view it a bit differently. The current situation presents the markets with a Hobson's Choice.[1] A strong economy will produce higher profits, to be sure, but those profits will be valued at a lower rate because interest (i.e., discount) rates will be higher. Alternatively, an economy not strong enough to elicit interest rate increases will be an economy too weak to grow profits to meet Wall Street's expectations. Consider the behavior illustrated in the charts in the table below. All of the charts, covering a 12-month period ending near the end of the quarter, suggest that investors are moving away from companies that are dependent on a continuation of economic expansion in favor of companies with less dependence on a robust economy.

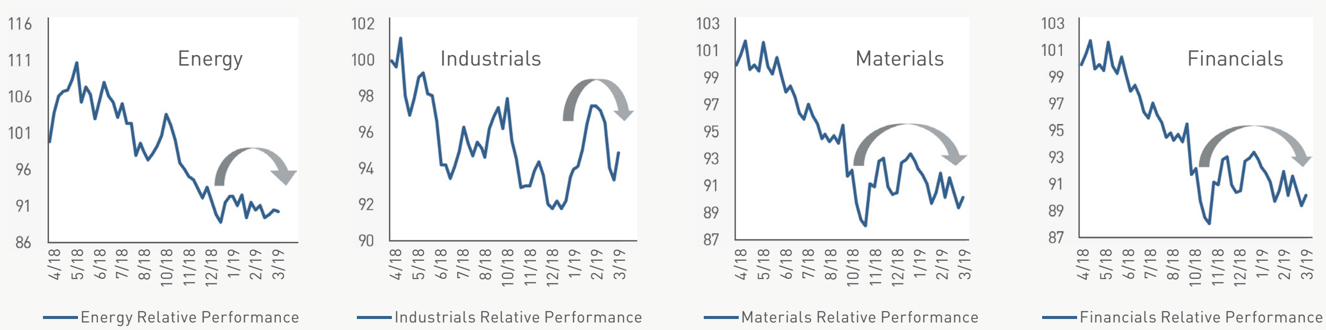
RELATIVE PERFORMANCE: MARKET INDICES AND SECTORS

APRIL 2018-MARCH 2019

Most Prominent Cyclical Indices are Lagging



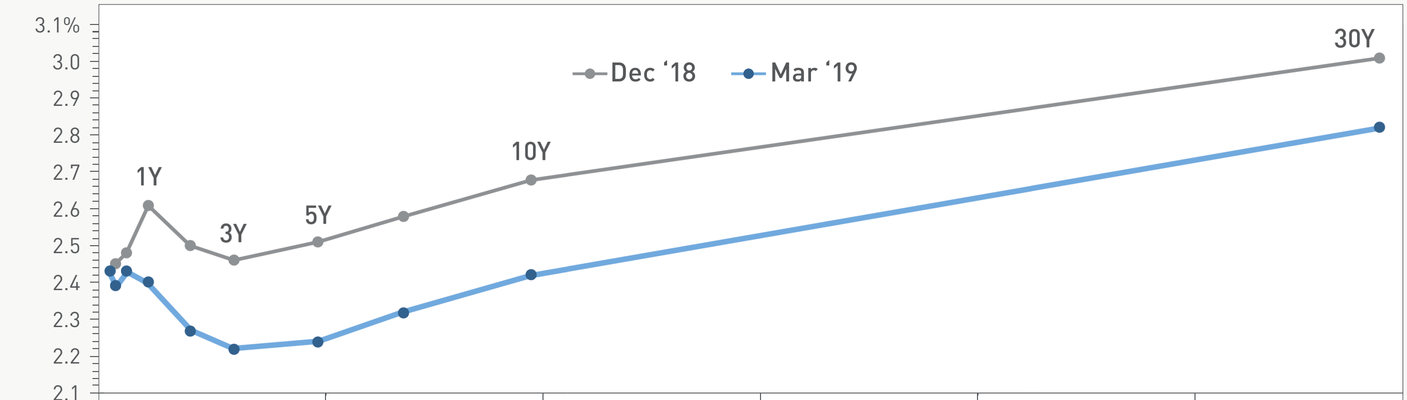
Classical Cyclical Sectors are All Underperforming



Source: FactSet, Cornerstone Macro. Past performance is not indicative of future results.

[1] There are many definitions offered of the phrase "Hobson's Choice" which dates from England in the 1600s. Merriam-Webster offer two, which are both applicable. The first is, "An apparently free choice when there is no real alternative." The second is, "The necessity of accepting one of two or more equally objectionable alternatives."

U.S. TREASURY YIELD CURVE



	1Y	3Y	5Y	10Y	30Y
Dec '18	2.61	2.46	2.51	2.68	3.01
Mar '19	2.40	2.22	2.24	2.42	2.82
Change (basis points)	-21	-24	-27	-26	-19

Source: FactSet, March 29, 2019.

The fixed income markets may be suggesting this is the correct pathway. As the first quarter ended, the yield curve began to invert. An inverted yield curve is generally considered a predictor of an economic recession. Inversions are not common, occurring when yields on short-term maturities are higher than those with longer ones. As of the beginning of the year (a scant three months ago), the market was grappling with the possibility of multiple interest rate hikes by the Fed in 2019. Today, because of weakness outside the U.S.—and negative interest rates to go along with that[2]—capital is flooding into the U.S., driving our interest rates lower. Trade tensions and a strong dollar may lead to a decline in export activity, raising further concerns about the durability of the U.S. economic expansion, which may also act to keep U.S. rates low.

In this environment, it is hard to find opportunity in the U.S. equity markets, at least as measured by the broad market indices. They are heavily dominated by large cap growth companies, mainly tech names. While most observers view the ability of the FAANG companies (Facebook, Amazon, Apple, Netflix, and Alphabet's Google [add your own favorite]) to grow indefinitely at above-average rates, given the compelling economics of their business models, history has shown that technology companies can lose even the most unassailable competitive positions. In many cases, the vulnerability does not appear from current business competitors but from the realm of government—regulatory and political. IBM was thought invincible in the 1970s, as was Microsoft (along with its buddy, Intel) in the late 90s. Both had to contend with anti-trust charges. Both prevailed, but the fallout had its consequences. While IBM and Microsoft continued to prosper, the returns of their stocks following these challenges proved to be a shadow of previous periods.

Large cap growth, led by tech, reigned supreme in the late 90s. When the tech bubble broke, the S&P 500 Index, dominated by such companies, fell out of relative favor for about a decade. In that period, the value part of the domestic market, led by financials, did well. International equities, spurred by the ascent of China (and dollar weakness), had quite a run while growth stocks languished. Based on current valuation levels, the disparities appear to be comparable today. In 2008, the economy was led almost exclusively by housing and financial activities related to residential real estate. Amazon wasn't much more than a bookseller. At that point, growth stocks became so cheap that one could say they had more "value" than "value stocks." Today, value stocks may indeed be "value." Our Small Cap Value Teams make a strong case in that direction.

International equities soared in 2017, suggesting a breakout from their decade-long lull but alas, in 2018, Lucy once again pulled the football away from Charlie Brown just as he was about to kick it. Last year was as dramatically bad for foreign equities as 2017 was good, and nagging questions remain about the international markets. Europe has been and remains in secular decline, largely due to very bad demographics, which similarly afflict Japan. China's economy is being challenged by tariff threats and the risks of trade wars. It is very hard for economies to transition

[2] Bloomberg News (March 26, 2019) reported that," …the stockpile of global bonds with below-zero yields hit $10 Trillion Monday [March 25], the highest level since September 2017 as 10-year {German} bunds trade in negative territory…"

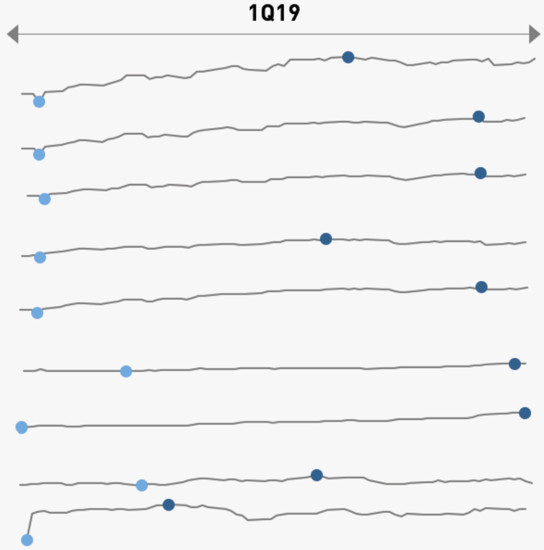
from investment- and export-led to consumer-driven, and China has stumbled in that regard. The Chinese government has used large infusions of capital, mostly debt, to spur its economy, but the stimulative effects seem to be smaller and smaller each time. Overall, as the global economy confronts the consequences of what looks like a slower secular growth rate, the optimism of investing to participate in more rapidly growing markets has waned. That caution may well be overdone, which produces opportunities. Our Quantitative International Team, led by Scott Decatur, wrote a paper in the first quarter, *Spotlight on Emerging Markets Small Caps*,[3] noting that the returns of the small cap part of emerging markets appear to be among the most uncorrelated with the U.S. market, creating the opportunity not only for better returns but also for superior risk-adjusted returns.

One of the attributes of the current bull market has been a marked increase in the tendency for stocks to behave in herd-like fashion, with sectors or segments moving as one rather than as individual sectors or securities. This has been accompanied by surprisingly low volatility, a measure of confidence in the direction of the markets. We believe that volatility in the financial markets will increase as the global central banks step back from Quantitative Easing. If so, the selection of individual stocks, which is the foundation of our equity approach, should become more critical in producing differentiated returns. A new era of stock picking is coming. It's spring and the start of a brand-new baseball season. Put us in, Coach. We're ready to Play Ball!

[3] *Spotlight on Emerging Markets Small Caps*, SBH Quantitative International Team Research, First Quarter, 2019. www.sbhic.com/media-center/insights/

MARKET BAROMETERS
AS OF MARCH 31, 2019

	Dec. 31, 2018	1Q19	Mar. 31, 2019	Low	High
Dow Jones Industrial Index	23,327.46		25,928.68	22,686.22	26,091.95
S&P 500 Index	2,506.85		2,834.40	2,447.89	2,854.88
Russell 3000 Stock Index	1,472.14		1,670.71	1,438.76	1,684.20
Russell 2000 Stock Index	1,348.56		1,539.74	1,330.83	1,590.06
Russell Midcap Growth Index	915.18		1,092.24	887.78	1,100.15
Barclays Aggregate Index	2,037.14		2,097.09	2,036.89	2,100.43
Barclays Muni Bond Index	1,216.99		1,252.24	1,216.99	1,252.24
Gold (Price/Oz) London AM Fix	1,281.65		1,291.15	1,278.70	1,345.75
Goldman Commodity Index	2,203.47		2,612.60	2,203.47	2,683.63



Source: Bloomberg.

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