THELEADING EDGE

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> "EQUITIES ARE IN A BEAR MARKET AND ARE LIKELY TO RETEST THEIR LOWS"

> "WE RECOMMEND PORTFOLIOS ARE POSITIONED MORE CAUTIOUSLY"

ISSUE 2

MARCH 2019

TOP SECTIONS INSIDE

CAVEAT EMPTOR

Caveat emptor can be translated to "buyer beware". It has its roots in early common law and came in use to reflect the increasing complexity of transactions. An "information asymmetry" where the seller was privy to more information than the buyer placed the buyer at a disadvantage. The principle of caveat emptor means that a buyer must still do their own due diligence, but they are protected from the seller wilfully concealing information about the item.

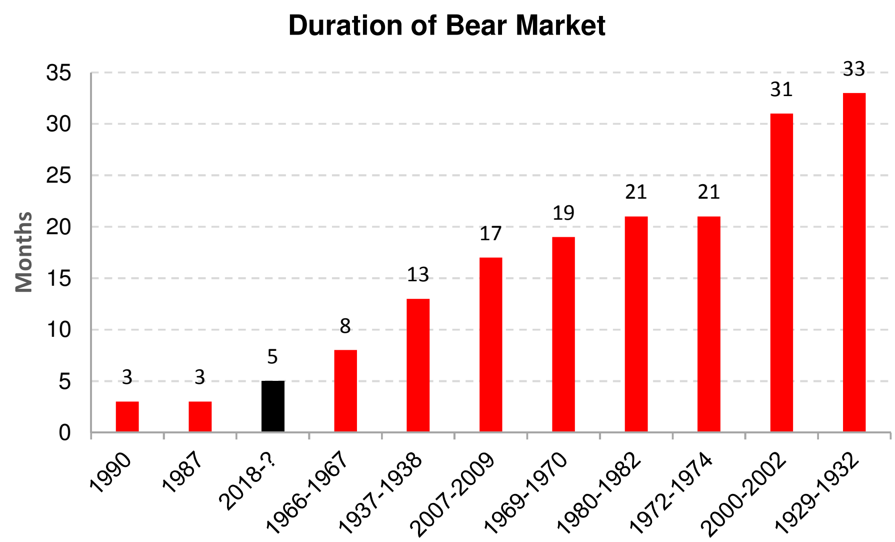
Caveat emptor – buyer beware – is especially apt in today's equity market. Although the S&P500 has bounced strongly off its December 26th low, and is only a few percent off its all-time highs, we would be wary of anyone who wanted to sell us their position. In fact, we think it's more likely we are in a bear market and we will re-test the December lows.

In this issue of TheLeadingEDGE we will show in a few simple charts why this equity rally doesn't look so hot when you start to look under the hood. And in the last section we will update our asset allocation to reflect this more cautious stance on stocks.

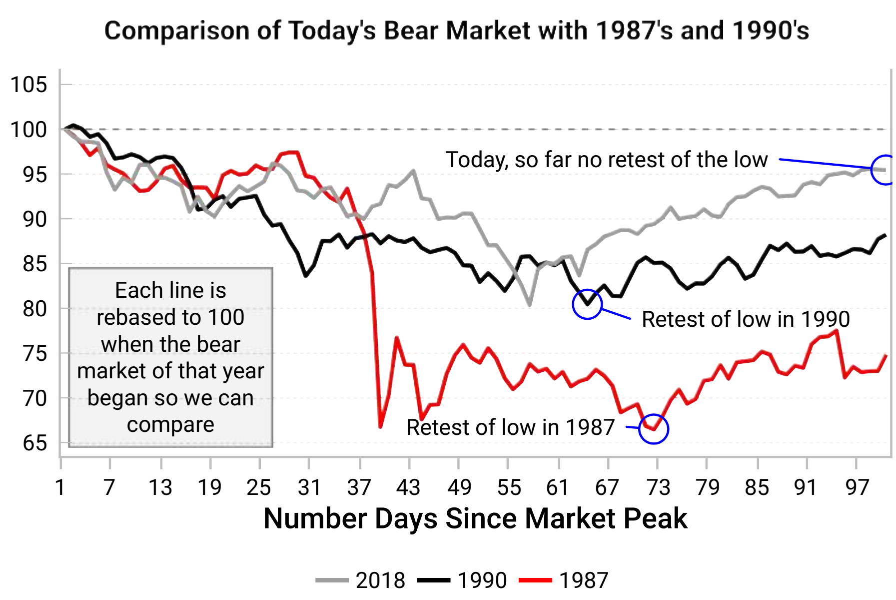
> **TheLeadingEDGE** keeps investors on the right side of trends in the economy and markets, with an actionable asset allocation recommendation each month

A SHORT AND SHALLOW BEAR? WE DON'T THINK SO

The S&P effectively entered a bear market in December. The Fed's rapid 180 degree dovish turn has helped push the market back to within a few percent of its all-time high. Yet most bear markets retest their lows. If we do not retest this lows this time, this bear market will be one of the shortest and shallowest in history.



> ❝ Most bear markets retest their **lows**



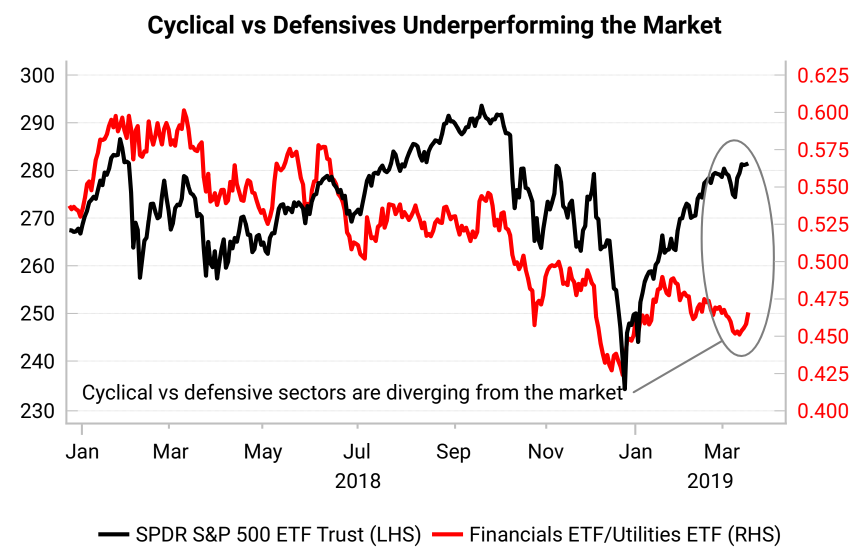
Even the very short bear markets in 1987 and 1990 saw a retest of the lows. And we would not need to see a recession in the US to retest the lows. Both the 1987 and 1990 bear markets were not accompanied by a recession, but still the low was retested.

> ❝ The **1987** and **1990** bear markets had a retest of the low – we expect the same today

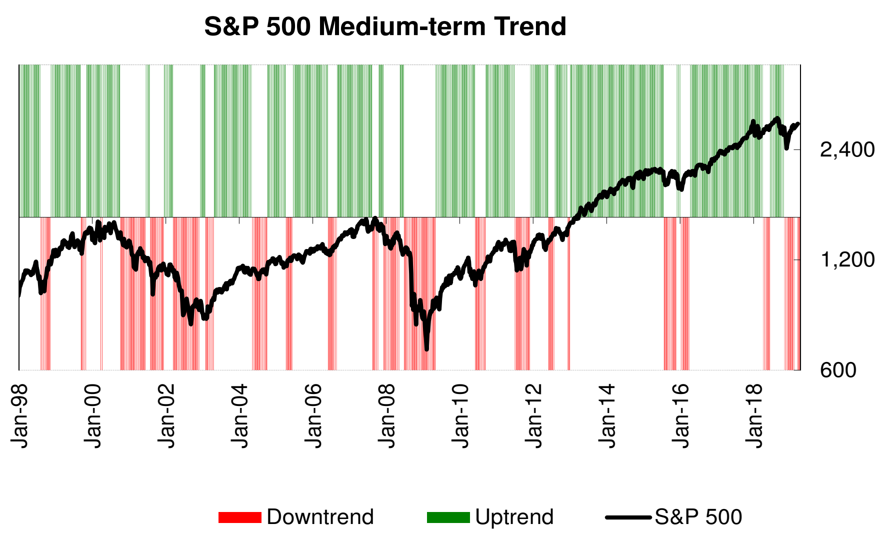
UNDER THE SURFACE, THIS RALLY DOESN'T LOOK TOO HOT!

When we look under the hood of the market, there are a few signs that make us uneasy about today's rally.

> **Cyclical sectors** underperforming make us uneasy about the rally



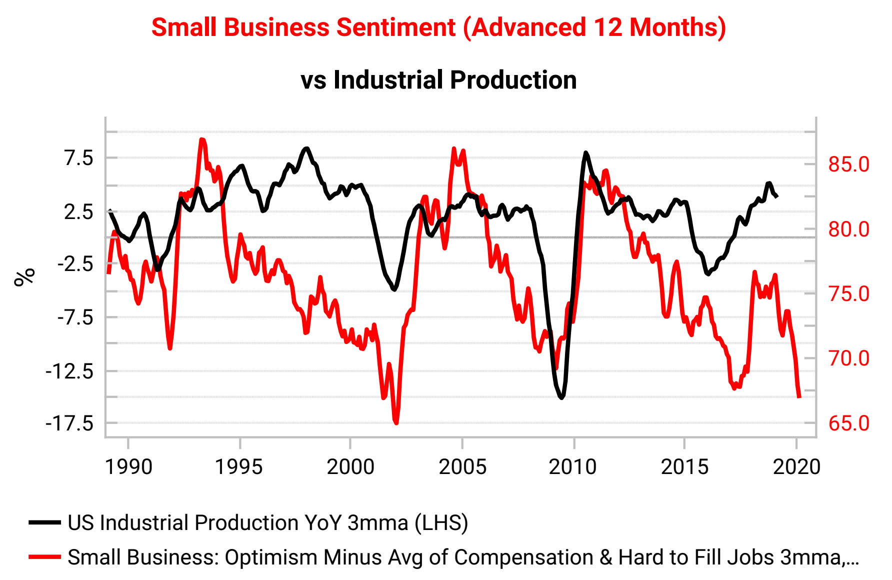
In a healthy rally, cyclical sectors should be outperforming, but this is not the case today. We can see from the chart that the ratio of the financials sector to the utilities sector is underperforming the S&P. It's the same story with consumer discretionary stocks vs utilities. Moreover, small cap stocks tend to outperform large caps in a healthy bounce, but that has not been the case this year.



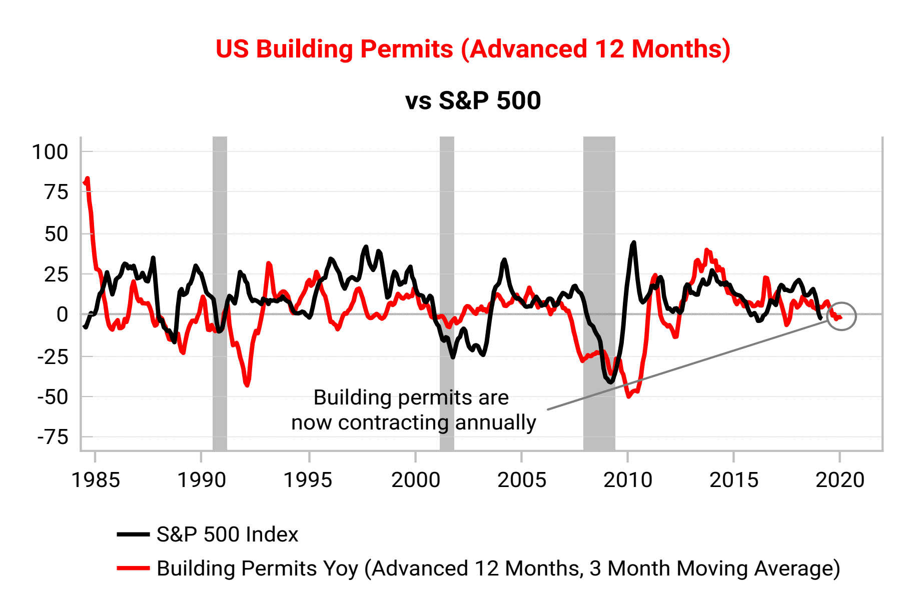
The market is also still in a downtrend if we look at medium-term moving averages (eg the 50 day moving average is still below the 200 day moving average), as the chart on the left shows. Once again, in a healthy bull-market expansion, the trend should be up. Investors should be wary of buying a market in a downtrend, as the S&P was through much of 2001-2002 and 2008-2009, both generally poor times to own stocks.

US ECONOMY IS SHOWING MORE SIGNS OF WEAKNESS

Growth in the US is showing more signs of slowing after last year's huge fiscal stimulus. Small business sentiment as collected by the Small Business Association (NFIB) is collapsing and this points to weaker industrial production – which is a proxy for overall economic growth – in the US as the year progresses.



> **Weaker growth** in the US is on the way



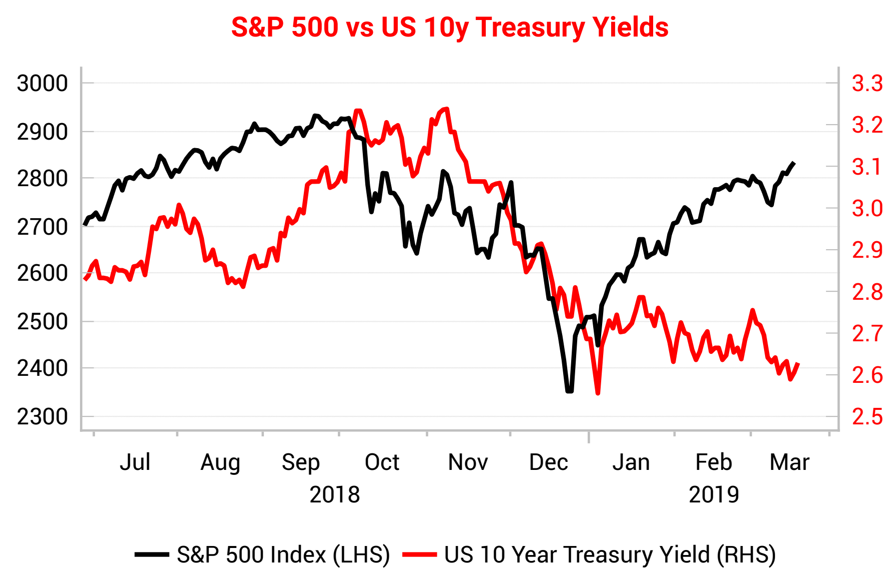
We are also seeing slowdowns in some US sectors, such as housing. Higher interest rates have fed through and are impacting housing. Sentiment has been hit and building permits – a key leading indicator of the housing market – are falling on an annual basis. Given how important the housing market is for consumer confidence, this is generally not a good set up for economic growth or equity markets.

> **Housing** is feeling the pinch from higher mortgage rates

HOW TO POSITION YOUR PORTFOLIO

Although equities may be ignoring the signs of slowing US growth, fixed income markets are not. US 10 year Treasury yields are seen as a reflection of long-term nominal GDP, and so far this year, they have remained very low even as equities have rallied.

This cautious message from the bond markets is another reason to limit equity market exposure.



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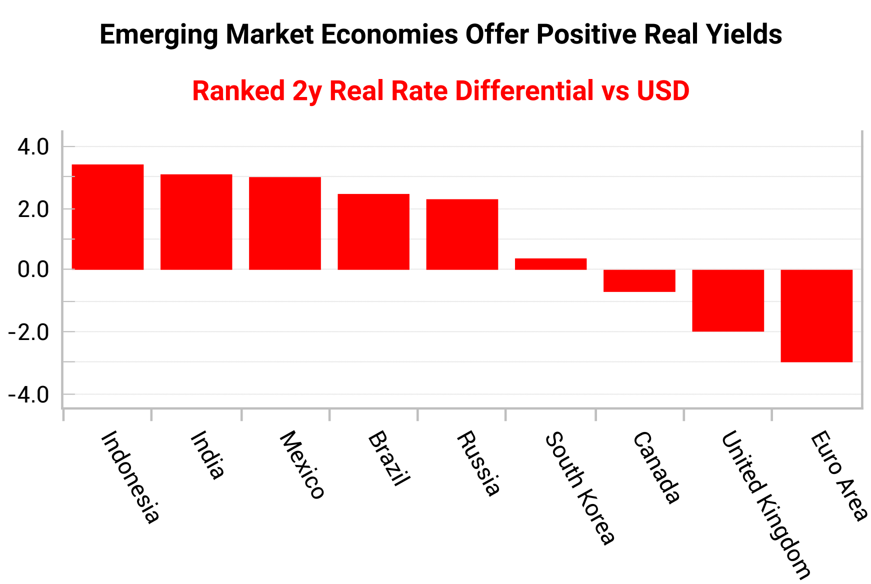
> Low 10y yields suggests **caution** for equities

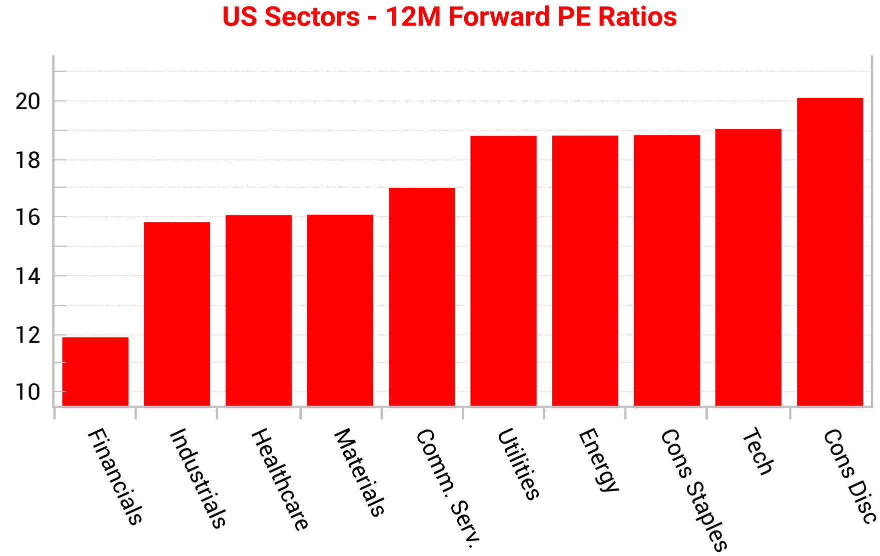


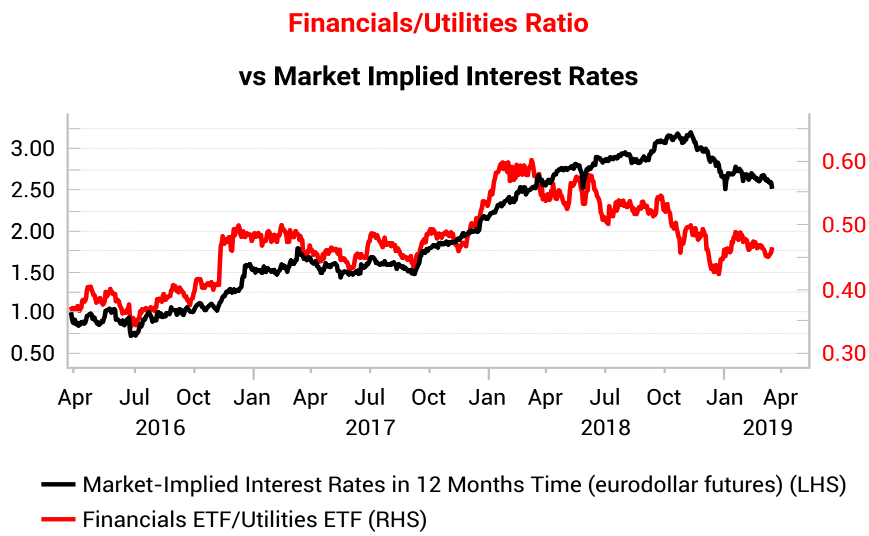
Looking outside the US, we notice that many emerging market economies currently offer much higher levels of yield than the US after adjusting for inflation. When we look at "real" yields, we notice that many EM countries like Indonesia, India, Mexico and Brazil offer real interest rates some 2-3 percentage points higher than that in the US. This encourages us to maintain our recommended allocation to EM bonds in our model portfolio to take advantage of higher EM real yields.

Turning to US equity sectors, when we rank by valuations (12 month forward P/Es), we can see that the financial sector remains the cheapest at just 12x, compared with the S&P 500 at 17x.

Utilities, Energy, Consumer Staples, Technology and Consumer Discretionaries all currently have valuations above that of the S&P.

Below we look more closely the relationship between financial stocks and utility stocks.





Utilities and financials are the sectors that are most exposed to changes in interest rates. Bank profits are tied to net interest margins that tend to rise with higher interest rates, while utilities generally have regulated fixed future income streams that are worth less today when interest rates rise. Therefore the ratio of financials to utilities can be viewed as a reaction to interest rate expectations.

When we look at the ratio of financials to utilities and compare this with expected interest rates, we can see that utilities seem too expensive while financials are cheap.

VERDICT: Equities are nearing all-time highs but given the backdrop of weakening US economic growth and the historical precedent that most bear markets see a retest of the lows, we maintain a very cautious view on US equities.

ASSET ALLOCATION

Our ongoing concerns about slowing US growth and a retest of the bear-market lows causes us to be more defensive than last month with our recommended portfolio allocations. We are increasing our cash/money-market allocation to 40% of the portfolio, with 50% invested in US equities and 10% in EM bonds to take advantage of the high real rates available in many EM countries (see chart at bottom of page 5). Within US equities, we continue to recommend investors overweight financials which are very cheap and where most bad news has already been priced in. We continue to recommend underweights in Technology and Utilities given high valuations.

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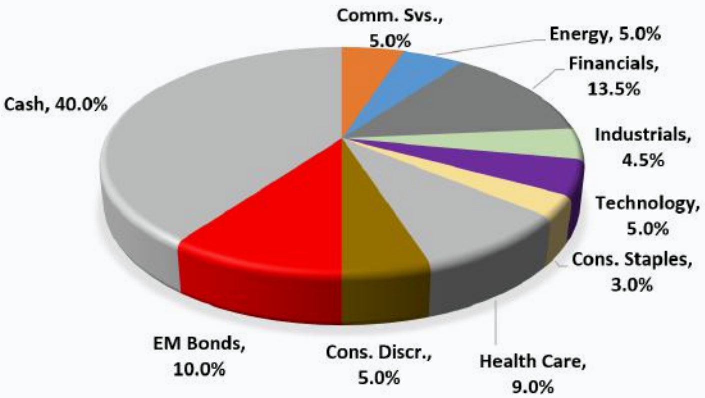
... We recommend holding EM equities and EM bonds as a relative value play



VP's asset allocation model aims to tell you how you should be positioned each month in US equity sectors, EM equities and bonds, and cash

SYMBOL	WEIGHT	FUND/ETF	SECTOR	LAST PRICE
XLC	5.0%	COMM SERV SELECT SECTOR SPDR	Comm. Svs.	46.875
XLE	5.0%	ENERGY SELECT SECTOR SPDR	Energy	66.58
XLF	13.5%	FINANCIAL SELECT SECTOR SPDR	Financials	26.93
XLI	4.5%	INDUSTRIAL SELECT SECT SPDR	Industrials	74.90
XLK	5.0%	TECHNOLOGY SELECT SECT SPDR	Technology	73.55
XLP	3.0%	CONSUMER STAPLES SPDR	Cons. Staples	54.85
XLV	9.0%	HEALTH CARE SELECT SECTOR	Health Care	92.54
XLY	5.0%	CONSUMER DISCRETIONARY SELT	Cons. Discr.	112.88
EMB	10.0%	ISHARES JP MORGAN USD EMERGI	EM Bonds	109.2985
CASH	40.0%	CASH/MONEY MARKET/SHORT-TERM TREASURIES		