FROM THE DESK OF THE CIO

2Q2018 Market Update

July 27, 2018

Michael Parker, CFA
Chief Investment Officer

The following is an excerpt from the 2Q2018 update report of our Dynamic Growth Opportunities (DGO) strategy. For a copy of this report in its entirety, please contact us.

Macro Backdrop

The second quarter did not disappoint in its delivery of market impacting geopolitical events. What began as a delegation appearance at the winter Olympics translated into the first steps a North Korean leader would take across the DMZ since the "end" of the Korean War in 1953, and later a face-to-face meeting with President Trump materialized in Singapore. Despite questions on actual accountability behind Pyongyang's denuclearization efforts, these actions are a stark contrast to the region's geopolitical posturing just eight months prior when threats of missiles capable of reaching Guam were being made simultaneously alongside live test fires over Japan. All political leanings aside, the equity market favors more certainty than less, and a more peaceful Korean peninsula arguably moves the needle further into the favorable category.

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Then came tariffs: Whatever forward progress was achieved in deescalation here was surely offset by the increased friction placed on multiple global trading partners with the institution of tariffs. As a $20.0 trillion economy that has been a consistent net importer since 1982, the US stands more to lose than gain in the Administration's risky deployment of bargaining chips. Since midterm elections are a little over three months away, odds are decent that these actions serve more as a short-term coercion mechanism rather than signify the cornerstones of a protectionist foundation. The latter has a much higher probability of being a persistent negative overhang for the equity markets. Since the S&P 500 derives 38% of its revenue from foreign-domiciled demand today, our sizable exposure would stand to be adversely impacted upon implementation of retaliatory actions by our trade partners. Additionally, 84% of the US private-sector labor force today shows up to work in service-oriented roles compared to manufacturing ones. This makes the US structurally ill-suited to absorb manufacturing capacity currently being outsourced elsewhere, even if it were possible to solve for the labor input cost disparity. If Fed Chairman Powell's stern warnings on the adverse impacts of protectionism failed to enlighten politicians, maybe a more lighthearted quip from Dave Chappelle in his recent NFLX special stands to resonate more deeply, "I want to wear Nikes, I don't want to make them!"

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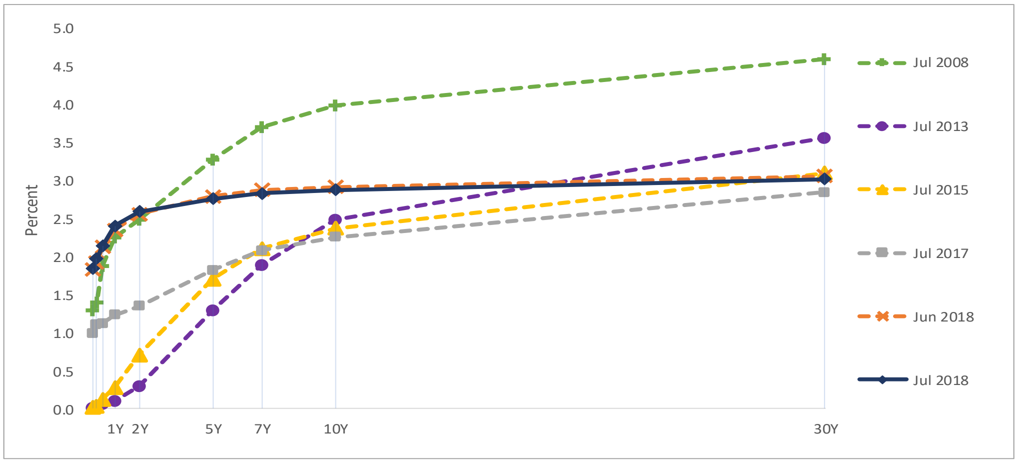
Following a series of steady Fed funds target increases that finally broke a seven-year dormancy in late 2015, the short end of the yield curve now hits the Y-axis at a higher point than it did at any time in the past decade (see chart 1). This has caused concerns of a flattening yield curve to reemerge, along with citations of how tightly correlated this is with impending doom in the equity markets.

Chart 1: US Yield Curve



Source: FactSet, data as of 7/20/2018.

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As tempting as it is to add fuel to the fire on fear mongering here, we believe that current conditions do not support the thesis of a cycle correction, as we discussed in greater context [here]. By no means do we take lightly the unprecedented size of the Fed's balance sheet, which sits at a bloated $4.3 trillion and also stands to be impacted by its own rate policy actions--positively so, when factoring is the yield earned from the portfolio. We just see this aspect of the macro backdrop as warranting further monitoring rather than sounding the alarm for defensive portfolio posturing.

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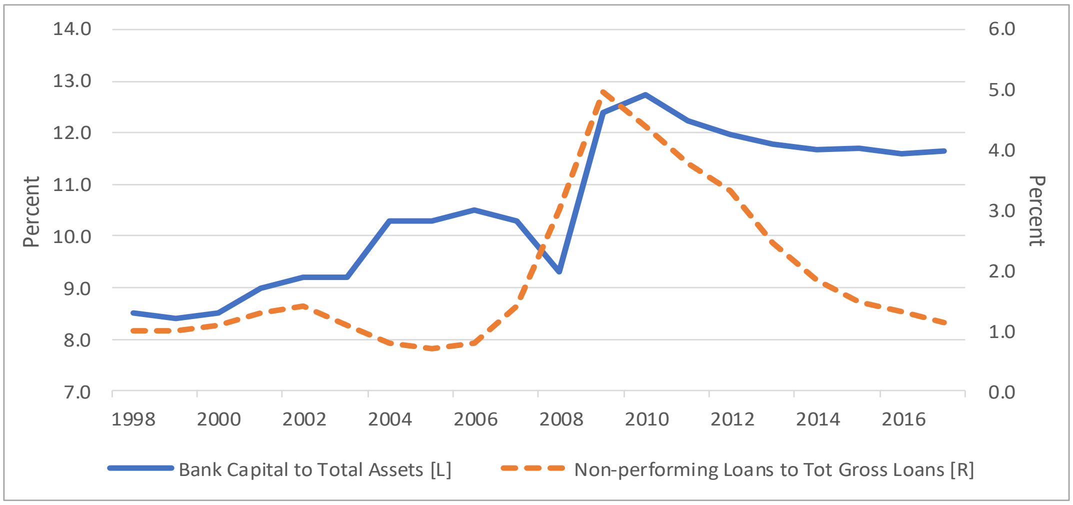
As far as more direct inputs to the economic engine of our economy, we remain bullish on existing conditions that allow companies to create value. The labor market continues to support the expansionary backdrop, with unemployment settling at 4.0% as of the most recent BLS release; labor scarcity does merit monitoring as we dip below "normal" unemployment levels, defined by the Fed as 4.1-4.7%. We also have started to see the implementation of tax cut savings by corporations stemming from the Tax Cuts and Jobs Act of 2017, which took effect January 1, 2018. Unlike temporary tax credits that are one-time in nature and receive little reward by the stock market, a recurring 14-point benefit (35% federal rate that was chopped to 21%) not only leaves more accruing to shareholder pockets, but it also influences capital allocation decisions of management teams looking to reinvest earnings into attractively returning ventures. The balance of "trapped" overseas cash topped more than $2.6 trillion, equating to the current economic output of the world's fifth largest economy, a figure that also excludes any net present value of what would have been future foreign-trapped earnings. As companies reinvest in making their manufacturing facilities more automated, the aggregate workforce has

Chart 2: Bank Capital to Total Assets vs. Non-Performing Loans to Gross Loans



Source: The World Bank, US Federal Reserve.

the opportunity to become more productive, which in turn could aid what has been rather anemic gains in labor productivity, as we explored here. Inflation is another important metric to monitor, especially in situations where companies cannot pass input cost increases through to their end customers via higher selling prices. We saw January's monthly inflation levels hike to 0.5% month-over-month, largely driven by gasoline and apparel categories. However, subsequent readings have leveled to -0.1% to 0.2% month-over-month since, and the Fed continues to see inflation remaining near 2% annualized over the next several years.

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In terms of the health of US financial centers, we continue to see a vastly different backdrop in 2018 than a decade ago with bank balance sheets in dramatically healthier shape. Relative bank capital levels have improved dramatically since the 2008/2009 downturn, as chart 2 highlights, while non-performing loans are hovering back to pre-2007 levels. Furthermore, as discussed previously, higher rates allow banks to reinvest into higher-yielding assets, which often occurs at a faster clip than the rate at which they pay depositors, in turn causing net interest margins to expand, all else equal. Meanwhile, the housing market remains robust. Despite some geographic pockets of price inflation testing the upward bounds of housing affordability, we are far from peak pre-downturn levels in terms of consumers overextending themselves by utilizing home equity as a piggy bank. Not only are adjustable rate mortgages far in the minority of the origination composition pie chart--today ARMs account for approximately 1% of originations versus 42% at their 2005 peak--but the share of median income required to purchase a median-priced home stands at 22% as of March 2018, based on national averages, another metric well below peak 2005/2006 per chart 3.

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We continue to believe that the environment is ripe for being able to discern relative winners from losers in the equity market.

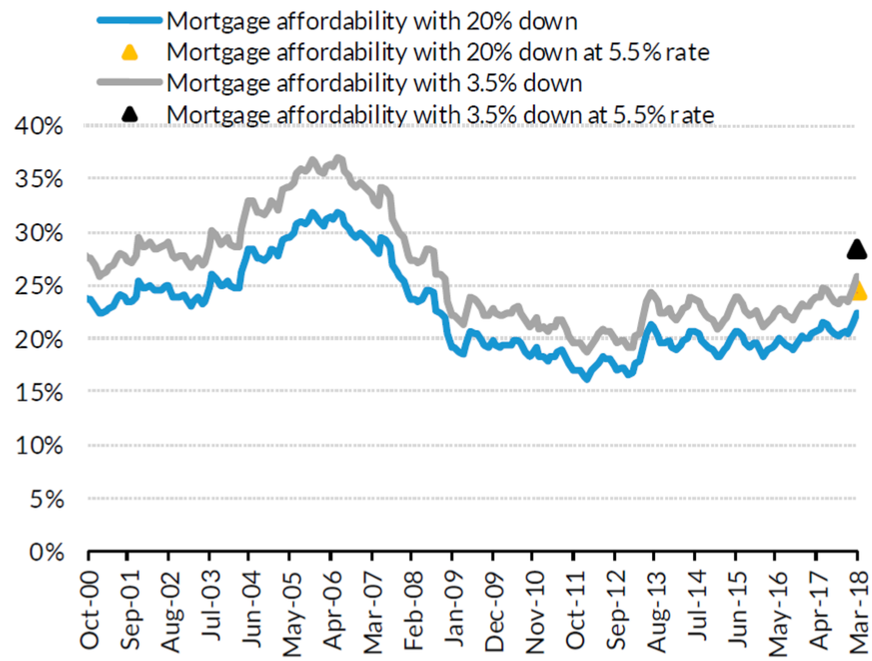
About the Author

Michael Parker, CFA
Chief Investment Officer

Mike joined SWS in 2017 as its CIO and leads portfolio management, risk management and research for the firm. Before joining SWS, Mike was a portfolio manager on $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS).

He leverages over fifteen years of experience on both the buy-side and the sell-side to bring an institutional research and portfolio management framework for SWS investors today. Prior to OPERS Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in Economics, Finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

Chart 3: Median Housing Expenses to Income



Source: The Urban Institute, Housing Finance Policy Center, Monthly Chartbook as of May 2018.

The above are examples of macro inputs that frame our view of a favorable backdrop for mindful risk allocation, and we continue to believe that the environment is ripe for being able to discern relative winners from losers in the equity market. The driving force of this is becoming increasingly synonymous with distinguishing "disruptor" versus "disrupted," a skill set that we believe will become increasingly critical to generating relative value in long-only equity portfolios, such as DGO.

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https://swspartners.net info@swspartners.net (614) 670-5733