Athena Capital Advisors

Interim Market Update

November 2018

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Summary

- Two-thirds of the way through the fourth quarter, Athena recommends clients maintain portfolio diversification. In light of recent volatility, we recommend clients rebalance to Strategic Targets, but to do so in a measured way and to favor US Equities ahead of International Equities. We continue to recommend low duration in fixed income portfolios and to hold extra cash as a means of hedging against, as well as capitalizing on, the expected sustained rise in market volatility.

- Notable themes thus far in 4Q18 include: the October-November equity selloff, global growth concerns, another quarter of strong earnings, an oil price bear market, rising concerns over corporate debt levels, and higher yields on high yield bond.

- In the final four weeks of 2018 trading activity, notable events to monitor include the G20 Summit on November 30th (with the primary focus on US/China trade), the OPEC meeting on December 6th, and the US Federal Reserve meeting on December 19th.

Current Drawdown in Historic Perspective

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The S&P 500 has experienced 23 drawdowns of over -5% since March 2009, with an average decline of -9.3%. The storylines associated with these selloffs have at times included sound fundamental reasons, while others look like clear overreactions in hindsight (e.g. North Korea, Ebola). Athena believes the narrative associated with the recent drawdown was much more reasonable than most in the post-GFC era; however, we do not believe the current market weakness is necessarily telegraphing an impending recession or the denouement for risk assets (particularly in the US).

S&P 500 Corrections of >5% since March 2009 Low

Correction Period	S&P High	S&P Low	% Decline	"Stocks Fall On…"
2018: Sep 21 - Oct 24	2941	2652	-9.8%	Inflation Fears, Rising Rates, China Slowdown, Trade War/Tariffs, Housing
2018: Jan 26 - Feb 9	2873	2533	-11.8%	Inflation Fears, Rising Rates
2016: Aug 15 - Nov 4	2194	2084	-5.0%	Election Fears/Concerns/Jitters
2016: Jun 8 - Jun 27	2121	1992	-6.1%	Brexit Concerns, Pound Crashing, European Banks
2015/16: Nov 3 - Feb 11	2116	1810	-14.5%	China, EM Currencies, Falling Oil, Middle East, North Korea Nukes
2015: May 20 - Aug 24	2135	1867	-12.5%	Greece Default Concerns, China Stock Crash, EM Currency Turmoil
2014/15: Dec 29 - Feb 2	2094	1981	-5.4%	Falling Oil, Strong Dollar, Weak Earnings
2014: Dec 5 - Dec 16	2079	1973	-5.1%	Falling Oil, Strong Dollar
2014: Sep 19 - Oct 15	2019	1821	-9.8%	Ebola, Global Growth Fears, Falling Oil
2014: Jan 15 - Feb 5	1851	1738	-6.1%	Fed Taper, European Deflation Fears, EM Currency Turmoil
2013: May 22 - Jun 24	1687	1560	-7.5%	Fed Taper Fears
2012: Sep 14 - Nov 16	1475	1343	-8.9%	Fiscal Cliff Concerns, Obama's Re-Election
2012: Apr 2 - Jun 4	1422	1267	-10.9%	Europe's Debt Crisis
2011: Oct 27 - Nov 25	1293	1159	-10.4%	Europe's Debt Crisis
2011: May 2 - Oct 4	1371	1075	-21.6%	Europe's Debt Crisis, Double-Dip Recession Fears, US Debt Downgrade
2011: Feb 18 - Mar 16	1344	1249	-7.1%	Libyan Civil War, Japan Earthquake/Nuclear Disaster
2010: Aug 9 - 27	1129	1040	-7.9%	Global Growth Concerns
2010: Apr 26 - Jul 1	1220	1011	-17.1%	Europe's Debt Crisis, Flash Crash, Growth Concerns
2010: Jan 19 - Feb 5	1150	1045	-9.2%	China's Lending Curbs, Obama Bank Regulation Plan
2009: Oct 21 - Nov 2	1101	1029	-6.5%	Worries About The Recovery
2009: Sep 23 - Oct 2	1080	1020	-5.6%	Worries About The Recovery
2009: Jun 11 - Jul 7	956	869	-9.1%	World Bank Neg Growth Forecast; Fears Market Is Ahead Of Recovery
2009: May 8 - 15	930	879	-5.5%	Worries That Market Has Gotten Ahead Of Itself
Average			-9.3%	

Pension Partners @CharlieBilello

Note: This exhibit is from October 25th. From September 21st thru November 28th, the maximum percentage decline for the S&P 500 was –10.2%.

Source: Pension Partners, @CharlieBilello

Global Growth Remains in the Spotlight

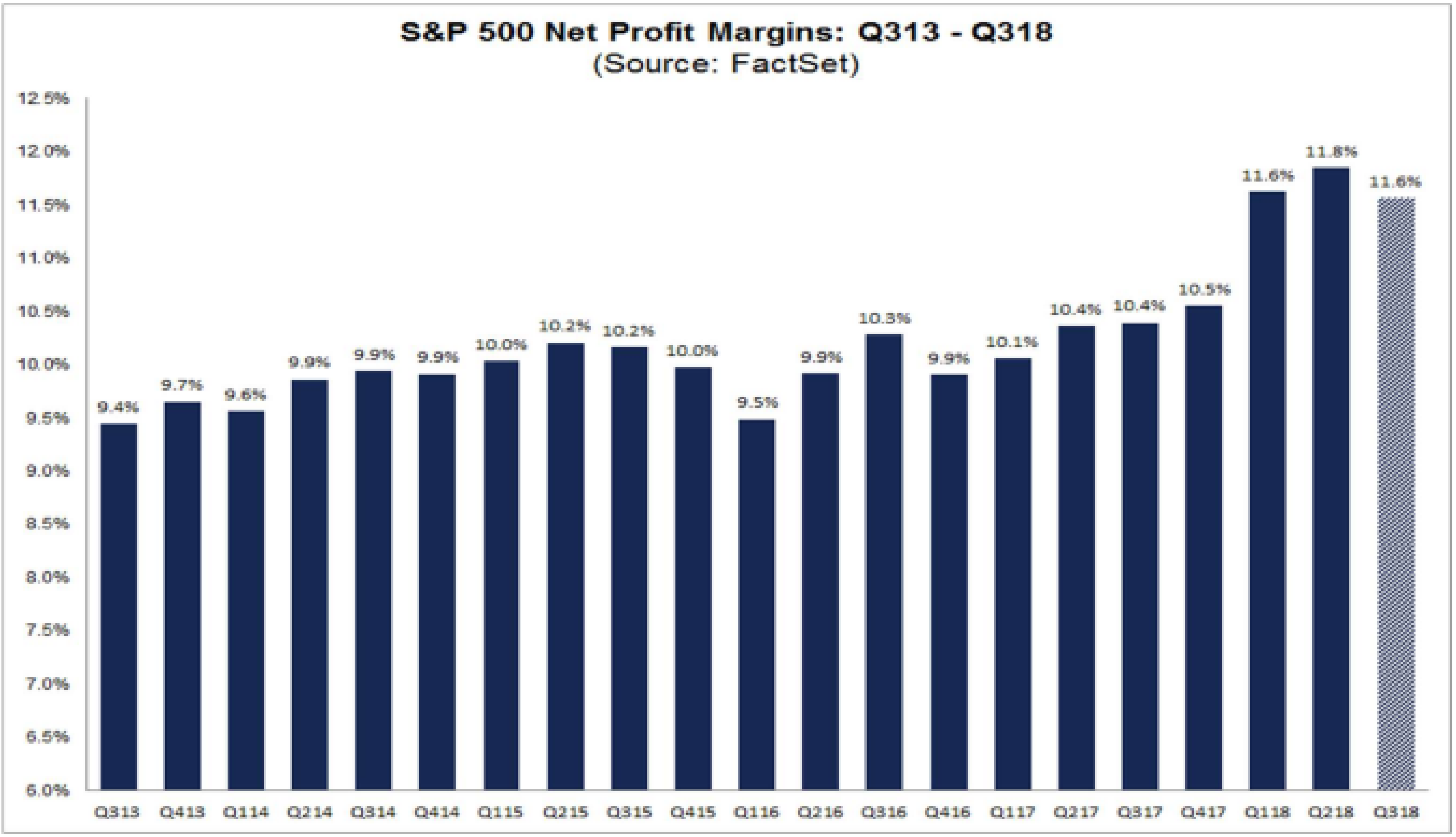
Global leading economic indicators continue to weaken from 1Q18 highs. Two notable 4Q18 growth-related events which failed to ease ongoing growth concerns included: (1) China reporting 3Q year-over-year GDP growth of 6.5%; the slowest pace of growth since 2009, and (2) the US 3Q18 GDP report showing a material slowdown in business capital expenditures, an area that was expected to continue its positive contribution to growth given the positive tailwind of fiscal policy.

Region	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Change Since Jan 18
Global	52	52	53	53	53	53	53	53	53	53	53	53	53	54	55	54	54	53	54	53	53	53	53	52	-2.3
Developed Markets	53	53	54	54	54	54	54	54	54	54	54	55	55	56	56	56	56	55	55	55	54	54	54	54	-2.6
Emerging Markets	51	51	51	51	51	52	51	51	51	51	52	51	51	52	52	52	52	51	51	51	51	51	51	50	-1.9
US	55	55	54	56	54	53	53	54	54	55	56	55	55	55	54	53	56	54	55	57	57	56	55	54	-0.2
Canada	51	52	52	54	55	56	56	55	55	56	55	55	54	54	55	56	56	56	56	56	57	57	57	55	0.1
UK	54	53	56	55	55	54	58	57	54	55	57	55	57	58	56	55	55	55	54	54	54	54	53	54	-2.5
Eurozone	54	54	55	55	55	56	57	57	57	57	57	58	59	60	61	60	59	57	56	56	55	55	55	53	-7.4
Germany	55	54	56	56	57	58	58	60	60	58	59	61	61	63	63	61	61	58	58	57	56	57	56	54	-9.6
France	52	52	54	54	52	53	55	54	55	55	56	56	56	58	59	58	56	54	54	54	53	53	54	53	-6.3
Italy	51	52	53	53	55	56	56	55	55	55	56	56	58	58	57	59	57	55	54	53	53	52	50	50	-7.4
Spain	53	55	55	56	55	54	55	55	55	54	52	54	56	56	56	55	56	55	54	53	53	53	53	51	-4.4
Greece	49	48	49	47	48	47	48	50	51	51	52	53	52	52	53	55	56	55	53	54	54	54	54	54	0.5
Ireland	52	54	56	56	54	54	55	56	56	55	56	55	54	58	59	58	56	54	55	55	57	56	58	56	-2.8
Japan	51	51	52	53	53	52	53	53	52	52	52	53	53	54	54	55	54	53	54	53	53	52	53	53	-1.5
China	51	51	52	51	52	51	50	50	50	51	52	51	51	51	52	52	52	51	51	51	51	51	51	50	-1.5
Indonesia	49	50	49	50	49	51	51	51	50	49	51	50	50	50	49	50	51	51	52	52	50	51	52	51	1.4
Korea	48	48	49	49	49	48	49	49	50	49	50	51	50	51	50	51	50	49	48	49	50	48	50	51	1.4
Taiwan	53	55	56	56	55	56	54	53	53	54	54	54	54	56	57	57	56	55	55	53	55	53	53	51	-5.8
India	54	52	50	50	51	53	53	52	51	48	51	51	50	53	55	52	52	51	52	51	53	52	52	52	-2.5
Brazil	46	46	45	44	47	50	50	52	51	50	51	51	51	54	52	51	53	53	52	51	50	51	51	51	-1.5
Mexico	52	51	50	51	51	52	51	51	52	51	52	53	49	52	52	53	52	52	52	51	52	52	51	52	0.0
Russia	52	54	54	55	53	52	51	52	50	53	52	52	51	52	52	52	50	51	51	50	50	48	49	50	-2.0

Source: Bloomberg, Markit

Peak Margin Concerns Persist

While slightly lower quarter-over-quarter, S&P 500 net profit margins remain near record levels. As indicated in previous market updates, Athena believes the current fundamental backdrop is one of strength – though, a combination of higher interest costs and wages, ongoing tariff-related uncertainty, and slowing global growth all present a risk to the downside for margins and forward earnings.



Source: FactSet

Oil Price Decline Presents Earnings Headwind

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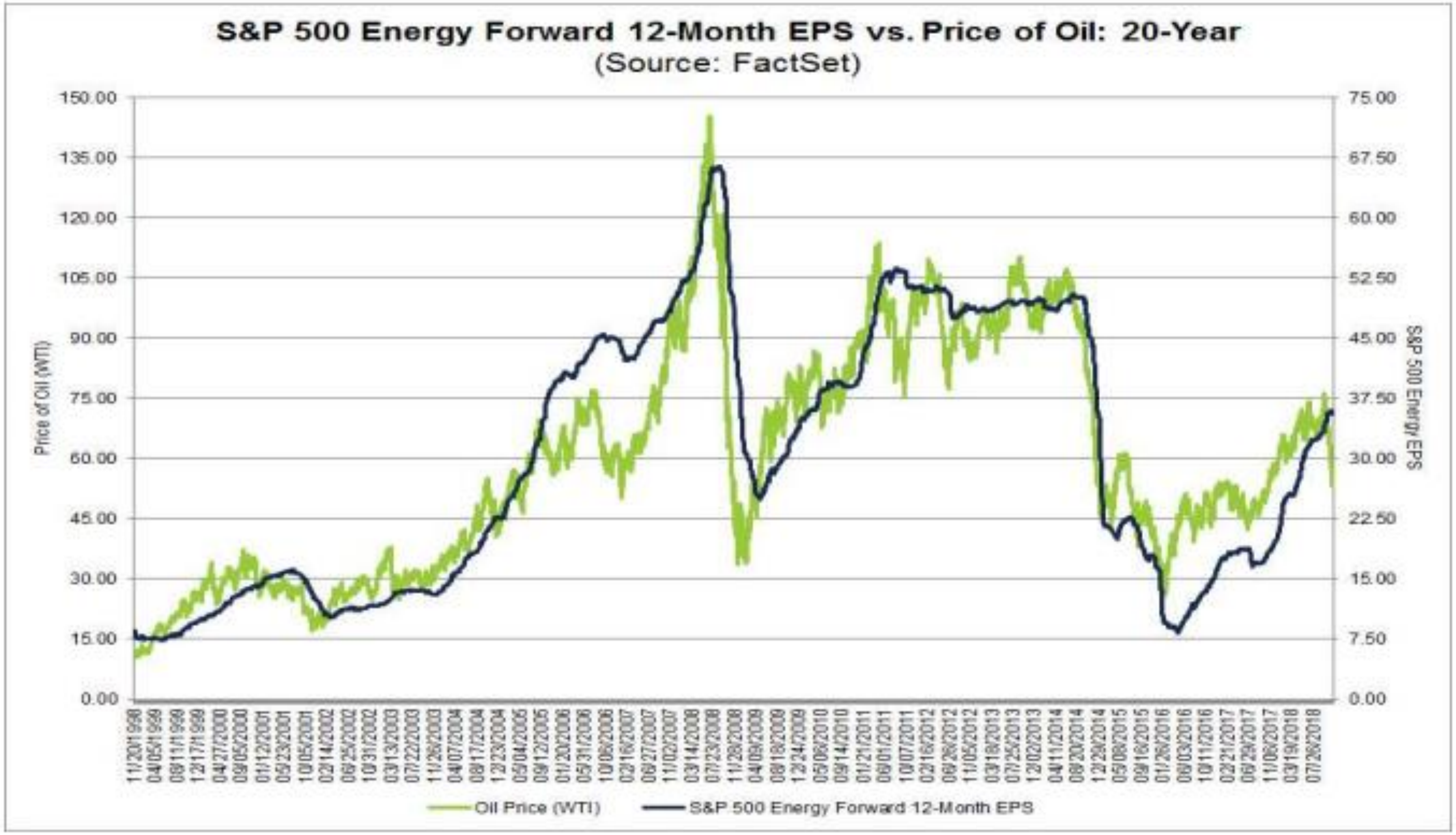
Since September 30th, the price of oil (WTI) has declined by –30%, from \$73/barrel to \$51/barrel. This presents a headwind for energy sector earnings, as the 20-year correlation between the daily forward 12-month EPS estimate and the daily price of oil (WTI) is 0.92. Although the energy sector accounts for only 6% of the S&P 500 Index, the persistence of an oil bear market has the potential to bring disproportionate pressure on index-level earnings, as experienced during the 2014-2016 oil selloff. The next material event for the commodity is the OPEC meeting on December 6th, where energy investors are hopeful a supply cut announcement will calm the market.



Source: FactSet

Reasonable Valuation Show Modest Upside

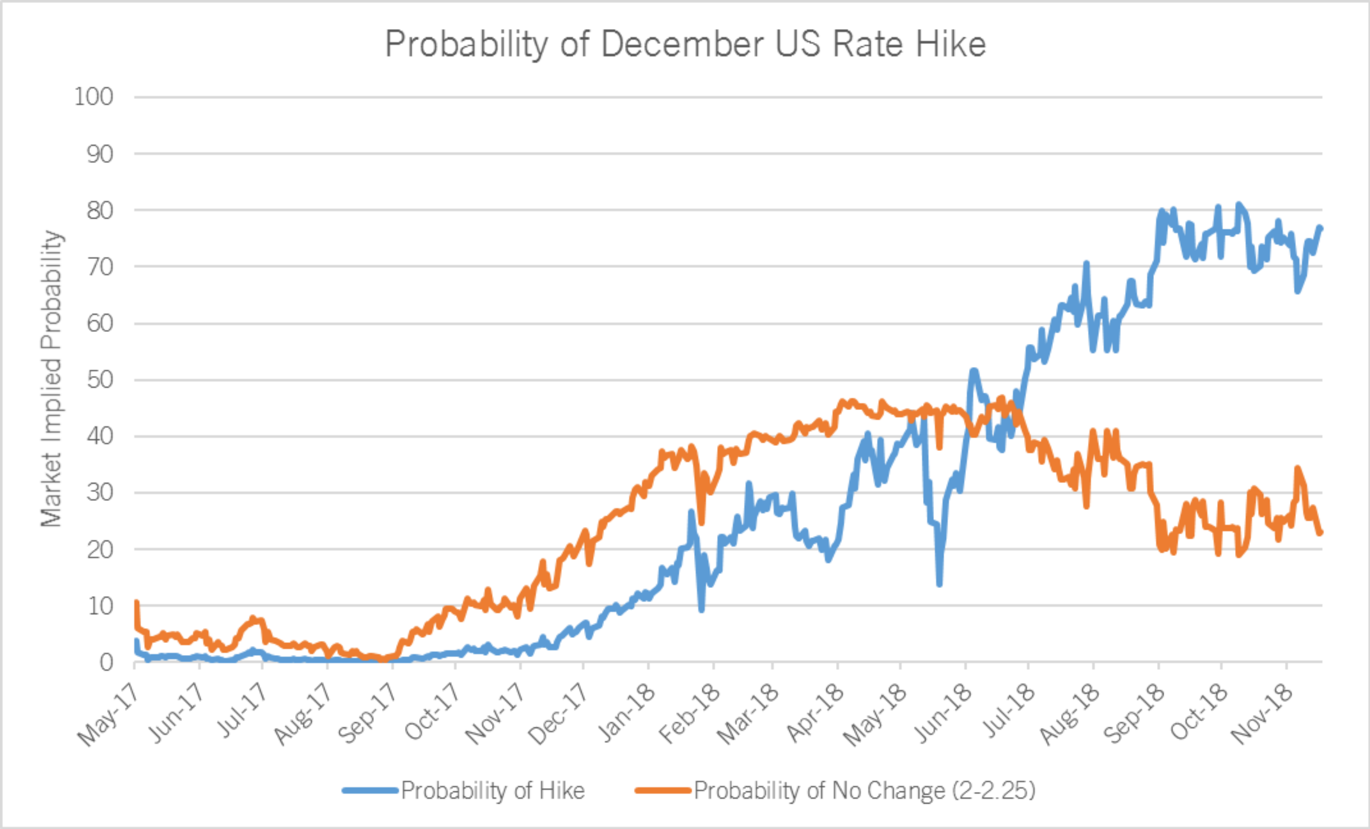
With the S&P 500 hovering above YTD lows, equity valuations have reset to near historical averages. Assuming no P/E multiple expansion or compression, the index is showing a +12% upside if the current 2018 earnings projections are realized. On the converse, if the current 16x forward P/E were to compress below its historic median to 15x, the index would trade -7% lower.

Bloomberg Bottom-Up Earnings Estimates*						11/28/2018 S&P 500 Index Level: 2678
2020	2019	2018	Trailing 12 Mos.	-20% Decline	P/E Multiples	Historical Occurences of P/E multiples
$197	$178	$164	$146	$117		
$1,376	$1,247	$1,146	$1,022	$818	7	
$1,573	$1,425	$1,309	$1,168	$934	8	Various occurences of single-digit trailing 12m P/E in the 1970s and 1980s
$1,769	$1,603	$1,473	$1,314	$1,051	9	
$1,966	$1,781	$1,637	$1,460	$1,168	10	
$2,162	$1,959	$1,800	$1,606	$1,285	11	Low trailing 12m P/E during 2008 - 2009 crisis
$2,359	$2,137	$1,964	$1,752	$1,402	12	Median trailing 12m P/E, 1970 - 1989
$2,555	$2,315	$2,127	$1,898	$1,519	13	
$2,752	$2,493	$2,291	$2,044	$1,635	14	
$2,949	$2,671	$2,455	$2,190	$1,752	15	
$3,145	$2,849	$2,618	$2,336	$1,869	16	**Current Forward P/E**, Median fwd P/E, 1990 - Present
$3,342	$3,027	$2,782	$2,482	$1,986	17	Median trailing 12m P/E, 1955 - Present
$3,538	$3,206	$2,946	$2,628	$2,103	18	**Current T12M P/E**; Median trailing 12m P/E, 1990 - Present
$3,735	$3,384	$3,109	$2,774	$2,219	19	
$3,931	$3,562	$3,273	$2,920	$2,336	20	
$4,128	$3,740	$3,437	$3,066	$2,453	21	
$4,325	$3,918	$3,600	$3,212	$2,570	22	
$4,521	$4,096	$3,764	$3,358	$2,687	23	
$4,718	$4,274	$3,928	$3,504	$2,803	24	
$4,914	$4,452	$4,091	$3,650	$2,920	25	
$5,111	$4,630	$4,255	$3,796	$3,037	26	Median trailing 12m P/E, 1998 - 2001
$5,307	$4,808	$4,419	$3,942	$3,154	27	
$5,504	$4,986	$4,582	$4,088	$3,271	28	
$5,700	$5,164	$4,746	$4,234	$3,388	29	
$5,897	$5,343	$4,910	$4,380	$3,504	30	
$6,094	$5,521	$5,073	$4,526	$3,621	31	Current CAPE

Source: Bloomberg

Expect a December Rate Hike

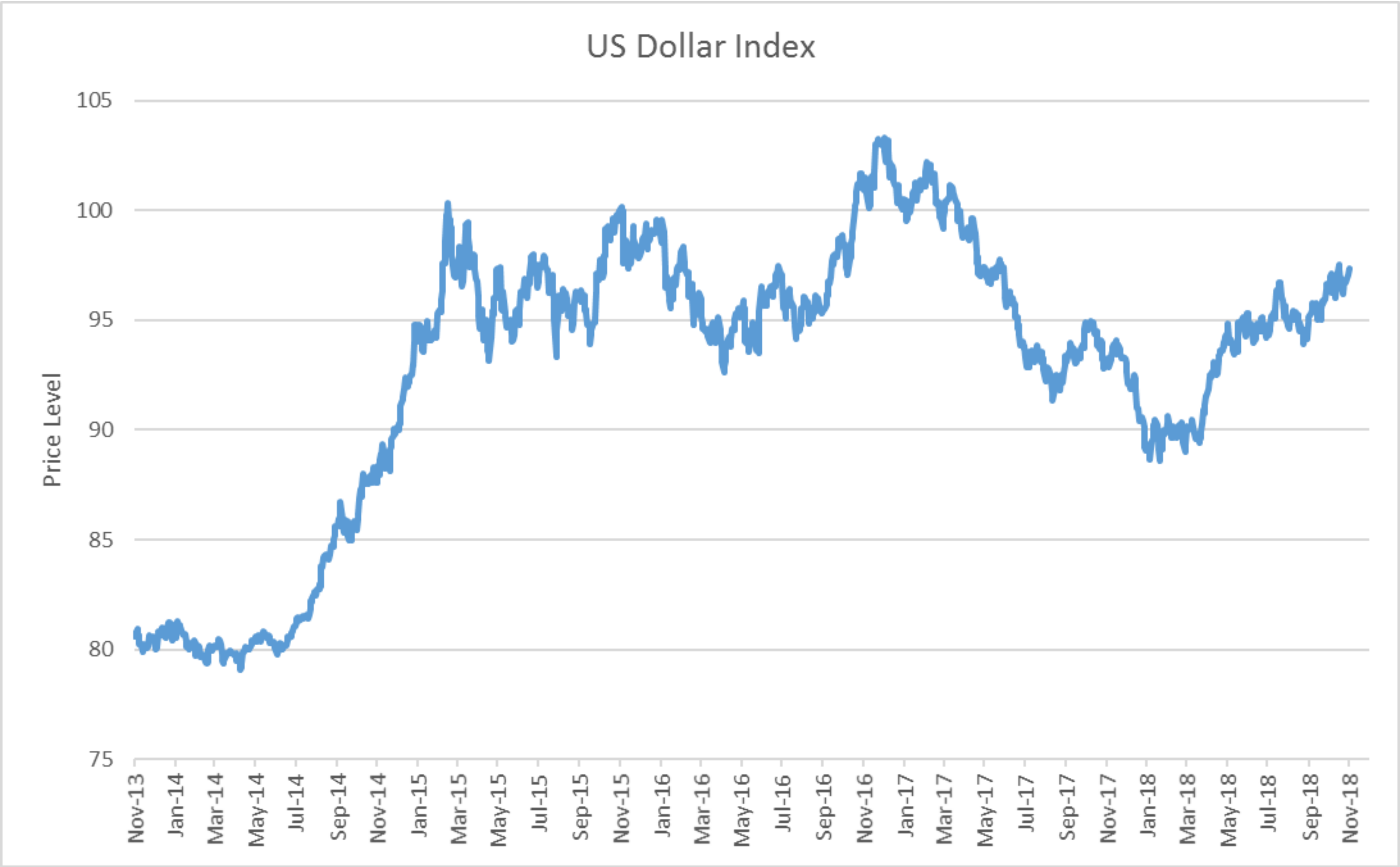
While the market implied probability of a December rate hike is ~80%, the Fed continues to forecast higher future rates than the market is implying through 2019. Recent jitters suggest the market may be misjudging the path of discount rates, and that the Fed could be more hawkish than previously anticipated. This latter point was highlighted in early October when Federal Reserve Chair Powell commented that the Fed Funds rate is "a long way" from neutral. Powell since walked back that statement when on November 28th he said the Fed Funds rate was "just below" neutral. Markets rallied in response. As a reminder, the neutral level of interest rates is the level at which monetary policy is neither accommodative nor restrictive.



Source: Bloomberg

USD Marches Past YTD Highs

The forward path of interest rates has led to a stronger dollar (up more than 7% this year), which in turn has put pressure on foreign equities and debt, most notably in emerging markets. The DXY Index is currently just -6% below its all time high seen in late 2016.



Source: Bloomberg

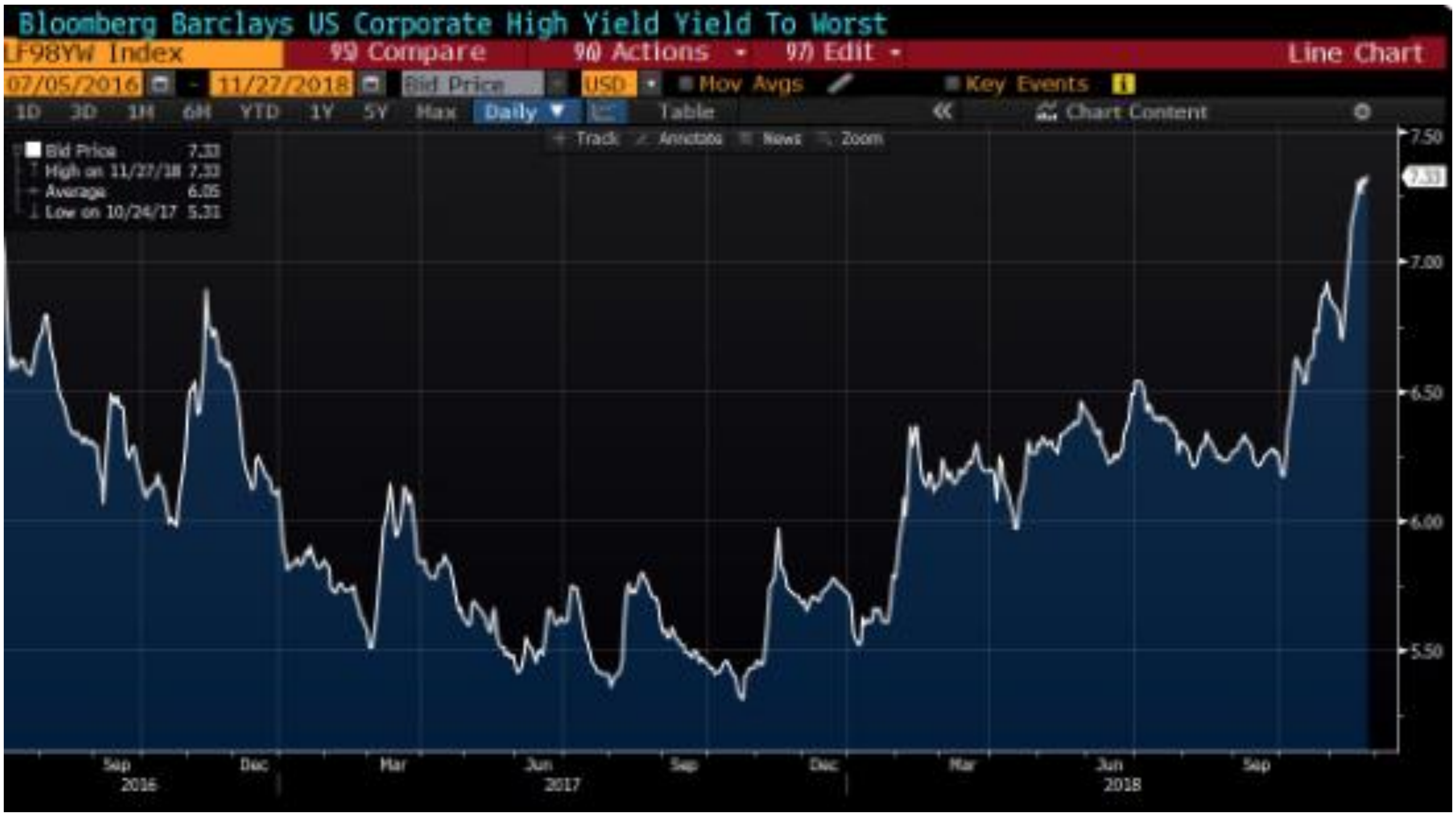
Rising Corporate Debt Concerns

Investors are growing concerned about corporate debt levels, which currently stand at a record high 46% of GDP. The narrative associated with corporate debt becomes even more alarming when considering the primary use of capital has gone to increasing payout ratios through share buy-backs and dividends as opposed to long-term productivity increases through capital expenditures.

Source: BofA Merrill Lynch, WSJ Daily Shot

High Yield Bond Yields Jump

Pressures are starting to materialize in the U.S. high yield bond market, where yields have reached their highest levels in more than two years. Borrowing costs for riskier companies have jumped approximately 1.3% since the end of September, and are now 2.5% higher than the all-time low reached in 2014.



Source: Bloomberg

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