Interim Market Update

May 2018

ATHENA
Capital Advisors
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Summary

- Mid-way through the second quarter, Athena upholds our current positioning of remaining neutral and prudently diversified in all asset classes with a slight overweight to cash. Our view to stay invested in risk assets is influenced by our expectation that the positive global growth narrative will continue on a tactical basis – albeit at a slightly moderated pace.

- Notable themes thus far in 2Q18 include: a robust earnings season, rising US interest rates, higher inflation, a stronger USD, oil at its highest level since 2014, and the resurgence of potential tail risks in select emerging markets and the European Union.

Expansionary Global Economy Continues

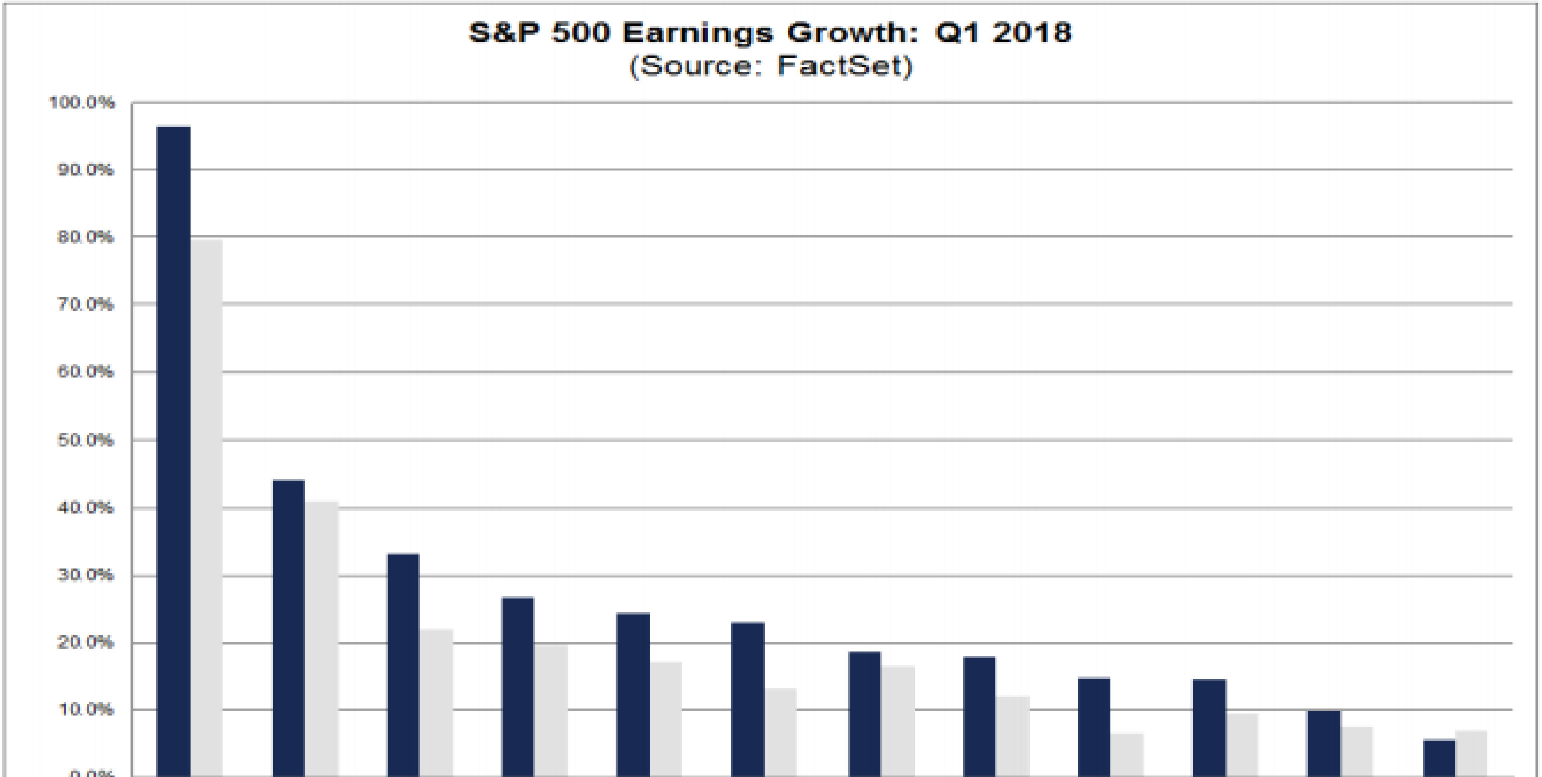
Although global growth remains less robust than the start of the year, the Purchasing Manager Index (PMIs) composite releases for April provide continued support for the synchronous global expansion narrative.

Region	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	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
Global	50	50	51	51	51	52	52	53	53	53	53	53	53	53	53	53	53	53	54	55	54	54	53	54
Developed Markets	50	51	51	51	52	53	53	54	54	54	54	54	54	54	54	54	55	55	56	56	56	56	55	55
Emerging Markets	50	49	50	50	50	51	51	51	51	51	52	51	51	51	51	52	51	51	52	52	52	52	51	51
US	51	51	51	51	52	55	55	54	56	54	53	53	54	54	55	56	55	55	55	54	53	56	54	55
Canada	52	52	52	51	50	51	52	52	54	55	56	56	55	55	56	55	55	54	54	55	56	56	56	56
UK	51	53	49	53	56	54	53	56	55	55	54	58	57	54	55	57	56	56	58	56	55	55	55	54
Eurozone	52	53	52	52	53	54	54	55	55	55	56	57	57	57	57	57	58	59	60	61	60	59	57	56
Germany	52	55	54	54	54	55	54	56	56	57	58	58	60	60	58	59	61	61	63	63	61	61	58	58
France	48	48	49	48	50	52	52	54	54	52	53	55	54	55	55	56	56	56	58	59	58	56	54	54
Italy	52	54	51	50	51	51	52	53	53	55	56	56	55	55	55	56	56	58	58	57	59	57	55	54
Spain	52	52	51	51	52	53	55	55	56	55	54	55	55	55	54	52	54	56	56	56	55	56	55	54
Greece	48	50	49	50	49	49	48	49	47	48	47	48	50	51	51	52	53	52	52	53	55	56	55	53
Ireland	52	53	50	52	51	52	54	56	56	54	54	55	56	56	55	56	55	54	58	59	58	56	54	55
Japan	48	48	49	50	50	51	51	52	53	53	52	53	53	52	52	52	53	53	54	54	55	54	53	54
China	49	49	51	50	50	51	51	52	51	52	51	50	50	50	51	52	51	51	51	52	52	52	51	51
Indonesia	51	52	48	50	51	49	50	49	50	49	51	51	51	50	49	51	50	50	50	49	50	51	51	52
Korea	50	51	50	49	48	48	48	49	49	49	48	49	49	50	49	50	51	50	51	50	51	50	49	48
Taiwan	49	51	51	52	52	53	55	56	56	55	56	54	53	53	54	54	54	54	56	57	57	56	55	55
India	51	52	52	53	52	54	52	50	50	51	53	53	52	51	48	51	51	50	53	55	52	52	51	52
Brazil	42	43	46	46	46	46	46	45	44	47	50	50	52	51	50	51	51	51	54	52	51	53	53	52
Mexico	54	51	51	51	52	52	51	50	51	51	52	51	51	52	51	52	53	49	52	52	53	52	52	52
Russia	50	52	50	51	51	52	54	54	55	53	52	51	52	50	53	52	52	51	52	52	52	50	51	51

Source: Bloomberg, ISM

S&P 500 Posts Highest EPS Growth Since 2010

Per FactSet, the blended S&P 500 earnings growth rate for 1Q18 was +24.5% which marks the highest earnings growth since 3Q10. All eleven sectors reported positive year-over-year EPS growth, with the Energy, Materials, Information Technology, and the Financial sectors all posting double-digit increases. As mentioned in previous updates, the Energy sector is a positive outlier given unusually low earnings from the prior year – which have subsequently rebounded as the price of oil is trading at its highest level since November 2014.



	Energy	Materials	Info. Technology	Financials	S&P 500	Industrials	Telecom Services	Utilities	Consumer Disc.	Health Care	Consumer Staples	Real Estate
Today	96.5%	44.1%	33.2%	26.8%	24.5%	23.0%	18.7%	18.0%	14.9%	14.6%	9.8%	5.5%
31-Mar	79.5%	41.1%	22.0%	19.7%	17.1%	13.3%	16.6%	12.0%	6.6%	9.6%	7.6%	6.9%

Source: FactSet

Strong Earnings Leads to Multiple Compression

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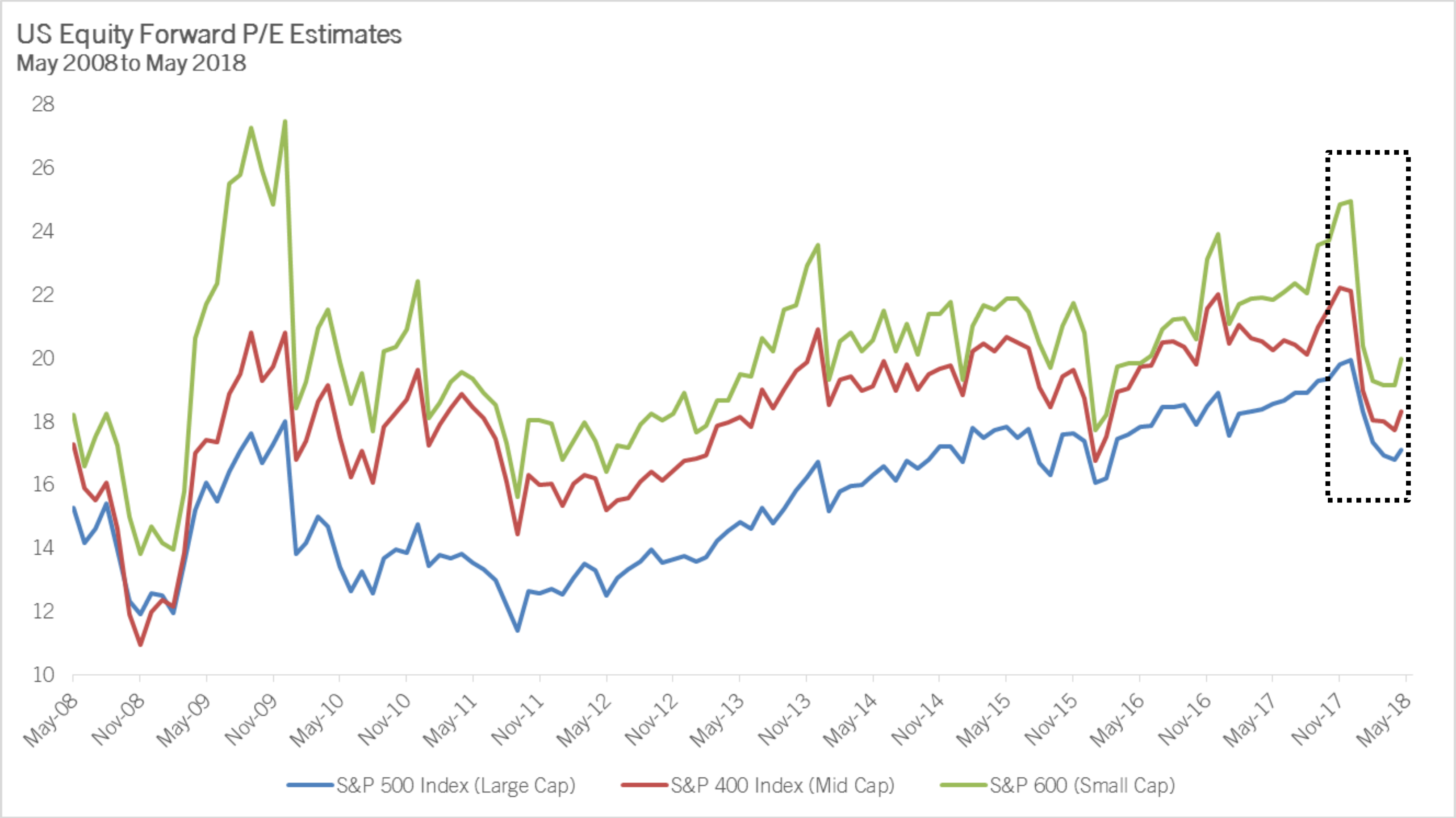
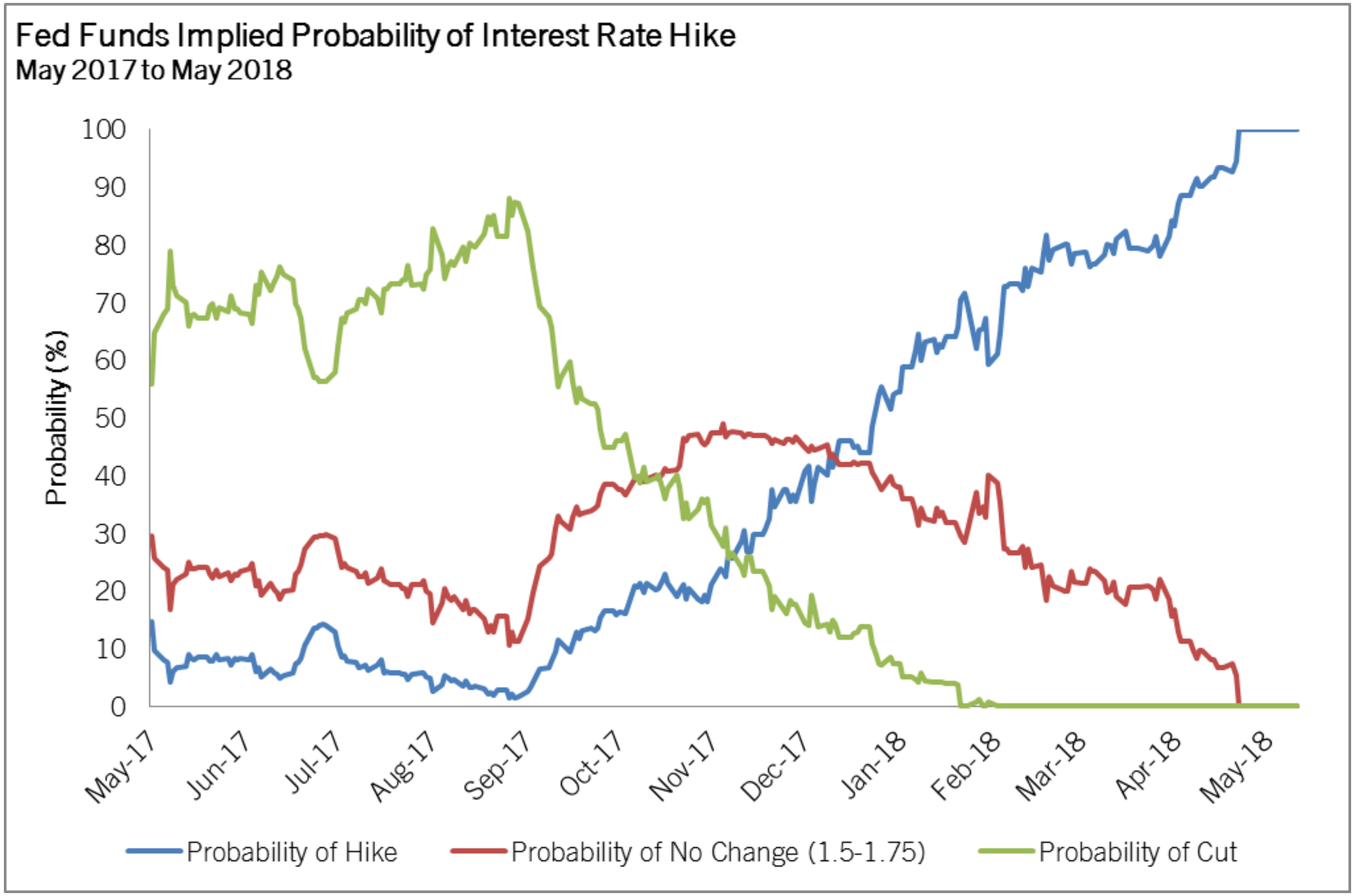
Given the strong 1Q18 earnings season and a relatively sideways moving market, forward price-to-earnings (P/E) multiples have declined sharply across the US market capitalization spectrum. With this recent drop, multiples have moved closer to longer-term averages – which is supportive of Athena's view that US equities trade within a range of fair value.



Source: Bloomberg

June Rate Hike Probability at 100%

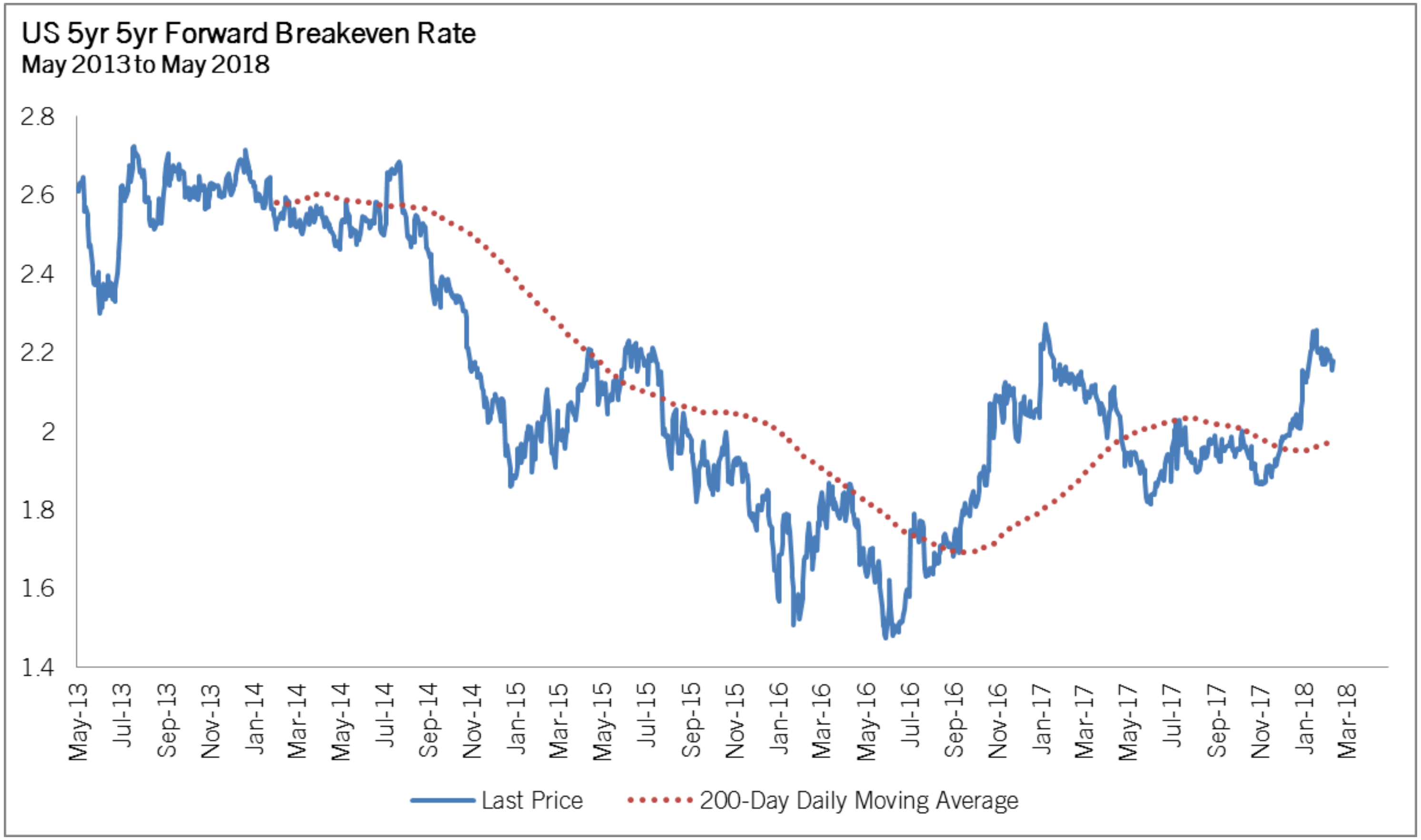
According to the futures market, investors are forecasting a 100% probability of a quarter-point hike in the federal funds rate at the upcoming Federal Open Market Committee (FOMC) meeting on June 12th. This consensus positioning was supported by the Fed's statement released on May 2nd, where they acknowledged inflation has approached their stated 2% target, and thus implied a forward march along the path to interest rate normalization.



Source: Bloomberg

Inflation On the Rise

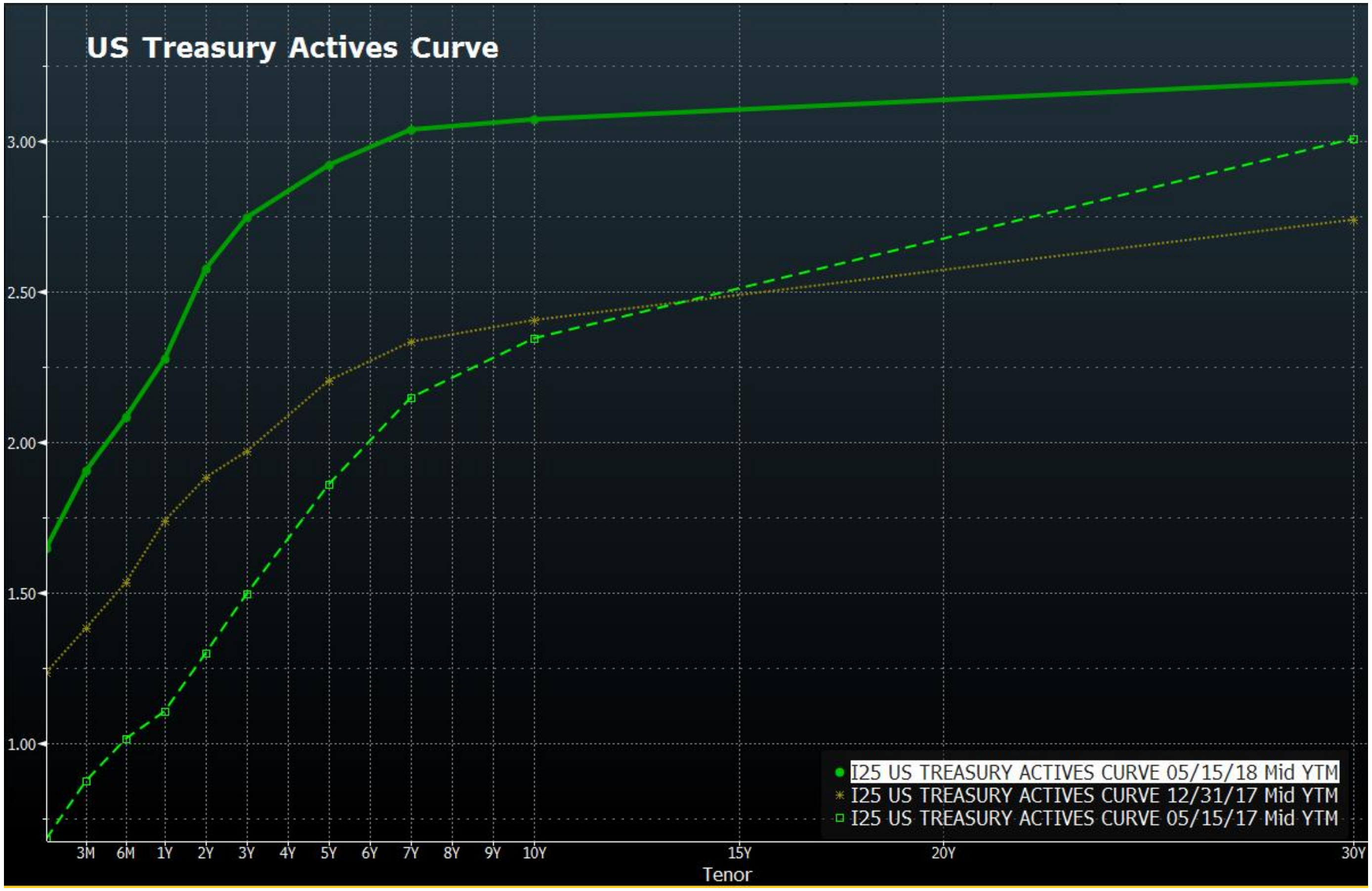
The headline US Consumer Price Index (CPI) number for the month of April came in at 2.5% – the highest rate since February 2017. This report is consistent with the recent rise in breakeven inflation rates (the difference between Treasuries and TIPS) which hit their highest levels in April since the tail end of the 2016/17 "Trump reflation trade".



Source: Bloomberg

Short End of the Curve Heads Higher

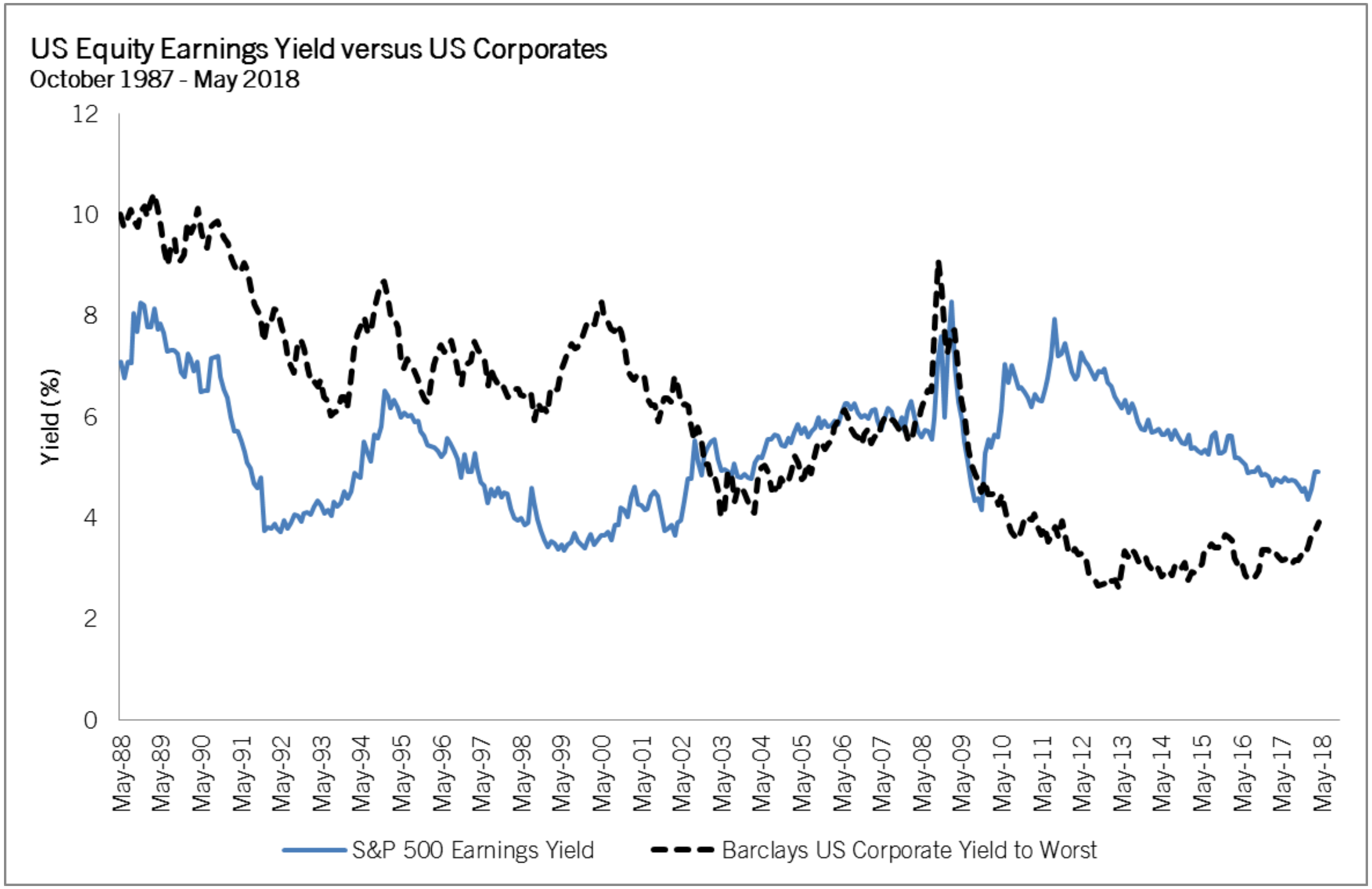
The 2-year Treasury yield stood at 2.56% on May 22nd – a 30bp rate increase thus far in 2Q18 and the highest level since 2008. Considering the current flatness of the yield curve, enhanced cash strategies are becoming increasingly attractive but remain subject to the tradeoff of achieving the highest yield while trying to minimize duration exposure and maximize liquidity.



Source: Bloomberg

Tightening Spread Between Equities and Bonds

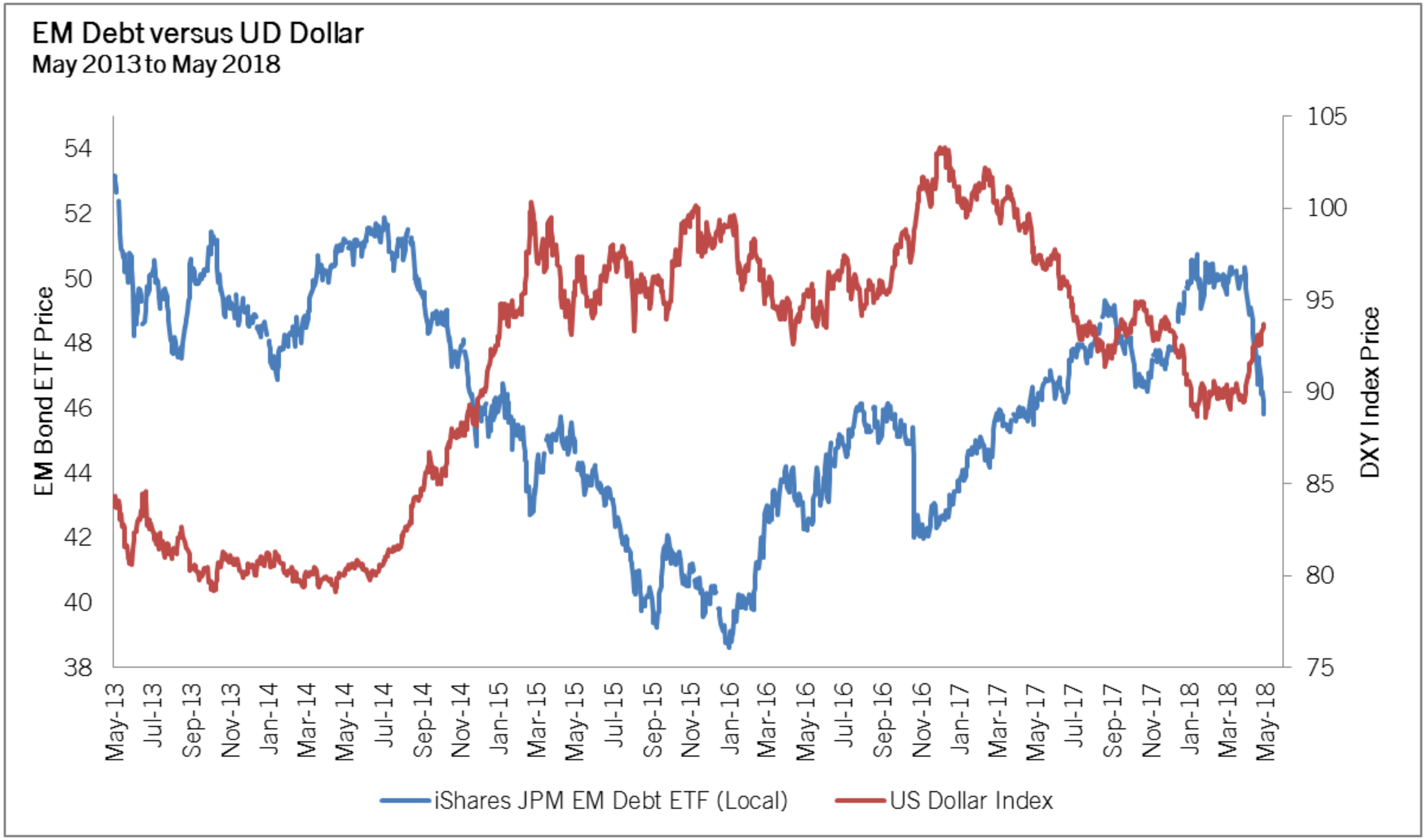
The spread between the S&P 500's trailing twelve month earnings yield (inverse of the P/E ratio) and the US Corporate Investment Grade Yield to Worst is at its tightest level since the US Federal Reserve's initial Quantitative Easing program. While accommodative monetary policy has been unequivocally beneficial for stocks – as interest rate rise and the relative value between equities and bonds compress, investors have begun to increasingly ask the question, "to what effect will the impact of restrictive monetary policy have on equity markets?".



Source: Bloomberg

USD Strength Puts Pressure on EM Debt

Rising yields have put a bid into the US carry trade which has led to a stronger USD (+4.0% in 2Q18 as of May 22nd). As historical precedent would suggest, challenges have started to brew in emerging debt markets – with the JP Morgan Emerging Market Bond Index down -5.9% for the year.

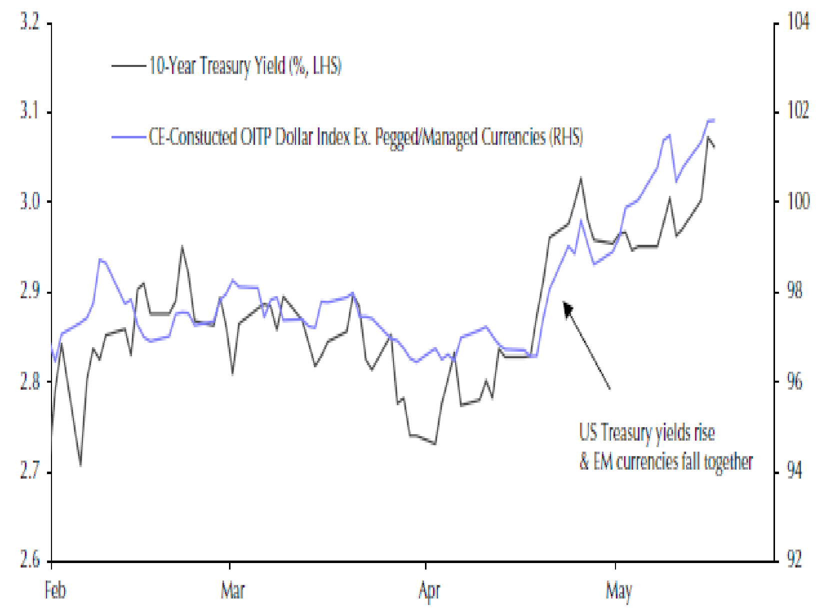


Source: Bloomberg

Time to Trim Emerging Markets Equities?

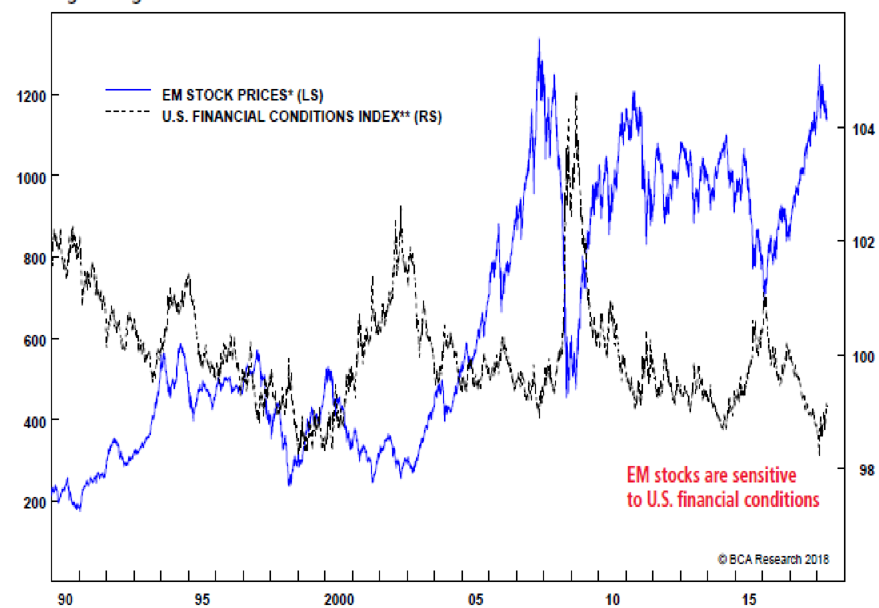
The MSCI Emerging Markets Index is flat on the year through mid-May, but is down -6.4% over the trailing three months. Athena recommends staying Neutral to EM equity targets, but paring overweight positioning that may have occurred due to EM's strong performance in 2017 (MSCI EM +37%). We remain positive on the long-term outlook for EM equities and would look to incrementally add on material weakness – but we are committed to being patient until the currency and interest rate headwinds abate.

Chart: US 10-Year Treasury Yield



Sources: Bloomberg, Thomson Reuters, CE

Tightening U.S. Financial Conditions Do Not Bode Well For EM Stocks

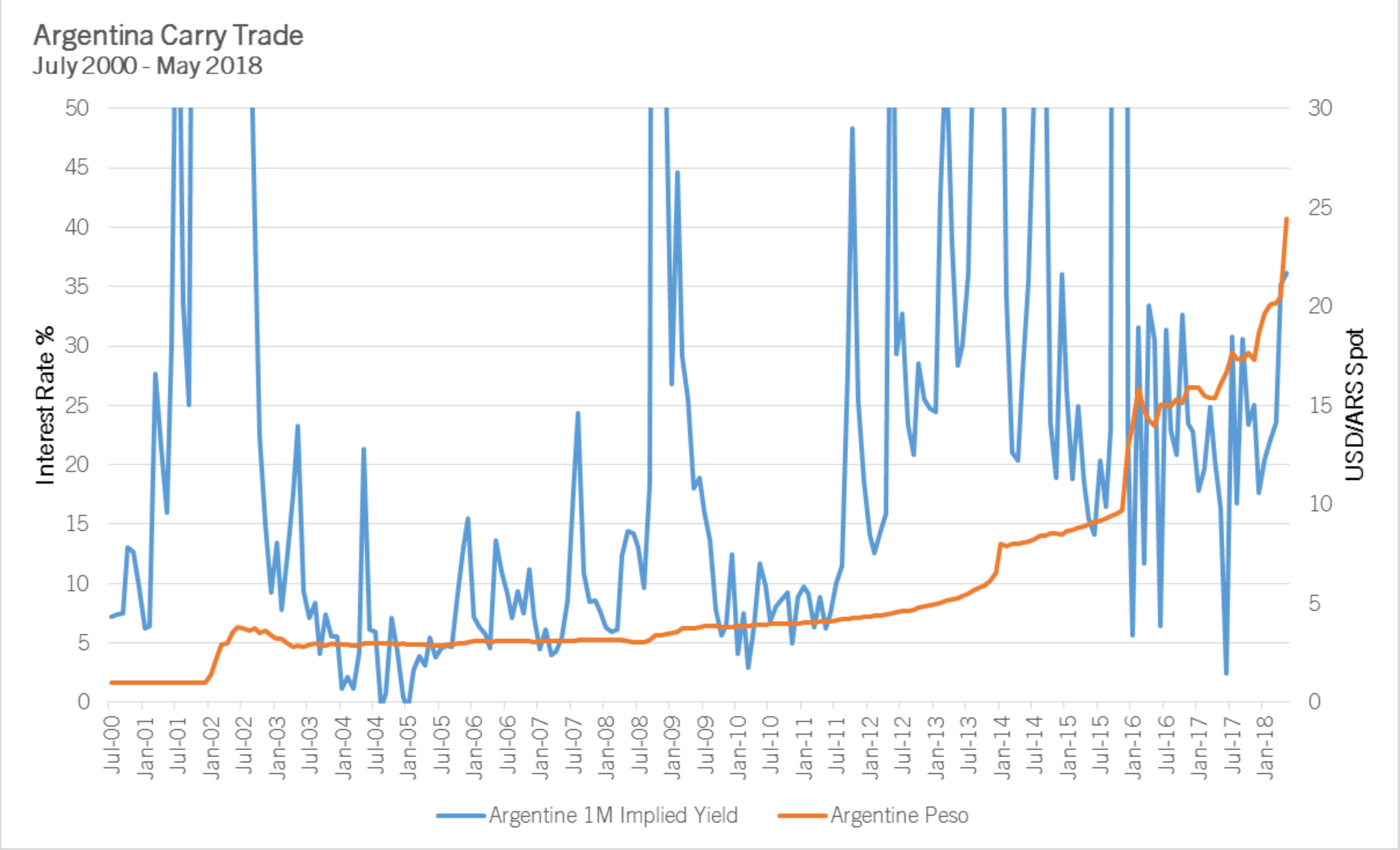


* IN U.S. DOLLARS. SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).
** SOURCE: GOLDMAN SACHS (VIA BLOOMBERG L.P.)

Source: Capital Economics (left), BCA (right)

Does the Argentina Sell-Off

Athena has spent the past few weeks assessing the opportunity set in Argentina as the country is experiencing a historically weak peso, recently set short-term benchmark interest rates >40%, and has seen the MSCI Argentina Index trade approximately –30% off of its January highs. From our initial analysis and conversations with managers that have Argentine exposure across asset classes – Athena does not recommend any client action at this time given the lack of an identifiably compelling risk-reward.



Source: Bloomberg

Italian Political Situation a Contagion Risk?

As evidenced by the negative price action in Italian risk assets, investors have developed caution after two populist parties (Five Star Movement and The League) announced plans to form a coalition government. The headlines associated with these developments are reminiscent of prior European political crises – as both parties reject EU austerity and have publically announced a desire to renegotiate the country's previous debt arrangements. Over the past two weeks, Italian yields have traded higher, stocks have traded lower, and the country's credit default swaps (CDS) have nearly doubled – though they remain materially lower than other periods of political uncertainty (chart below).

Source: Bloomberg, BBC

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