

Athena Capital Advisors

Interim Market Update

August 2018

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Summary

- At the halfway point of the third 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 3Q18 include: strong US economic growth, continued tailwinds from fiscal stimulus, a flat yield curve, ongoing concerns over a US-China trade war, and weakness across emerging market assets. With the EM equity selloff now considered a “bear market,” Athena is recommending rebalancing for clients with appropriately long horizons and a commitment to the asset class.

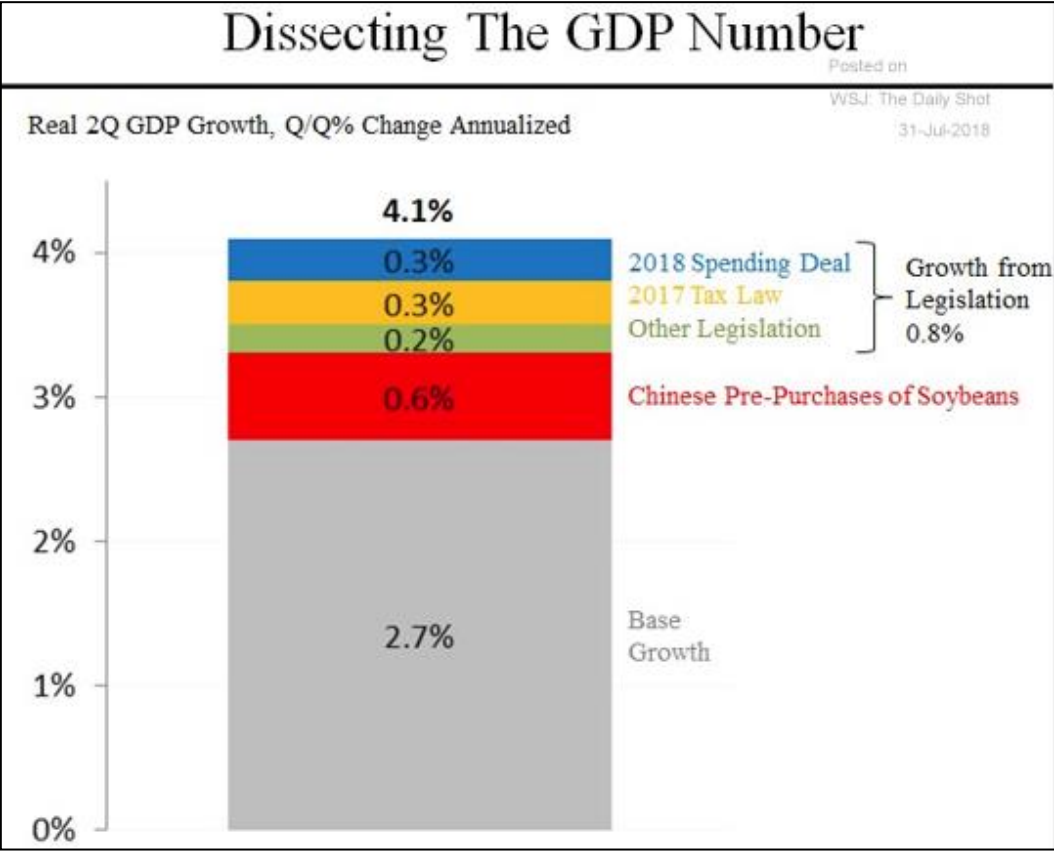
US Growth Decouples from the World

Global growth has become less synchronized in 2018 following broad-based strength last year. As seen below, a majority of the world's Purchasing Manager Index (PMI) surveys are lower than they were in January 2018, with the US being one of the few (and strongest) exceptions to the upside. This strength has been primarily attributed to a boost in late stage fiscal stimulus, which has materialized on a macro level through resilient GDP growth, and on a micro level through another quarter of impressive company earnings.

Region	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	May-18	Jun-18	Jul-18	Change Since Jan 18
Global	51	51	52	52	53	53	53	53	53	53	53	53	53	53	53	54	55	54	54	53	54	53	53	53	-1.7
Developed Markets	51	52	53	53	54	54	54	54	54	54	54	54	55	55	55	56	56	56	56	55	55	55	54	54	-2.2
Emerging Markets	50	50	51	51	51	51	51	52	51	51	51	51	52	51	51	52	52	52	52	51	51	51	51	51	-0.9
US	51	52	55	55	54	56	54	53	53	54	54	55	56	55	55	55	54	53	56	54	55	57	57	56	2.7
Canada	51	50	51	52	52	54	55	56	56	55	55	56	55	55	54	54	55	56	56	56	56	56	57	57	1.0
UK	53	56	54	53	56	55	55	54	58	57	54	56	57	56	56	58	56	55	55	55	54	54	54	54	-1.0
Eurozone	52	53	54	54	55	55	55	56	57	57	57	57	57	58	59	60	61	60	59	57	56	56	55	55	-4.5
Germany	54	54	55	54	56	56	57	58	58	60	60	58	59	61	61	63	63	61	61	58	58	57	56	57	-4.2
France	48	50	52	52	54	54	52	53	55	54	55	55	56	56	56	58	59	58	56	54	54	54	53	53	-5.1
Italy	50	51	51	52	53	53	55	56	56	55	55	55	56	56	58	58	57	59	57	55	54	53	53	52	-7.5
Spain	51	52	53	55	55	56	55	54	55	55	55	54	52	54	56	56	56	55	56	55	54	53	53	53	-2.3
Greece	50	49	49	48	49	47	48	47	48	50	51	51	52	53	52	52	53	55	56	55	53	54	54	54	-1.7
Ireland	52	51	52	54	56	56	54	54	55	56	56	55	56	55	54	58	59	58	56	54	55	55	57	56	-1.3
Japan	50	50	51	51	52	53	53	52	53	53	52	52	52	53	53	54	54	55	54	53	54	53	53	52	-2.5
China	50	50	51	51	52	51	52	51	50	50	50	51	52	51	51	51	52	52	52	51	51	51	51	51	-0.7
Indonesia	50	51	49	50	49	50	49	51	51	51	50	49	51	50	50	50	49	50	51	51	52	52	50	51	0.6
Korea	49	48	48	48	49	49	49	48	49	49	50	49	50	51	50	51	50	51	50	49	48	49	50	48	-2.4
Taiwan	52	52	53	55	56	56	55	56	54	53	53	54	54	54	54	56	57	57	56	55	55	53	55	53	-3.8
India	53	52	54	52	50	50	51	53	53	52	51	48	51	51	50	53	55	52	52	51	52	51	53	52	-0.1
Brazil	46	46	46	46	45	44	47	50	50	52	51	50	51	51	51	54	52	51	53	53	52	51	50	51	-0.7
Mexico	51	52	52	51	50	51	51	52	51	51	52	51	52	53	49	52	52	53	52	52	52	51	52	52	-0.5
Russia	51	51	52	54	54	55	53	52	51	52	50	53	52	52	51	52	52	52	50	51	51	50	50	48	-4.0

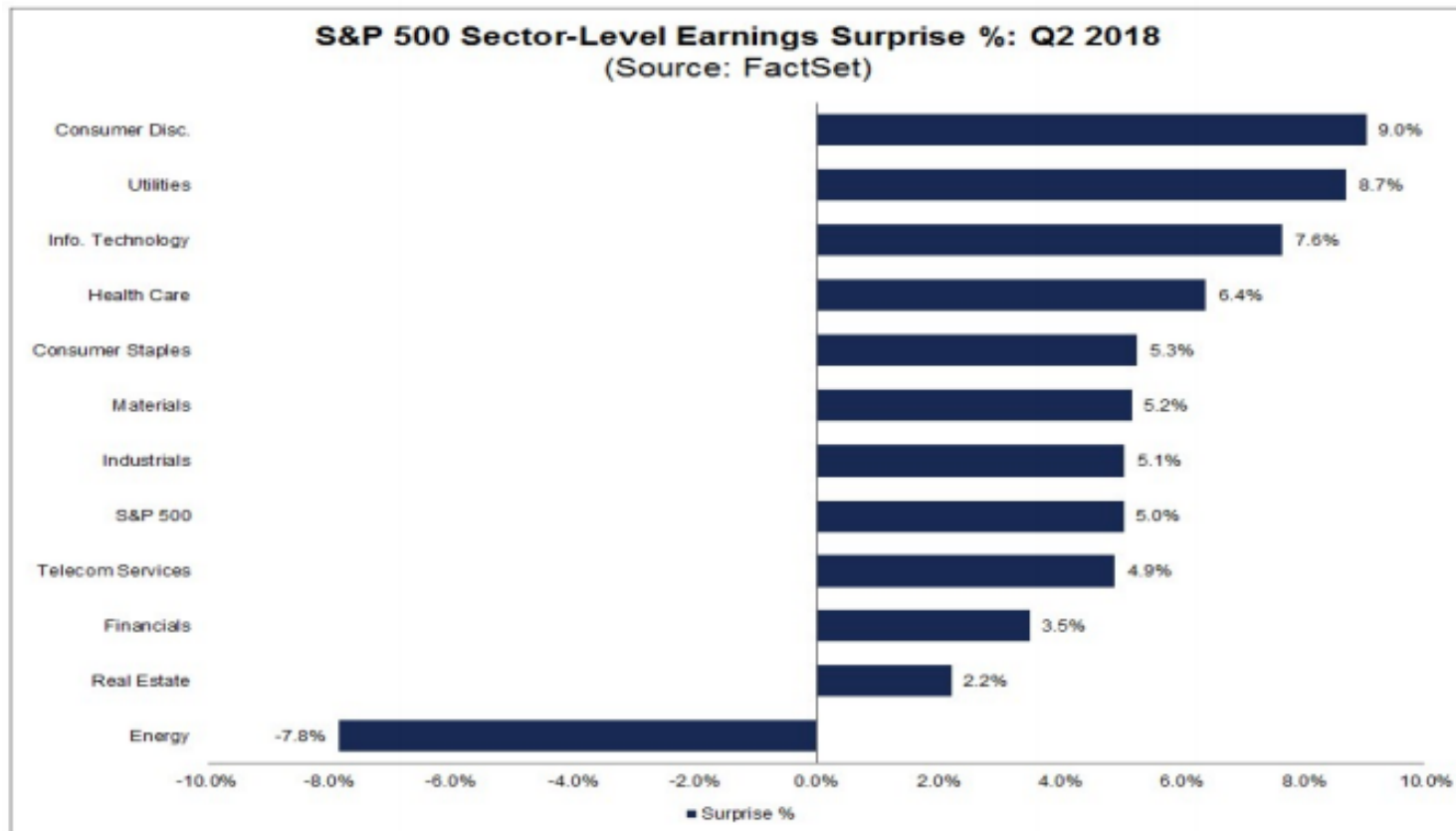
Breaking Down the 2Q GDP Report

The headline 2Q18 US GDP number came in at +4.1%, making it the strongest quarter for US growth since 2014. Dissecting the GDP growth number shows continued tailwinds from fiscal stimulus, in addition to a surge in soybean exports to China. The latter is viewed as a one-off event which was intended to beat the imposition of the tariffs that began in early July. Economists do not expect this contribution to be repeated, and lower soybean exports in future quarters may prove a drag on GDP.



Another Strong Quarter of Earnings

With over 90% of companies reporting, the blended S&P 500 earnings growth rate of +24.6% marks the second highest earnings growth since 3Q10 (+34.1%). One of the most prominent themes this quarter has been the amount of earnings beats across sectors as 79% have reported actual EPS above the mean EPS estimate, which is the highest percentage since FactSet began tracking this data in 3Q08.



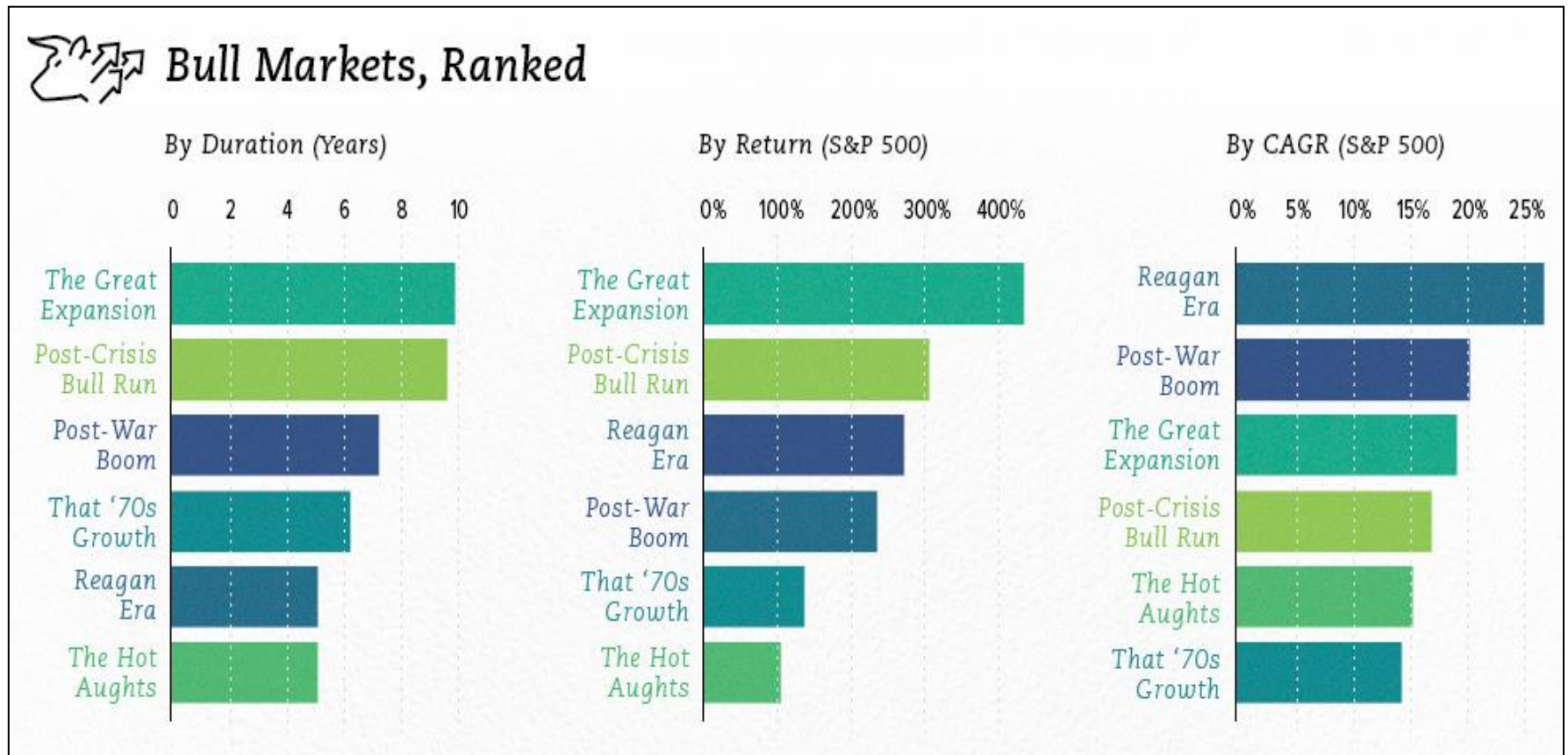
S&P 500 Price Level Scenarios

Assuming no P/E multiple expansion or compression, the index is showing a +21% upside if the current 2020 earnings projections are realized. On the converse, if the current 18x forward P/E were to compress to its historical average of 16x in 2018, the index would trade -11% lower.

Bloomberg Bottom-Up Earnings Estimates*						8/16/2018 S&P 500 Index Level: 2835
2020	2019	2018	Trailing 12 Mos.	-20% Decline	P/E Multiples	Historical Medians/Occurrences of P/E multiples
\$195	\$177	\$160	\$134	\$107		
\$1,367	\$1,238	\$1,122	\$936	\$749	7	
\$1,562	\$1,415	\$1,282	\$1,069	\$856	8	Various occurrences of single-digit trailing 12m P/E in the 1970s and 1980s
\$1,758	\$1,592	\$1,443	\$1,203	\$962	9	
\$1,953	\$1,769	\$1,603	\$1,337	\$1,069	10	
\$2,148	\$1,946	\$1,763	\$1,470	\$1,176	11	Low trailing 12m P/E during 2008 - 2009 crisis
\$2,344	\$2,123	\$1,924	\$1,604	\$1,283	12	Median trailing 12m P/E, 1970 - 1989
\$2,539	\$2,300	\$2,084	\$1,738	\$1,390	13	
\$2,734	\$2,476	\$2,244	\$1,871	\$1,497	14	
\$2,930	\$2,653	\$2,404	\$2,005	\$1,604	15	
\$3,125	\$2,830	\$2,565	\$2,139	\$1,711	16	Median CAPE, 1920 - Present; Median fwd P/E, 1990 - Present
\$3,320	\$3,007	\$2,725	\$2,272	\$1,818	17	Median trailing 12m P/E, 1955 - Present
\$3,516	\$3,184	\$2,885	\$2,406	\$1,925	18	Current Forward P/E, Median trailing 12m P/E, 1990 - Present
\$3,711	\$3,361	\$3,046	\$2,540	\$2,032	19	
\$3,906	\$3,538	\$3,206	\$2,673	\$2,139	20	
\$4,102	\$3,715	\$3,366	\$2,807	\$2,246	21	Current T12M P/E
\$4,297	\$3,892	\$3,527	\$2,941	\$2,353	22	
\$4,492	\$4,068	\$3,687	\$3,074	\$2,460	23	
\$4,687	\$4,245	\$3,847	\$3,208	\$2,567	24	
\$4,883	\$4,422	\$4,007	\$3,342	\$2,673	25	
\$5,078	\$4,599	\$4,168	\$3,476	\$2,780	26	Median trailing 12m P/E, 1998 - 2001
\$5,273	\$4,776	\$4,328	\$3,609	\$2,887	27	
\$5,469	\$4,953	\$4,488	\$3,743	\$2,994	28	
\$5,664	\$5,130	\$4,649	\$3,877	\$3,101	29	
\$5,859	\$5,307	\$4,809	\$4,010	\$3,208	30	
\$6,055	\$5,483	\$4,969	\$4,144	\$3,315	31	
\$6,250	\$5,660	\$5,130	\$4,278	\$3,422	32	Current CAPE
Nearest Price Level at Current Trailing Multiple						
Nearest Price Level at Current Forward Multiple						

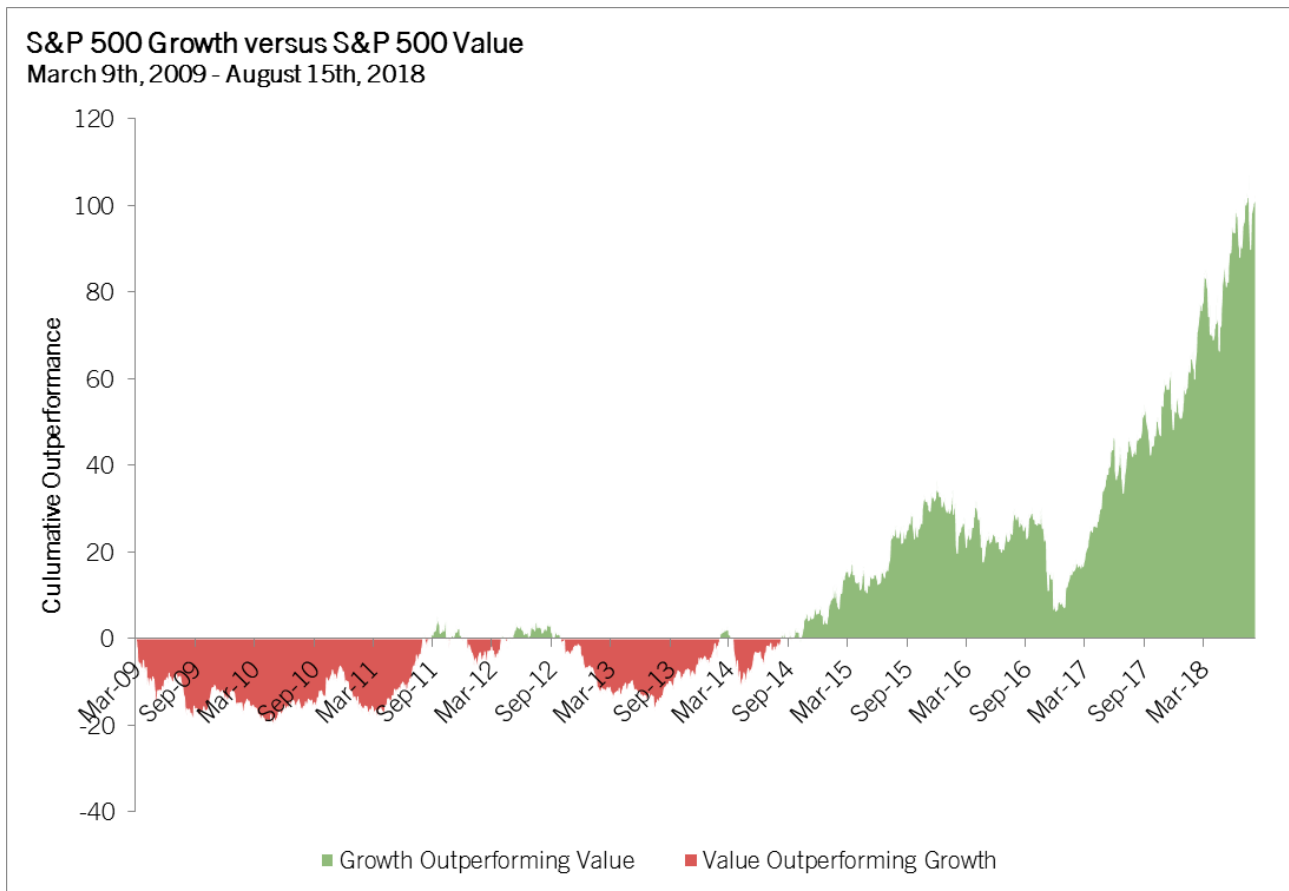
Longest Bull Market in US History

The current S&P 500 bull market turns 3,453 days old on August 22nd, officially making it one day older than 'The Great Expansion' which ran from October 1990 and ended with the bursting of the tech bubble in March 2000. From March 9th, 2009 through August 17th, the S&P has returned +413% cumulative (including dividend).



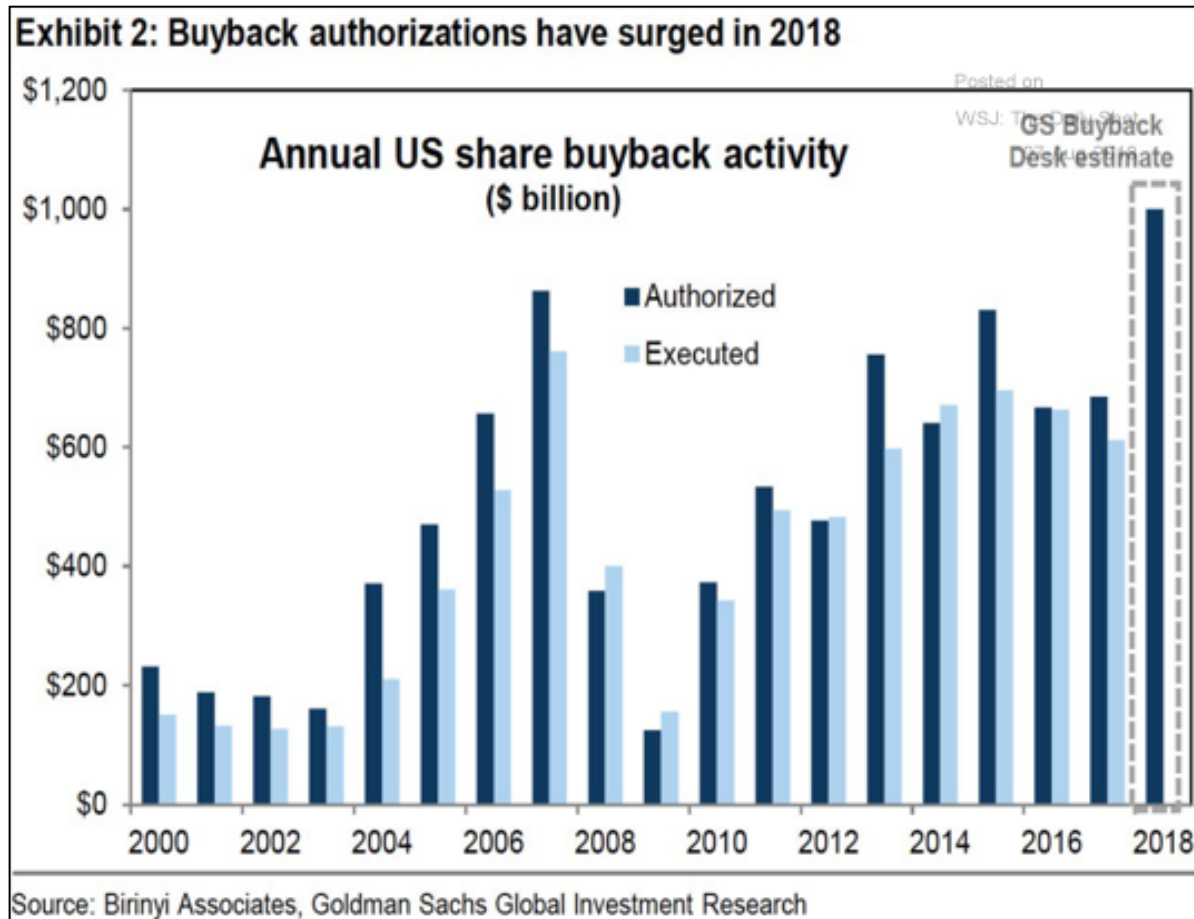
Growth Outperforms Again and Gets More Expensive

Growth stocks outperformed Value stocks for a rare sixth consecutive quarter in 2Q18, adding to the tremendous level of outperformance seen since 2014. The S&P 500 Growth Index ended the quarter with a valuation of 19.1x forward earnings estimates, a 5.5x premium to the S&P 500 Value Index at 13.6x. Per Parnassus, an Athena approved equity manager, this valuation gap is nearly the widest it's been in the past 10 years, and more than double its 10-year average of 2.5x.



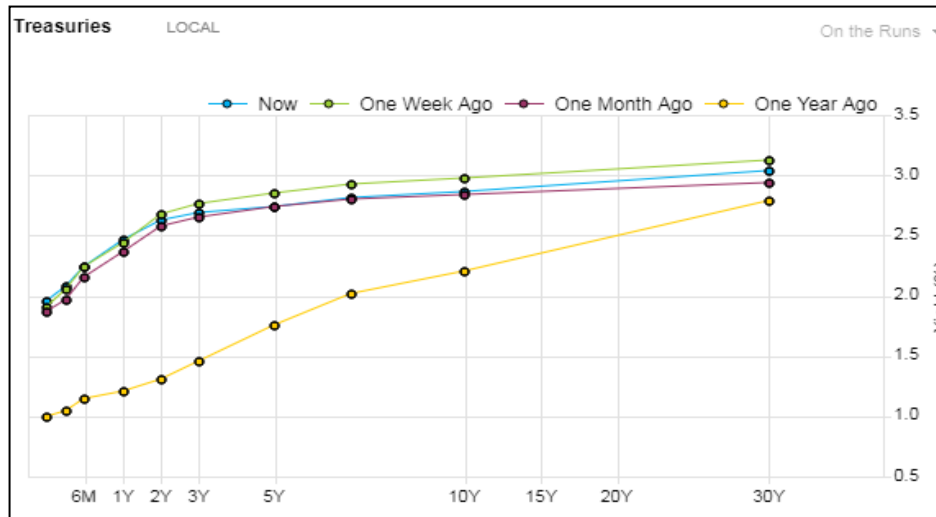
Share Buybacks a Continued Tailwind for Stocks

Aided by corporate dollar repatriation tax cuts and strong cash flow, Goldman Sachs estimates that S&P 500 companies will likely authorize a record \$1 Trillion in share repurchases in 2018, representing a nearly +50% increase on a year-over-year basis and may represent the highest level since 2007.



Treasury Curve Flattest Since 2007

As of August 20th, the spread between the US 10-year (2.82%) and the US 2-year (2.59%) was 23bps – its narrowest since 2007. As highlighted by MarketWatch, “A narrowing spread between yields for short-dated bonds and their long-dated peers tends to signal investors' fears over further central bank tightening or weaker growth prospects. Economists worry that a negative spread, or an inverted curve, would be a prelude to a recession, even though the timing of an economic slowdown after the bond market signal is triggered remains uncertain”. As the bottom chart shows, historically there has been an average of 21 months between yield curve inversion and recession.

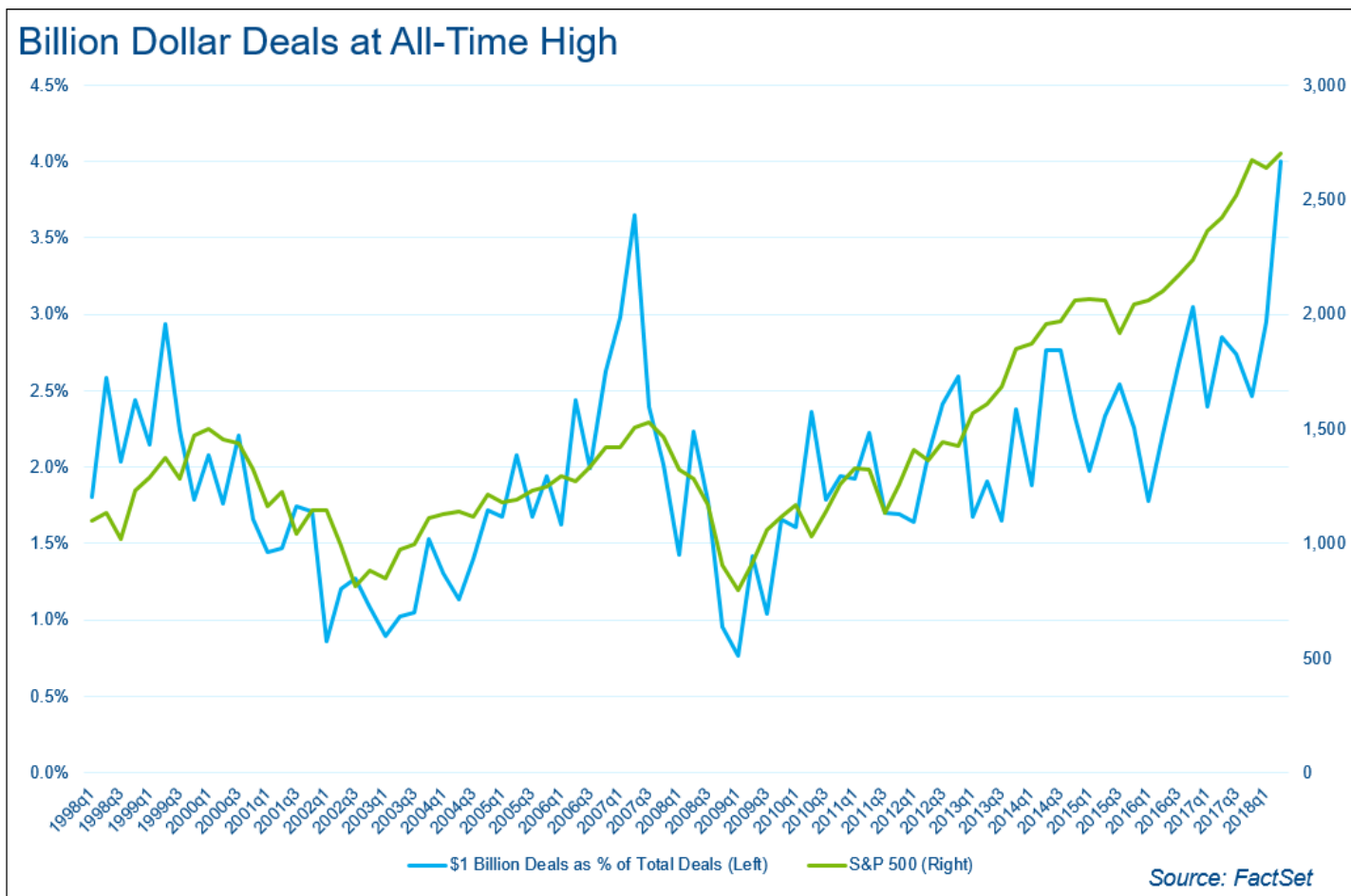


2-10 Year Yield Curve Inverts	Recession Starts	Months From Inversion to Recession	S&P 500 Price Return From Inversion to Recession
08/18/78	02/01/80	17.7	9.9%
09/12/80	08/01/81	10.8	4.3%
12/13/88	08/01/90	19.9	28.5%
05/26/98	04/01/01	34.7	6.1%
01/31/06	01/01/08	23.3	14.7%
	Average	21.3	12.7%
	Median	19.9	9.9%

Source: LPL Research, FactSet, NBER, 07/05/18

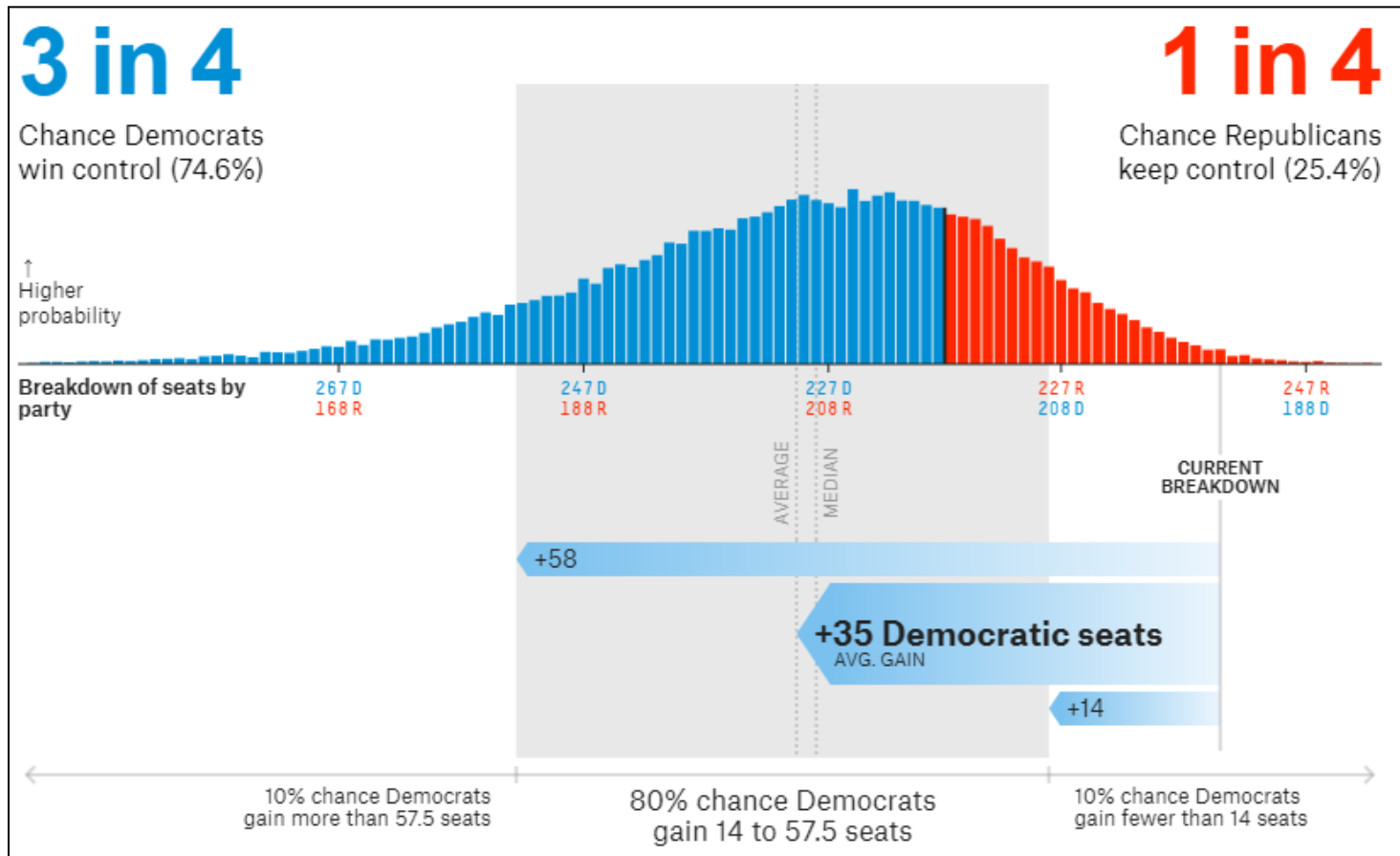
Large M&A Deals at All-Time High

According to FactSet, transactions valued over \$1 billion are at an all-time high both on an absolute basis and as a percentage of overall M&A deals. The first half of 2018 saw the second-highest level of deals valued over \$1 billion to start the year with 200 deals; the highest level was attained in the first half of 2007 with 210 deals.



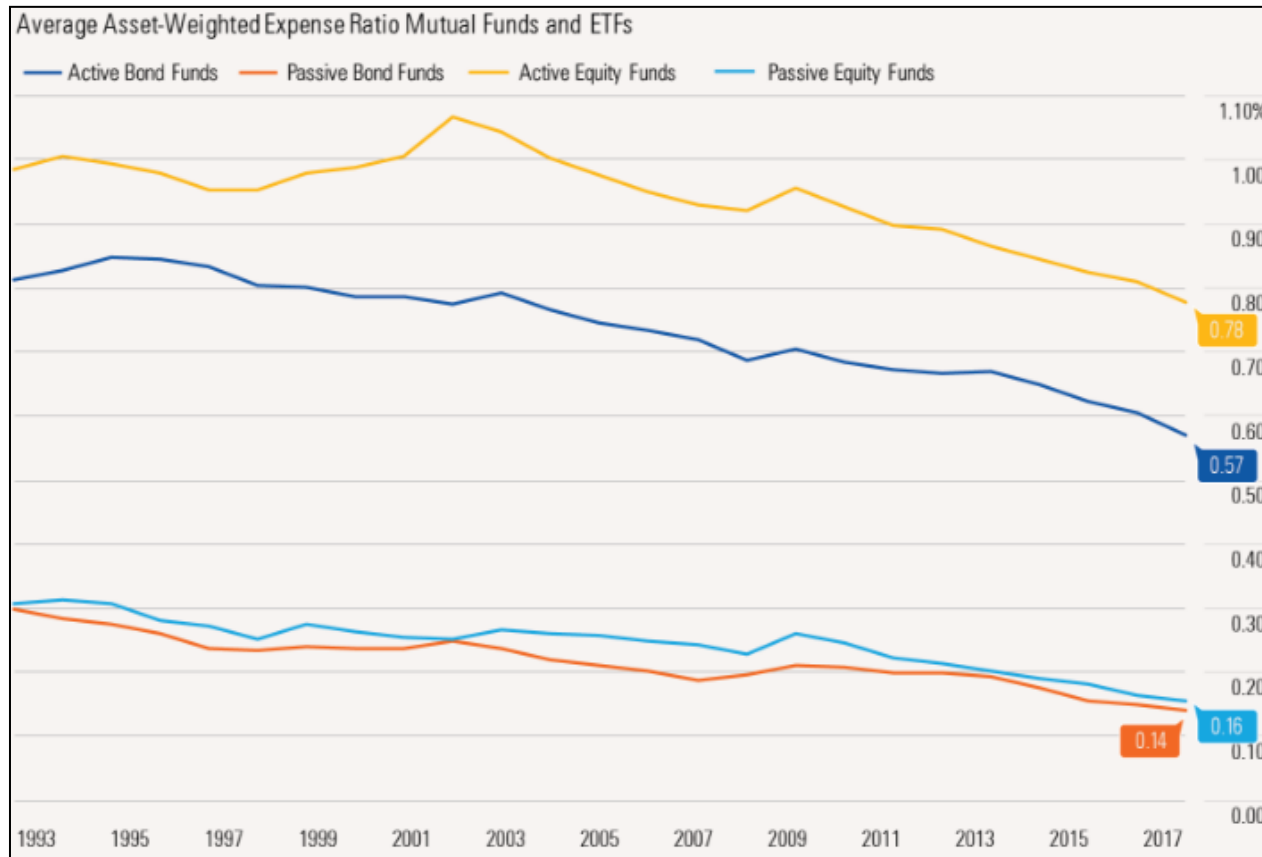
Approaching US Mid-term Elections

According to race ratings conducted by the Cook Political Report, a nonpartisan election handicapper, there are currently 62 highly competitive House seats in the upcoming November mid-term elections. The political forecaster Five Thirty Eight currently projects (as of August 16th) Democrats to flip the minimum 23 Republican-held seats needed to retake a House majority.



Fidelity Launches Zero Fee Products

In August, Fidelity announced it was reducing fees on 21 mutual fund products, and launching a pair of zero-fee index mutual funds, the Total US Market Index and Total International Index. As seen in the chart below, the theme of fund companies lowering fees is nothing new, but the “zero fee” headline has sparked an industry-wide discussion on the potential implications for both passive and active managers.



Pressure on the Chinese Yuan

The Chinese yuan has weakened considerably since the US-China trade dispute developed into a primary concern for the global economy. The USD/CNY cross is currently at the highs seen in late 2016, and remains slightly below 7, which many cite as a key technical and psychological level for possible further depreciation.



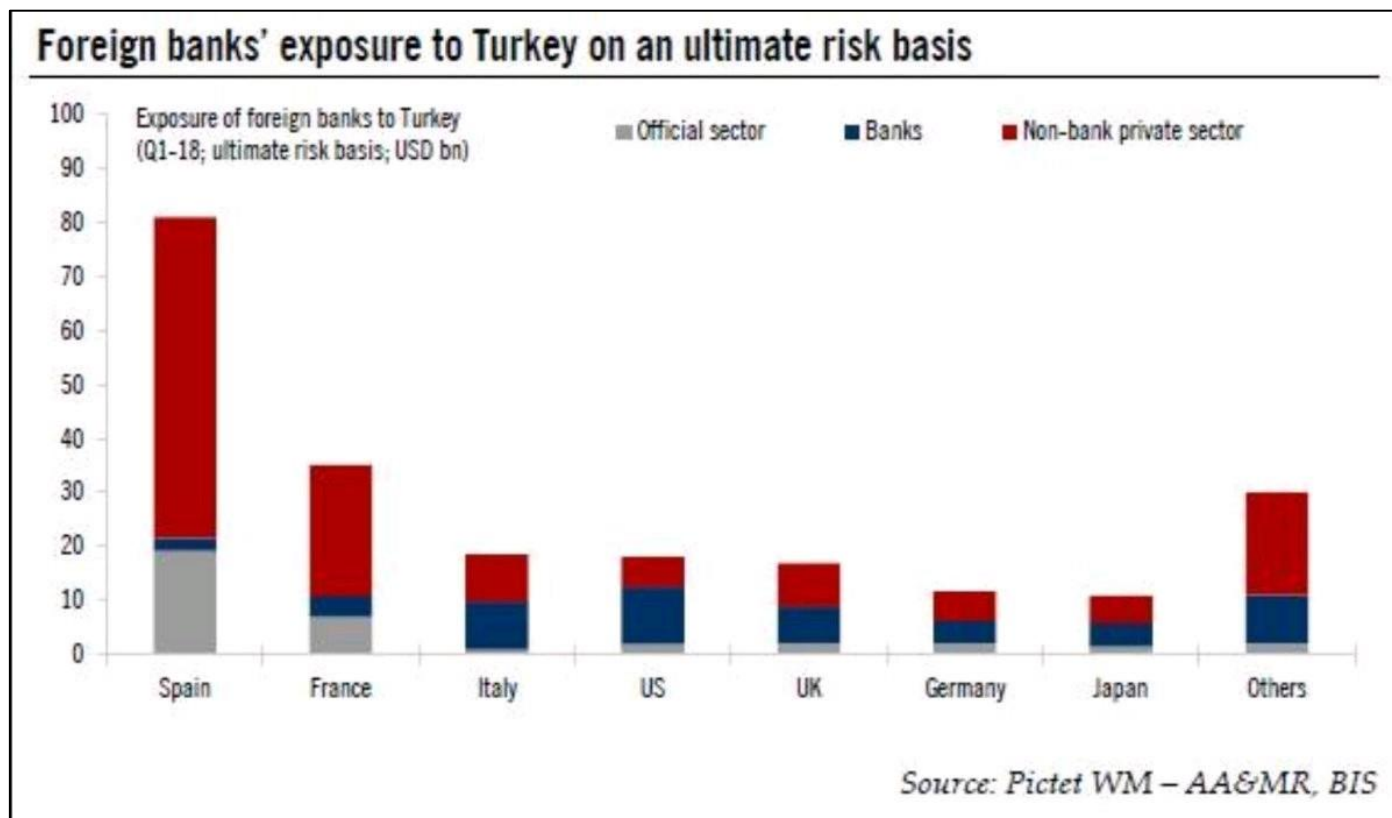
Turkey Selloff Sparks Contagion Fears

While the recent selloff in Turkish assets has been attributed to the sanctions and increasing tensions with the U.S. over the continued detention of an American pastor, much of the pain YTD can be tied to the country having the largest current account deficit within EM. Having lost a fifth of their value in lira terms YTD (-55% in USD terms), Turkish stocks are trading at their lowest level since March 2009. Additionally, the local 5-year Turkish bond yield is trading above 24%, almost double where it traded a year earlier, and the five-year Turkish CDS is the highest since 2008, surpassing the similar maturity CDS for Greece.



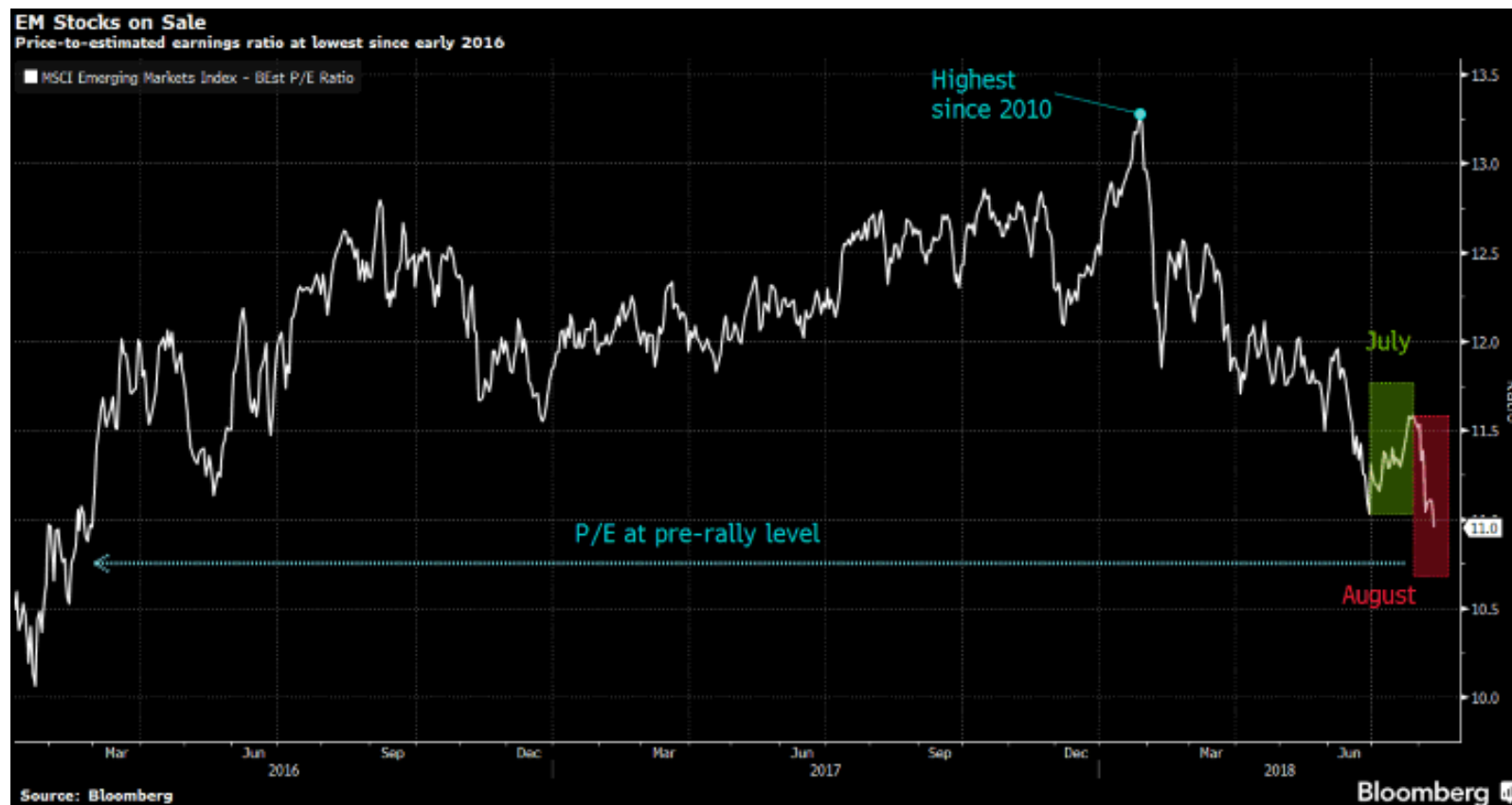
European Bank Exposure to Turkey

While Athena has limited direct exposure to Turkish assets, we have indirect exposure through European banks, which have sold off as the European Central Bank (ECB) has announced a growing concern about the region's exposure to the Turkey (specifically Spanish, French and Italian banks). While the ECB does not yet view the situation as critical, the sudden drop in bank stocks underscores the potential for contagion. The EuroStoxx Banks index is -17% YTD through August 17th, falling to its lowest since late 2016.



EM P/E Ratio Drops to Lowest Since Early 2016

Given the selloff in emerging market equities, the trailing twelve month (TTM) P/E ratio for the MSCI EM Index has fallen to 11x, which is the lowest level since March 2016. While this reading is not screamingly cheap in a historical context, this reading is approximately half that of the S&P 500.




EM Selloff Brings An Opportunity to Rebalance

Given the weakness seen across emerging markets since their January highs, Athena is recommending rebalancing for clients with appropriately long horizons and a commitment to the asset class. While geopolitical, trade, and monetary headwinds lessen the probability of a straight line recovery, we believe our current EM manager lineup continues to offer exposure to compelling long-term growth opportunities tied to EM consumer themes.

Country ETF Returns (US vs. EM, in US \$)			
Country	Ticker	2018 Total Return	Total Return since Jan 26
US (Nasdaq 100)	QQQ	16.3%	6.0%
US (S&P 500)	SPY	7.0%	-0.4%
Taiwan	EWT	3.1%	-4.7%
India	PIN	-0.9%	-6.1%
Mexico	EWX	2.0%	-7.1%
Malaysia	EWM	1.0%	-7.7%
Thailand	THD	-3.5%	-11.2%
Russia	ERUS	-6.8%	-16.9%
Chile	ECH	-11.7%	-17.9%
South Korea	EWY	-13.6%	-18.1%
China	FXI	-6.1%	-19.8%
Indonesia	EIDO	-14.0%	-20.0%
South Africa	EZA	-18.7%	-25.2%
Argentina	ARGT	-19.6%	-26.1%
Brazil	EWZ	-15.0%	-27.3%
Turkey	TUR	-49.1%	-52.6%

Pension Partners
THE ASSET ALLOCATION MANAGER

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MSCI Emerging Markets: 1994-2018		
Market Environment	Dates	Drawdown
Bear	Sept 1994 - Mar 1995	-32.6%
Correction	Jul 1995 - Nov 1995	-14.3%
Bear	July 1997 - Jan 1998	-38.2%
Bear	Mar 1998 - Sept 1998	-46.4%
Bear	Mar 2000 - Sept 2001	-53.7%
Bear	April 2002 - Oct 2002	-30.0%
Correction	Jan 2003 - Mar 2003	-12.4%
Bear	April 2004 - May 2004	-20.4%
Correction	Feb 2005 - April 2005	-10.6%
Bear	May 2006 - June 2006	-24.5%
Correction	Feb 2007 - March 2007	-10.6%
Correction	July 2007 - August 2007	-17.7%
Bear	Oct 2007 - Oct 2008	-66.1%
Bear	Nov 2008	-23.0%
Bear	Jan 2009 - Mar 2009	-21.8%
Correction	April 2010 - May 2010	-18.3%
Bear	May 2011 - Oct 2011	-31.1%
Correction	Oct 2011 - Nov 2011	-13.1%
Correction	Mar 2012 - June 2012	-18.3%
Correction	Jan 2013 - June 2013	-18.4%
Correction	Oct 2013 - Feb 2014	-12.3%
Correction	Sept 2014 - Dec 2014	-17.3%
Bear	April 2015 - Jan 2016	-35.5%
Bear	Jan 2018 - Aug 2018	-19.7%

Bear Markets defined as 20% peak-to-trough losses
Corrections defined as double digit losses not exceeding 20%
Price index only; no dividends included

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