Athena Capital Advisors

Interim Market Update

March 2019

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Summary

- The fear and panic of 4Q18 gave way to a strong rally for risk assets to start 2019. We view the rally as a sign of relief that things aren't quite as bad as the market action implied at the end of 4Q18. This is in contrast to the euphoria we saw in January of 2018.

- In the current environment we recommend maintaining portfolio exposures near strategic targets. More specifically:
  - In Fixed Income: Maintain short duration and a preference for enhanced cash. Though the Federal Reserve is on pause now, we believe the next move is more likely a hike rather than a cut as the market implies.
  - In US Equities: Valuations have moved from reasonably attractive at year-end to fairly valued following the market's rally and the decline in forward earnings expectations. We continue to prefer our active managers whose portfolios are comprised of companies we consider "quality", e.g. cash flow generative, low leverage, perceived runway for above average growth, and led by disciplined stewards of capital.
  - In International Equities: We believe the outlook is favorable for our global growth-sensitive managers as we see signs of a bottoming in economic data, particularly from China—the world's key marginal contributor to growth. Valuations are also attractive on a relative and absolute basis. We like our overweight to Asia and China on a long-term basis, while in the short-term we welcomed the announcement from MSCI for greater inclusion of China A-shares in their Emerging Markets Index.

Summary Con't

– Hedge Funds: We favor strategies that we believe can capitalize on or run largely immune to expected increases in volatility, e.g. certain global macro managers, as well as fixed income relative value and merger arbitrage strategies.

– Inflation Hedges: We continue to prefer gold and TIPS. We believe inflation and inflation expectations will return to the Fed's 2% target as we progress through 2019, but we do not expect a meaningful inflation surprise.

Risks to our view:

- Federal Reserve is more hawkish
- Global growth slows, in particular in China
- China/US trade talks deteriorate
- Britain's exit from the EU is bungled
- Corporate refinancing risk rises as a result of significant debt maturities in 2019

We view the China economy as both a credible threat given its importance to global growth, its policy opacity, its reliance on credit for growth, etc. but also as one of the most compelling investment opportunities globally. It is the investment equivalent of the Thalia and Melpomene drama mask. Given its significance and juxtaposition, Athena spent the first few weeks of the year in China.

One of the biggest takeaways from our time abroad was the importance of embracing the notion that the "rules don't always apply" in the Chinese business climate. We have thus developed a greater preference for investing in companies that are market share leaders with the flexibility to navigate the rapidly changing regulatory environment, and who are aligned with the government policy and who deliver their product or service in a win-win framework.

Along with the Interim Market Overview we have provided a more in-depth review of our trip to China. We welcome the opportunity to discuss with you further our trip as well as any of our views.

Global Growth is Mixed

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Global output metrics have declined from last year's ebullient levels and country-level divergence has increased. While the US is a positive outlier, Eurozone and Asia regions are slowing mainly due to the lowered level of credit growth in China, and the ramifications of escalating tariffs and trade rhetoric. A resumption in credit growth in China and/or a trade deal would likely ease such pressures, especially for export-oriented economies like Germany.

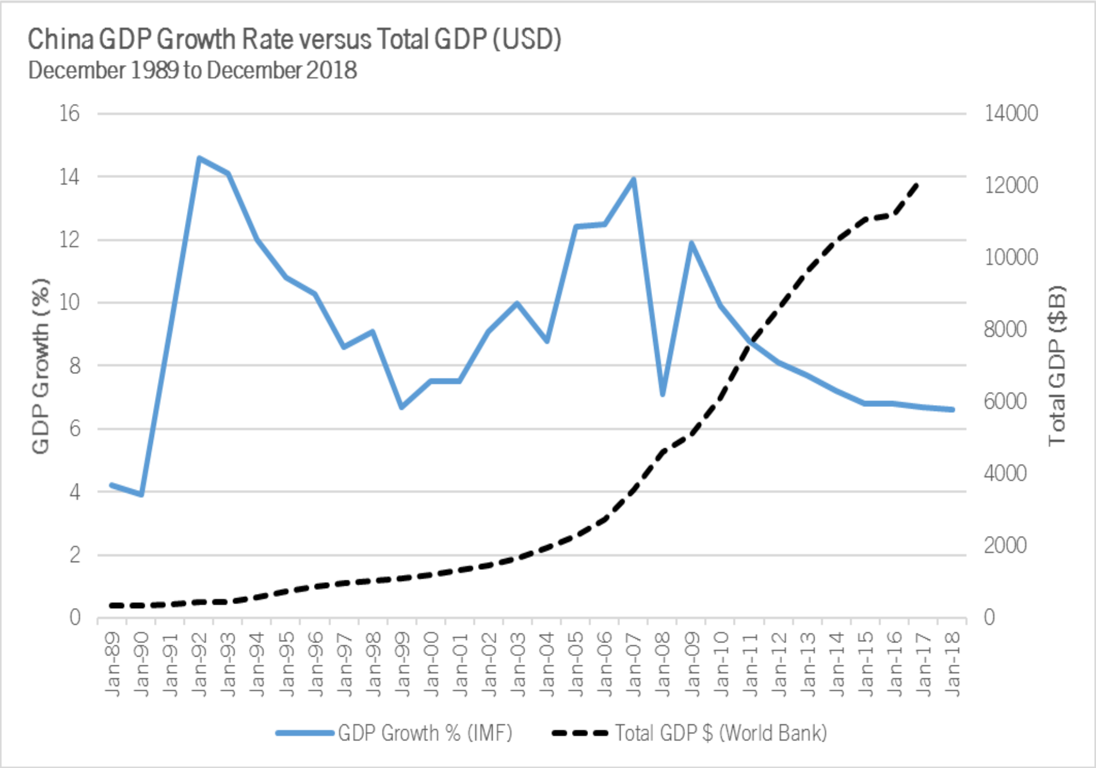
ISM Manufacturing PMI

Region	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	Nov-18	Dec-18	Jan-19	Feb-19
US	53	53	52	53	53	53	55	54	55	56	55	56	57	56	55	55	55	56	56	55	54	55
UK	57	57	54	55	57	56	56	58	56	55	55	55	54	54	54	54	53	54	51	53	54	53
Eurozone	57	57	57	57	57	58	59	60	61	60	59	57	56	56	55	55	55	53	52	52	51	51
Germany	58	60	60	58	59	61	61	63	63	61	61	58	58	57	56	57	56	54	52	52	52	50
France	55	54	55	55	56	56	56	58	59	58	56	54	54	54	53	53	54	53	51	51	50	51
Italy	56	55	55	55	56	56	58	58	57	59	57	55	54	53	53	52	50	50	49	49	49	48
Spain	55	55	55	54	52	54	56	56	56	55	56	55	54	53	53	53	53	51	52	53	51	52
Japan	53	53	52	52	52	53	53	54	54	55	54	53	54	53	53	52	53	53	53	52	53	50
China	50	50	50	52	53	51	51	51	52	52	52	51	51	51	51	51	51	50	50	50	50	48
Brazil	50	52	51	50	51	51	51	54	52	51	53	53	52	51	50	51	51	51	51	53	53	53

Source: Factset

China Growth Long-Term: Law of Large Numbers

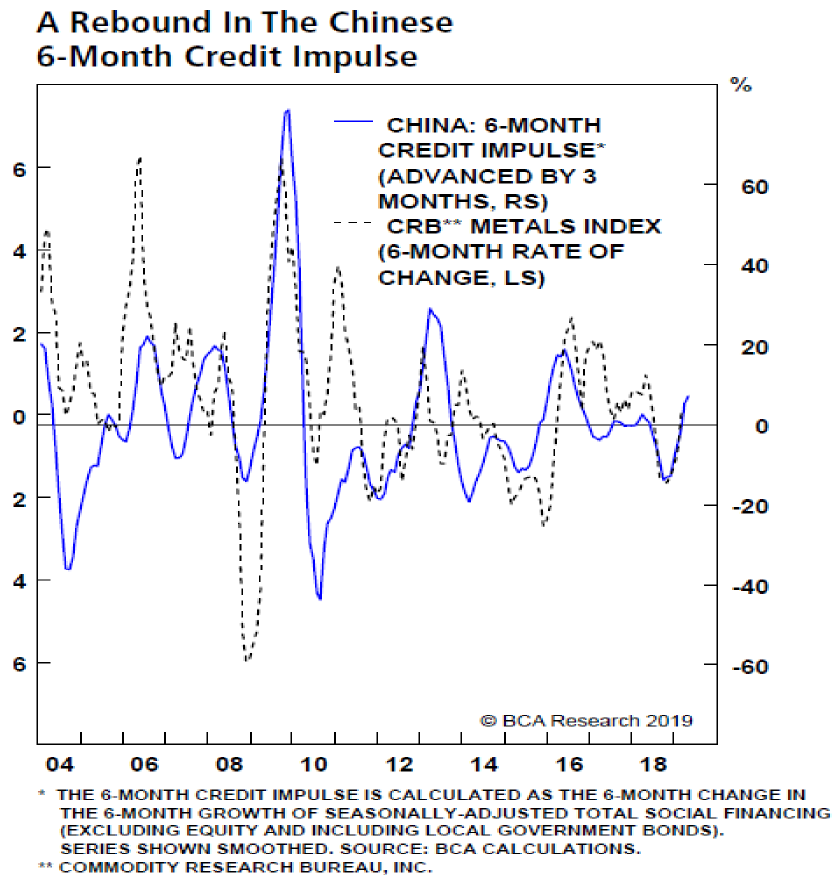
In 1Q19 China revised its forward outlook for growth in 2019 to 6% from 6.5%. This decline needs to be taken in context of the significant size of the Chinese economy--a 6% growth rate is still a significant incremental add to the country's GDP. Additionally, we view the shift lower in expectations as a prudent move toward lower, but sustainable growth levels.



Source: Bloomberg, IMF, Worldbank

China Growth: Short Term Inflection

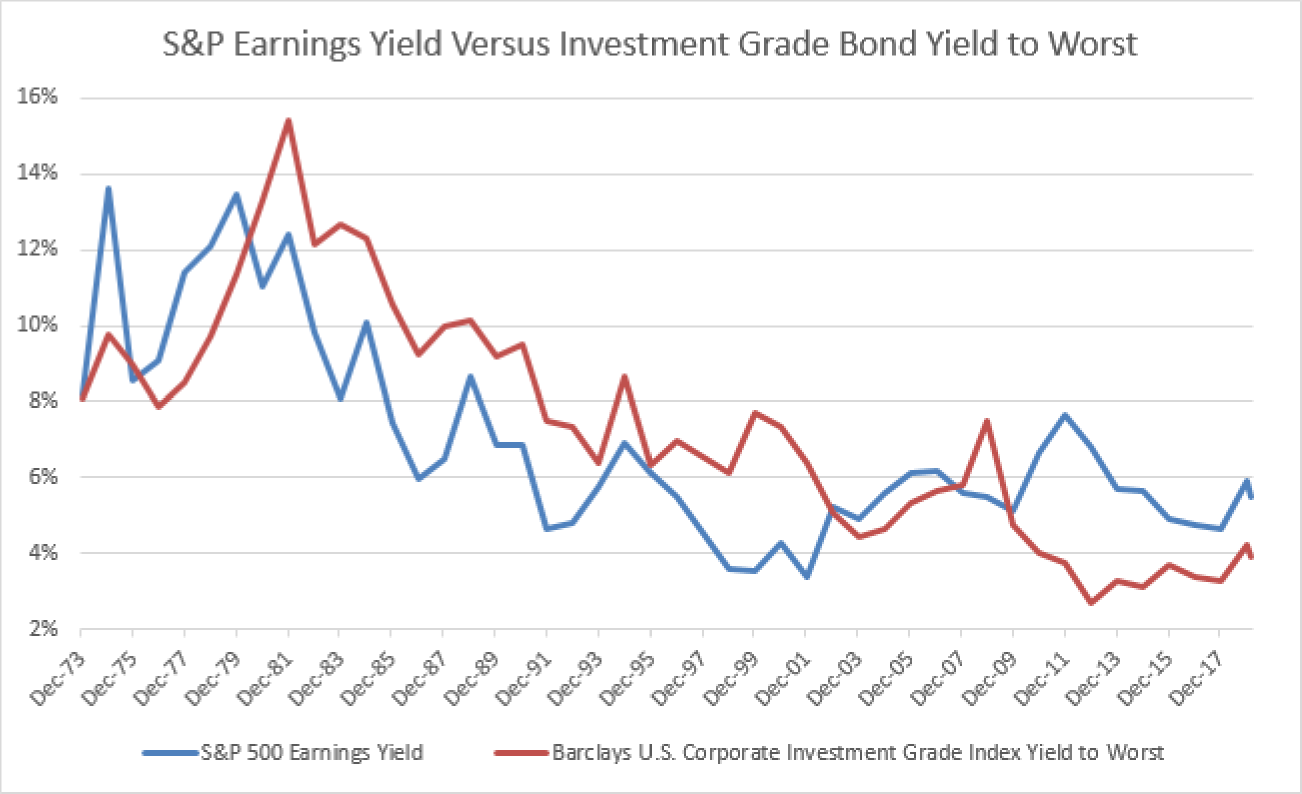
Though China continues to transition away from its dependence on credit growth to drive its economy, the significance of credit growth on the economy remains. Through 2018 we saw a tightening of credit growth, which underpinned the slower growth in China and the global economy. Per the chart below, there are signs of an uptick in credit growth which we expect to flow through to China growth and ultimately to the more globally sensitive economic areas such as Europe.



Source: BCA

Equities: Remain Attractive Vs Bonds

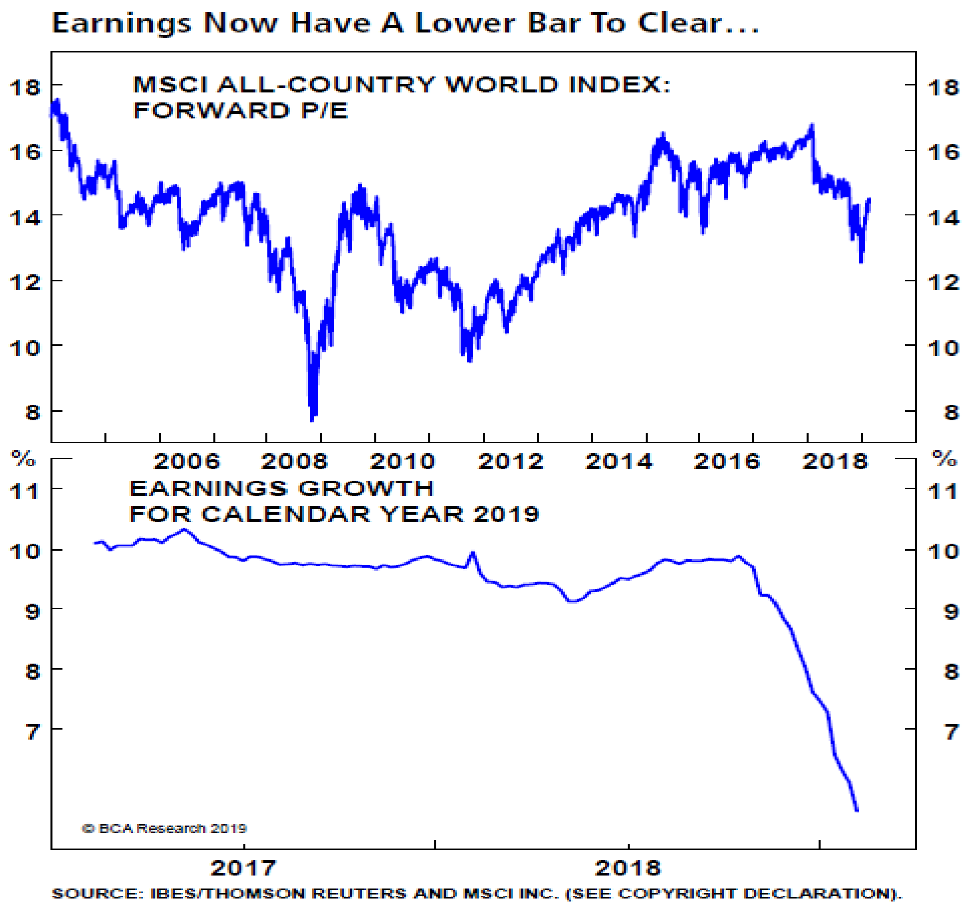
Athena thinks equities are more attractive than bonds based on several valuation metrics. For example, despite the rally in US equities so far in 2019, the earnings yield (earnings/price) of the S&P 500 remains higher than the yield of the Barclays Investment Grade Bond Index. US equities have recovered from their 4Q18 selloff but do not yet reflect frothy valuations in Athena's view. Bonds, however, continue to trade at tight spreads to Treasuries despite the risks of the late stage in the credit cycle.



Source: S&P, Barclays

Global Earnings Growth: Curbed Enthusiasm

Earnings estimates have come down considerably for global equities, bottom chart, which we view as lowering the bar and setting up for possible upside surprise.



US Markets: A Return to Fair Value

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Despite the strong rally to start the year, the P/E multiple on the S&P 500 has only moved back 18x, which is in line with its historical median level since 1990. The forward P/E is also in line with its historical median since 1990. Each of these indicate a market that has recovered to fairly valued.

Bloomberg Bottom-Up Earnings Estimates*						3/6/2019 S&P 500 Index Level: 2783
2020	2019	2018	Trailing 12 Mos.	-20% Decline[1]	P/E Multiples	Historical Medians/Occurences of P/E multiples
$204	$186	$167	$152	$121		
$1,429	$1,299	$1,168	$1,063	$850	7	Various occurences of single-digit trailing 12m P/E in the 1970s and 1980s
$1,633	$1,484	$1,335	$1,214	$972	8	
$1,837	$1,670	$1,502	$1,366	$1,093	9	
$2,041	$1,855	$1,669	$1,518	$1,214	10	
$2,245	$2,041	$1,836	$1,670	$1,336	11	Low trailing 12m P/E during 2008 - 2009 crisis
$2,449	$2,227	$2,003	$1,822	$1,457	12	Median trailing 12m P/E, 1970 - 1989
$2,653	$2,412	$2,170	$1,973	$1,579	13	
$2,858	$2,598	$2,337	$2,125	$1,700	14	
$3,062	$2,783	$2,504	$2,277	$1,822	15	
$3,266	$2,969	$2,670	$2,429	$1,943	16	Current Forward P/E, Median fwd P/E, 1990 - Present
$3,470	$3,154	$2,837	$2,581	$2,065	17	Median trailing 12m P/E, 1955 - Present
$3,674	$3,340	$3,004	$2,733	$2,186	18	Current T12M P/E; Median trailing 12m P/E, 1990 - Present
$3,878	$3,525	$3,171	$2,884	$2,307	19	
$4,082	$3,711	$3,338	$3,036	$2,429	20	
$4,286	$3,896	$3,505	$3,188	$2,550	21	
$4,490	$4,082	$3,672	$3,340	$2,672	22	
$4,695	$4,268	$3,839	$3,492	$2,793	23	
$4,899	$4,453	$4,006	$3,643	$2,915	24	
$5,103	$4,639	$4,173	$3,795	$3,036	25	
$5,307	$4,824	$4,340	$3,947	$3,158	26	Median trailing 12m P/E, 1998 - 2001
$5,511	$5,010	$4,506	$4,099	$3,279	27	
$5,715	$5,195	$4,673	$4,251	$3,400	28	
$5,919	$5,381	$4,840	$4,402	$3,522	29	
$6,123	$5,566	$5,007	$4,554	$3,643	30	
$6,327	$5,752	$5,174	$4,706	$3,765	31	Current CAPE

Nearest Price Level at Current Trailing Multiple
Nearest Price Level at Current Forward Multiple

independent research firms. Estimates are for diluted EPS from continuing operations, which excludes the effects of extraordinary

[1]-20% decline in the current trailing 12-month represents the historical average peak-to-trough earnings contraction during recessions
[2]CAPE = Cyclically Adjusted P/E Ratio (Real S&P 500 Price/Normalized Real Earnings)

Source: Bloomberg

Int'l Valuations: Better Prospects

While the US equity market appears fairly valued, we believe developed international equities present a reasonable opportunity based on current valuations and the nascent upward inflection in economic data in China and in Europe. The upside potential is shown below in the elevated earnings yield of the MSCI EAFE on an absolute and relative basis.

If our view is proven correct, we would look to trim our global growth-sensitive international managers in favor of our global and international quality-focused managers.

MSCI EAFE Z-Score Calculation (since Feb. 1995)					
	E/P	P/S	P/B	P/CF	Average
Average	4.9%	1.0	1.9	9.2	3.1
Stdev	1.8%	0.2	0.4	2.4	0.7
Current	6.6%	1.1	1.6	9.0	2.9
Z-Score	-0.92	0.61	-0.86	-0.11	-0.19

S&P 500 Z-Score Calculation (since Jan 1990)					
	E/P	P/S	P/B	P/CF	Average
Average	5.3%	1.5	2.9	11.0	3.86
Stdev	1.0%	0.4	0.7	3.2	1.03
Current	5.5%	2.1	3.3	12.0	4.37
Z-Score	-0.15	1.5	0.6	0.3	0.50

Source: Bloomberg

Duration: Risk Remains Unattractive

Despite the dovish turn in the Federal Reserve's tone in 1Q19, Athena does not think that duration risk is attractive at this time. The yield curve, shown below as the difference in yield earned on 10 year and 2 year Treasuries, remains flat and investors are not earning enough yield to justify the risk of additional interest rate exposure. Also, there is a stark disconnect between current US macroeconomic data and the market's expectation for a rate cut this year, which may result in interest rate volatility later in 2019.

10 Year Minus 2 Year Treasury Yield

Source: Federal Reserve Bank of St. Louis

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