ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

1Q2019

Last quarter (4Q18) the S&P 500® Index declined -13.52%. During the first quarter (1Q19) the S&P 500® Index rose +13.65%. We had to actually look at those returns twice when preparing our returns table on the next page given how closely they were aligned to make sure there wasn't an error in the download. This significant reversal was consistent, though not nearly as exact, across most equity asset classes. Bonds were much more stable with the exception of the corporate categories, which largely tracked in line with the equity reversal.

As long-term investors, these last two quarters have provided a nice view into the risks of pivoting a long-term plan based on short-term market moves. We probably say that too often, so we won't belabor the point, but when the examples are plentiful it is hard to just gloss over. Investing cannot be an emotional exercise – it brings into the fray way too many destructive, behavioral biases. Investing needs to be a thoughtful exercise. It has to be grounded in process and always be disciplined.

If we stay committed to those simple ideas, we are confident we can serve our clients well over the long-term.

We hope you find a portion of this newsletter useful.

Thank you for taking the time to read it. If you have any feedback, it is always appreciated.

Bob Charles Mark

Market Performance | Market Notes | Equity Portfolio Comments
Fixed Income Portfolio Comments | Research Focus | Client Focus

Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 3/31/19)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	9.50	13.51	10.91	15.92
Russell 1000 Index	Mid/Large Cap Stocks	9.30	13.52	10.63	16.05
Russell 1000 Growth Index	Growth Stocks	12.75	16.53	13.50	17.52
Russell 1000 Value Index	Value Stocks	5.67	10.45	7.72	14.52
Russell 2000 Index	Small Cap Stocks	2.05	12.92	7.05	15.36
MSCI EAFE Index	Non-U.S. Developed Market Stocks	-3.71	7.27	2.33	8.96
MSCI Emerging Markets Index	Emerging Markets Stocks	-7.41	10.68	3.68	8.94
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	-9.49	7.01	3.26	11.86
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	5.03	5.01	6.29	11.46
Barclays Municipal Bond Index	U.S. Municipal Bonds	5.38	2.71	3.73	4.72
Barclays Aggregate Bond Index	U.S. Bonds	4.48	2.03	2.74	3.77
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	4.24	1.66	2.12	3.14
BofAML U.S. Treasury Master Index	Treasury Bonds	4.25	1.07	2.34	2.49
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	4.55	1.81	2.65	3.11
BofAML U.S. Corporate Master Index	Corporate Bonds	4.95	3.68	3.74	6.77
BofAML U.S. High Yield Master II Index	High Yield Bonds	5.93	8.68	4.70	11.21
BofAML Convertible Bonds Index	Convertible Bonds	7.63	14.17	8.50	13.22
BofAML Euro Broad Market Index	European Bonds	-6.68	0.85	-1.04	2.64
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	-4.82	3.19	-0.02	4.01

Calendar Year % Returns (QTD as of 3/31/19)

Source: Morningstar Direct

	QTD	2018	2017	2016	2015	2014	2013
S&P 500 Index	13.65	-4.38	21.83	11.96	1.38	13.69	32.39
Russell 1000 Index	14.00	-4.78	21.69	12.05	0.92	13.24	33.11
Russell 1000 Growth Index	16.10	-1.51	30.21	7.08	5.67	13.05	33.48
Russell 1000 Value Index	11.93	-8.27	13.66	17.34	-3.83	13.45	32.53
Russell 2000 Index	14.58	-11.01	14.65	21.31	-4.41	4.89	38.82
MSCI EAFE Index	9.98	-13.79	25.03	1.00	-0.81	-4.90	22.78
MSCI Emerging Markets Index	9.91	-14.58	37.28	11.19	-14.92	-2.19	-2.60
MSCI ACWI Ex USA Small Cap Index	10.26	-18.20	31.65	3.91	2.60	-4.03	19.73
BofAML Preferred Stock Fixed Rate Index	8.70	-4.34	10.58	2.32	7.58	15.44	-3.65
Barclays Municipal Bond Index	2.90	1.28	5.45	0.25	3.30	9.05	-2.55
Barclays Aggregate Bond Index	2.94	0.01	3.54	2.65	0.55	5.97	-2.02
Barclays Intermediate U.S. Gov/Credit Index	2.32	0.88	2.14	2.08	1.07	3.13	-0.86
BofAML U.S. Treasury Master Index	2.18	0.80	2.43	1.14	0.83	6.02	-3.35
BofAML U.S. Mortgage Backed Securities Index	2.27	1.00	2.45	1.67	1.46	6.07	-1.39
BofAML U.S. Corporate Master Index	5.01	-2.25	6.48	5.96	-0.63	7.51	-1.46
BofAML U.S. High Yield Master II Index	7.40	-2.27	7.48	17.49	-4.61	2.51	7.41
BofAML Convertible Bonds Index	10.36	0.68	16.03	11.94	-1.15	9.97	26.60
BofAML Euro Broad Market Index	0.70	-4.39	14.61	0.37	-9.30	-2.48	6.89
BofAML Local Debt Market Plus Index	3.93	-4.90	14.71	6.53	-12.02	-4.50	-5.75

How should you use the information provided in the table?

- The returns are not projections. They are historical. Future returns will vary.
- Annualized returns can generally be used to understand historical return trends.
- Calendar returns provide a general understanding of year-by-year return volatility.

Global Market Drivers

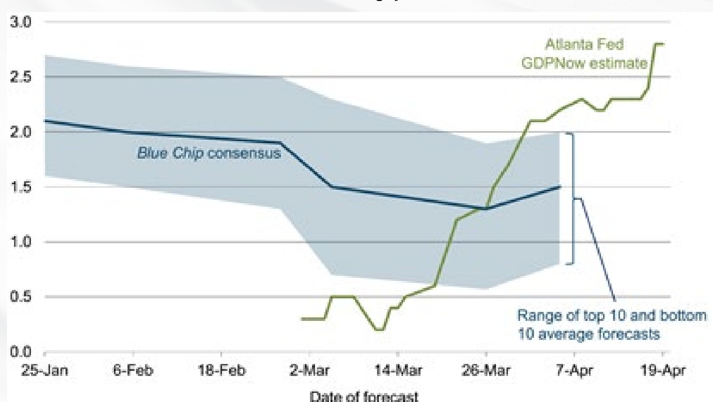
The first quarter could be characterized as a quarter of reversals. The most prominent of which was the U.S. Federal Reserve (Fed) about-face regarding the trajectory of interest rates due to signs of stress in credit markets and weakening economic data. Early in the quarter (January 4) Fed Chairman Jerome Powell stressed that the Fed would not hesitate to respond with all tools necessary to counteract an economic downturn or increased turmoil in financial markets. The Fed's stance was reaffirmed later in January (following its policy meeting January 29-30) as they removed all references to further rate increases for 2019 and raised the possibility that the Fed may not continue to wind down its balance sheet. Not surprisingly, short-term market participants cheered the developments, which sent stocks sharply higher. In fact, the equity market experienced its two best days of performance in the first quarter following the aforementioned statements. Nonetheless, some market participants were not as inspired by the accommodative stance because they believed it simply delayed dealing with underlying economic issues as opposed to confronting them. Said more simply, they believed the Fed was "kicking the can down the road," even though the "can" largely remained. Whether or not the Fed assists in manufacturing more equity gains in the face of corporate earnings weakness from this point forward will be a central theme for the remainder of 2019.

The Economy

From an absolute perspective, U.S. economic growth was solid in the fourth quarter of 2018 (+2.2%) and for the calendar year (+2.9%). However, momentum was slowing into 2019, as downside risks emerged amid the broader global growth slowdown. Data coming in early in the first quarter suggested we could see 1Q19 economic growth of less than +1%, but data firmed midway through the quarter. Many important indicators including core durable goods orders and shipments, manufacturing and services ISM surveys, housing activity and job creation data all showed improvement later in the quarter. Ultimately, the economy generated a +3.2% growth rate in the first quarter of 2019, beating most projections. Despite an impressive top line number, when you look under the hood, there were some concerning developments. First, household spending generated its lowest level of growth in five years. Second, a large portion of the growth came from an improvement in net exports, which sounds good, but is misleading because the uptick was due to a decrease in imports. This suggests slowing consumer demand for imported goods. These two factors are important because the consumer accounts for 70% of the economy.

The global economy was struggling as the fourth quarter of 2018 concluded, and this weakness continued through much of the first quarter. At 3.0%, 1Q19 GDP growth is projected to be at its lowest level since mid-2016. The slowdown was broad-based. In addition to the United States, Europe, the United Kingdom, Canada and China all slowed meaningfully. The underlying drivers of the slowdown were three-fold. First, the Chinese de-risking campaign had a much larger effect on the economy than the

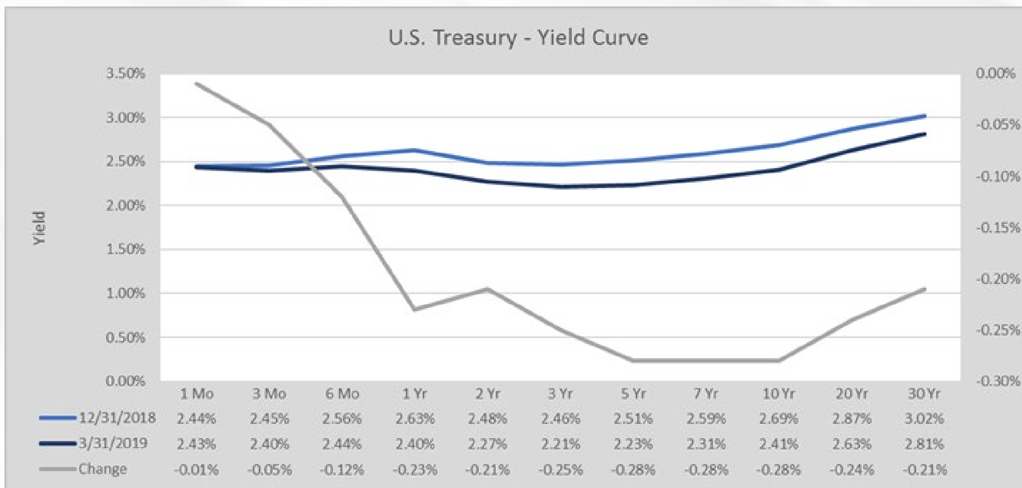
Federal Reserve Bank of Atlanta Fed 1Q19 GDPNow Estimate



government anticipated. In tandem with the slowdown in China, the euro-area manufacturing sector went into a recession. Second, the ongoing trade war between the U.S. and China continued to negatively impact growth for both countries and their trading partners. Third, the market's belief that the Fed would be inflexible in its pursuit of higher rates and balance sheet reduction led to a deterioration in sentiment and ultimately undercut activity.

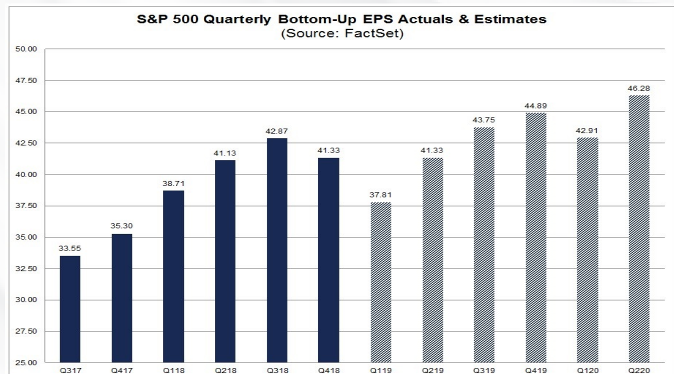
Interest Rates

Due to slowing economic growth, the 10-year Treasury yield declined 28 basis points to end the first quarter at 2.41%. Yields declined across maturities, which caused the yield curve to continue its flattening bias. The 2-year yield finished the quarter at 2.27%, down 21 basis points from the previous quarter end. The widely followed 10-year to 2-year spread ended the quarter at +14 basis points, the lowest level of the post great recession recovery.



Earnings

Corporate earnings growth (year-over-year) is expected to decline -2.3% (S&P 500® Index) for the first quarter. If this rate of growth were to materialize, it would mark the first year-over-year earnings decline for the S&P 500® Index since 2Q16. Estimated earnings growth is expected to slowly improve over the next three quarters of 2019 (-0.6% for 2Q, +1.3% for 3Q and +8.1% for 4Q) to finish the full calendar year at +3.6%. See chart to the right.



Slide courtesy of FactSet Earnings Insight (April 26, 2019)

Equity Market Results

As a result of the about-face by the Fed, many areas of the equity market that had posted significant losses in the fourth quarter of last year, rebounded strongly in the first quarter. U.S. equities finished with their highest first quarter return since 1998, gaining +13.65% (as represented by the S&P 500® Index). Within the U.S. equity market, growth-oriented equities and small-cap equities, both of which posted significant losses in the fourth quarter, rebounded with large gains in the first quarter (+16.10% and +14.58%, respectively – Russell Index performance). Value-oriented equities, which held up relatively well in the fourth quarter, posted solid gains (+11.93% as represented by the Russell 1000® Value Index), but the gains were not as large as in other areas of the market. From a sector perspective, the technology sector and the real estate sector were the two best performers for the quarter (+19.86% and +17.53%, respectively – S&P 500 sector performance), while the financial sector and the health care sector were the weakest (+8.56% and +6.59%, respectively – S&P 500 sector performance).

Overseas, developed foreign stocks also performed strongly for the quarter (+9.98% as represented by the MSCI EAFE® Index). Unfortunately, similar to the U.S., the strong returns in Europe were largely due to central bank announcements rather than any notable improvements in underlying economic conditions. In a major policy reversal, the European Central Bank (ECB) announced on March 7 that it would restart its stimulus program and that it would also maintain negative interest rates through the end of 2019 in an effort to provide cheap loans to banks.

Emerging markets equities registered a solid gain of +9.91% (as represented by the MSCI Emerging Markets Index) in the first quarter, although performance dispersion among individual countries was wide. The clear leader for the quarter on a country basis was China (+17.60% as represented by MSCI China IMI). Chinese equity performance was buoyed by a combination of factors (and reversals) including stimulative efforts on the part of the government, an improved outlook for a trade resolution with the U.S. and a strong uptick in several economic data points that were released late in the quarter. In aggregate, returns for emerging markets equities tended to be less than U.S. equities for the quarter, although this was partially because U.S. equities had declined significantly more than emerging markets equities in the fourth quarter.

Equity Market Comments

After several years of strength, corporate earnings are showing signs of weakness. **What is driving the decline in earnings?** Unfortunately, many of the concerns that we discussed in previous newsletters (we spoke at length about the possibility of a corporate earnings recession in our 4Q18 newsletter) have finally come to the forefront. Most notably, the factors that have been most prevalent on first quarter corporate earnings calls have been the negative effects of U.S. dollar strength and increased labor costs. Nearly 40% of revenues for S&P 500 companies comes from overseas. With economic weakness emanating out of Europe and the residual effect of a strong U.S. dollar relative to most currencies in 2018, companies have found it difficult to generate meaningful top-line (revenue) growth. Increased labor costs have also begun to weigh on corporate profit margins. Average hourly earnings in the U.S. are currently near 10-year highs and are not expected to reverse course anytime soon, which does not bode well for margin improvement in the near term. Furthermore, corporate tax rates are now the same on a year-over-year basis, so companies are no longer getting an artificial boost to margins like they once were.

Taking all factors together, many questions arise regarding future earnings. Top-line growth is tepid and margins now appear to be in decline (margin improvements were the largest contributor to earnings growth in 2016, 2017 and 2018). **Will corporations continue to repurchase their own shares and artificially inflate earnings per share?** Corporate share repurchases were discussed in our 3Q18 newsletter, but the relatively significant impact they have had on corporate earnings growth makes this topic worthy of discussion again this quarter. Based on data from Goldman Sachs, it is estimated that share repurchases have added roughly +2.6% per year to earnings growth over the past four years. And since 2010, corporate demand for shares has far exceeded demand from all other investor categories combined. In total, share repurchases have averaged $420 billion per year for the past nine years. This compares to foreign investor demand, households, mutual funds and pension funds, which have purchased less than $10 billion per category per year over the same timeframe, even though these categories own a combined 83% of corporate equities. This begs the question – **What happens to earnings growth (earnings per share growth) when share repurchases begin to dry up?**

As we have noted many times in the past, stock prices generally follow corporate earnings over the long term, which is why we focus a part of our commentary on corporate earnings every quarter. While this relationship generally holds over long-term periods, over short-term periods there can be relatively large disconnects. The first quarter appears to be one of these short-term periods. To illustrate the extent of this disconnect, see the chart below.

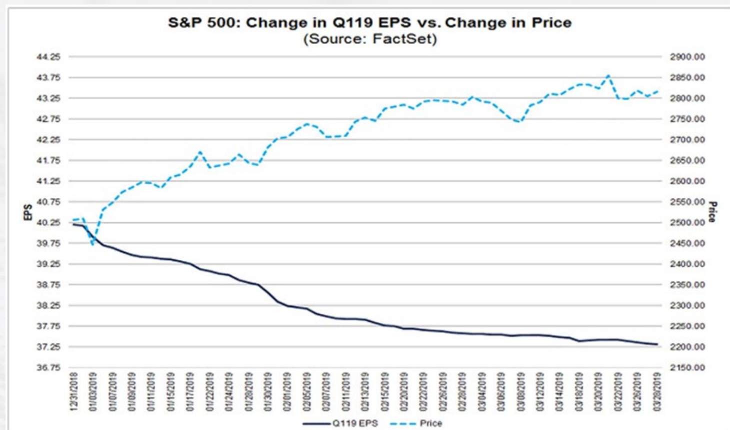


Chart courtesy of FactSet Earnings Insight (March 29, 2019)

The chart plots the direction of 1Q19 earnings per share (EPS) expectations for the S&P 500® Index (left axis) relative to the change in price of the S&P 500® Index (right axis) over the course of the first quarter. While a recovery in price (to a certain degree) was to be expected after the sharp selloff in the fourth quarter, in our opinion, it appears the stock market may have gotten ahead of itself. The large increase in price without a subsequent increase in earnings means that the rally we have experienced in the stock market so far in 2019 has been driven almost entirely by multiple expansion (an increase in valuation levels – more on this below). This may mean that the market is expecting a fairly robust recovery in earnings from this point forward.

What does all of this mean for future equity returns? Over the short-term, we are not sure. As we noted above, stock prices can become detached from underlying fundamentals for extended periods. However, what we will say is that we are not overly thrilled about multiple expansion driving equity returns from this point forward without a subsequent recovery in earnings. Unfortunately, we do not have much confidence in an earnings recovery over the short run, especially at this point in the economic cycle. In fact, we believe earnings growth expectations for 2019 (+3.6% for the S&P 500 Index) may still be too optimistic despite the already significant decline in earnings expectations. We would not be surprised if corporate earnings growth actually ended negative for 2019 instead of the low-single digit growth currently expected. As a result, we believe that downside risks outweigh the potential for meaningful surprises to the upside over the short run, particularly in the U.S. equity market. We have positioned client portfolios for this possibility.

Equity Portfolio Comments

The S&P 500® Index's forward P/E ratio (price-to-earnings ratio) expanded to approximately 16.4x at the end of the first quarter (16.8x as of the third week of April). As a reminder, 16.4x is roughly the amount that investors are willing to pay for $1 of future earnings. This is higher than the 10-year average of 14.7x, and in line with the 5-year average of 16.4x. See the chart below.

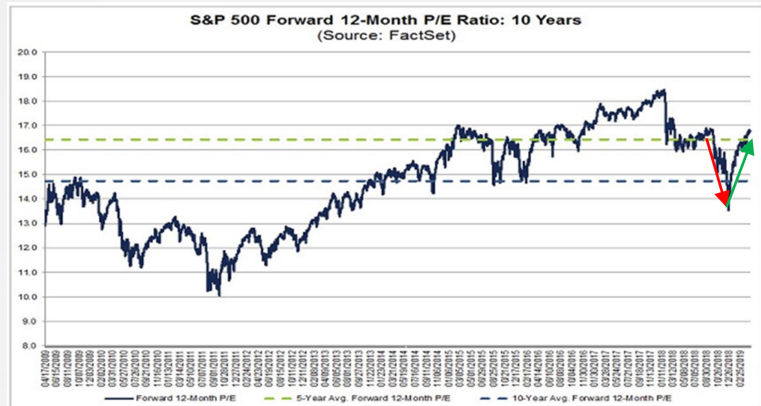


Chart courtesy of FactSet Earnings Insight (April 18, 2019)

Based on a quick glance at the forward P/E chart, it can be seen that P/E multiples contracted sharply in the fourth quarter (red arrow) but expanded just as rapidly to start 2019 (green arrow). The sharp reversal corresponds with investor hope that the Fed's about-face can prevent, or at least delay, an economic recession. However, as we have stated many times, "hope" is not a good investment strategy. In our opinion, without a corresponding rebound in earnings growth, there is little reason for further multiple expansion from this point forward. If multiples do expand, we believe the expansion would be fleeting. This is because P/E multiples generally expand during periods when underlying earnings are accelerating (or expected to) and contract during periods when underlying earnings are decelerating (or expected to). The exact opposite occurred in the first quarter. Based on our discussion of earnings and the large hurdles in place for future earnings growth (residual effects of U.S. dollar strength, economic weakness overseas and deteriorating corporate profit margins), we do not believe we are in a period that is conducive for multiple expansion. This leads us to be less constructive on equity market returns from this point through the remainder of the year.

As we have noted in the past, we look at many different types of valuation data because it allows us to develop a mosaic about how expensive or inexpensive the stock market may be and what that may mean for longer-term equity market returns. We find it helpful to examine different types of valuation data because no one measure is perfect and many measures can be manipulated by the underlying data. Manipulation is one of the reasons why we highlight the different components that go into a "P/E" ratio (price, earnings per share, revenue growth, profit margins, share repurchases, etc.) because without understanding the data that makes up the ratio, and the reasons for changes (and expected changes) in the direction of the data, the end number is relatively meaningless.

With this in mind, we thought it would be helpful to highlight one other valuation measure that we review on a regular basis – a ratio of the total value of U.S. equities relative to the total size of the U.S. economy. This valuation measure has been coined the "Buffett Indicator" following acclaimed investor Warren Buffett's statement in December 2001 that, "it is probably the best single measure of where valuations stand at any given moment." The chart on the right displays historical levels of the ratio dating back to the 1970's.

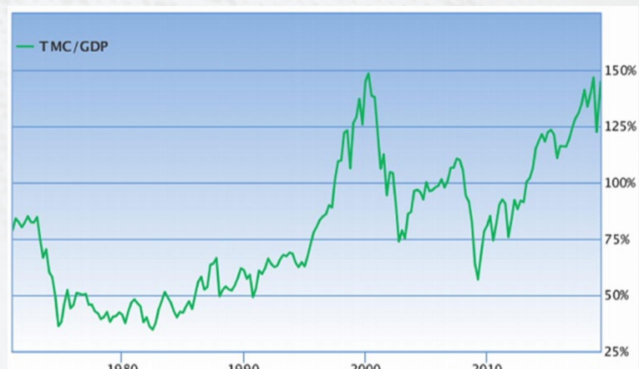


Chart courtesy of gurufocus (data as of April 29, 2019)

As a general rule of thumb, for any value in the 75%-90% range, the market could be described as being "fairly valued," for ratios below 50% the market could be described as "significantly undervalued" and for ratios above 115% the market could be described as "significantly overvalued." The measure is not a perfect indicator for short-term stock price movements, but it has a relatively good track record for providing general guidance on what investors should expect over a subsequent 10-year investment horizon. For instance, investors that purchased equities in the late 1980's to early 1990's enjoyed outsized equity returns over the next 10 years. Investors that purchased equities at the height of the dotcom boom around 2000 experienced relatively poor returns over the subsequent 10-year period.

What does this mean for investors? We believe it means that investors should be prepared to dial-in their expectations for future long-term returns. In our opinion, the fantastic U.S. equity market returns that were achieved over the last 10 years (in absolute terms and relative to other global equity markets) are unlikely to repeat over the next 10 years. For these reasons, and many more, we believe investors need to increasingly look for attractive opportunities outside of the U.S. equity market, and with companies and sectors in the U.S. market that are still able to grow their businesses consistently despite less favorable underlying economic conditions. We are not suggesting it means we are at an inflection point for a market timing call.

Even though we highlighted the "Buffett Indicator" in this quarter's newsletter, it is important to note that we could have highlighted any of the other 20+ valuation measures that we routinely review. Some of those measures reflect values that are more supportive of stock prices moving forward, while others are even more negative. Again, no one measure is perfect, especially over short timeframes. However, these measures can provide general "guard rails" for developing a better understanding of where stock prices currently reside relative to history, and what that may mean for the general direction of stock prices looking ahead over the long-term.

Regarding valuation levels and the potential path for equity returns, the key question in the coming months will be corporate earnings. Even though the Fed's statements during the first quarter completely overshadowed earnings, we believe earnings will eventually return as one of the key components of determining future equity returns and areas of opportunity.

Client Portfolio Impact

At the time of writing this, the S&P 500® Index had gained roughly +16% since the beginning of the year, which put it on a pace to gain over +70% for the year! Is this achievable? We should "never say never," but considering we believe that an earnings recession is likely for the first half of 2019 (an earnings recession is defined as two consecutive quarters of year-over-year earnings declines), and the outlook for earnings growth over the latter half of 2019 is tepid at best, significant equity market returns from this point through the end of the year do not appear likely.

What does this mean for our equity positioning? As always, we remain close to fully invested at each client's long-term broad asset allocation target (i.e. stocks vs. bonds). However, we have positioned portfolios to reflect our relatively cautious outlook for U.S. equities at the sub-asset class level. We have tilted portfolios towards areas of the market that have traditionally held up relatively well during periods of equity market uncertainty – large-capitalization stocks from a market-capitalization perspective and value-oriented stocks from a style perspective. Within the value-oriented portion of portfolios, we remain committed to REITs (real estate investment trusts), which have typically performed well during periods of decelerating economic growth and relatively tame inflation.

Equity Portfolio Comments

Due to the significant change from the Fed (from restrictive to supportive), we are looking at becoming a bit more style "neutral" by reducing our emphasis on broader-based value-oriented investments (outside of REITs).

In the foreign equity portion of portfolios, we have taken on a more aggressive approach since we believe markets and many (not all) economies have a relatively more favorable outlook relative to the U.S. We continue to have an emphasis on foreign small-/mid-cap stocks, where we see active management benefitting from a large opportunity set and widening dispersion in equity markets and corporate results. We also continue to remain convicted in emerging markets equities where the short-term picture showed signs of improvement in the first quarter. A few of the more notable developments included:

- The dramatic shift by the Fed made it less likely that there would be a continuation of U.S. dollar strength, which was a significant detractor to emerging markets equities results for most of 2018.
- A U.S./China trade deal began to appear more likely than it had at the beginning of the year. Tariffs on Chinese goods were temporarily suspended, and dialogue between the two countries remained productive.
- Stimulus measures implemented by China in 2018 began to bear fruit over the latter part of the first quarter into April as loan growth, sales growth and industrial activity all saw sizable turnarounds. See the chart below for a comparison of the Manufacturing Purchasing Managers Index (PMI) for emerging markets relative to developed markets. PMI is a gauge of economic trends in manufacturing. As a general rule, values above 50 reflect expansion, while values below 50 signal contraction.

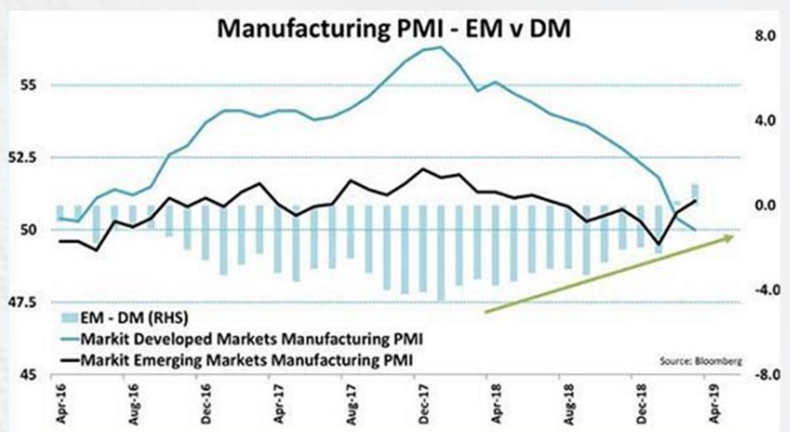


Chart courtesy of 361 Capital Market Commentary (April 8, 2019)

If the data continues to trend this way, it points to the possibility that China, many other emerging markets countries, and select developed foreign markets may begin to recover from this point while the U.S. deals with weak growth. This would be the exact opposite of what has occurred for much of the past few years. From a longer-term perspective, the economic/demographic picture for many emerging markets remains bright. Many of these countries have relatively smaller current account deficits, larger foreign exchange reserves, and more flexible currencies than they have had historically. Additionally, corporate earnings have recovered, stocks are more attractively priced relative to developed markets (in aggregate), the outlook has improved for their currencies (in aggregate) relative to the U.S. dollar and investment flows have remained supportive even in the face of global equity market weakness (what occurred in the fourth quarter of 2018).

Fixed Income Portfolio Comments

Fixed Income Market Results

Fixed income returns were positive across the board in the first quarter as interest rates and spreads (yield difference between a Treasury bond and a similar maturity bond in another category) were both lower. Below investment grade corporate bonds led the way with a return of +7.40%. Emerging markets bonds and investment grade corporate bonds also generated solid returns of +3.93% and +5.01%, respectively. U.S. Treasury bonds ended the quarter with a return of +2.18%.

The Fed's shift to a more dovish (accommodative monetary policy typically defined as lowering interest rates or leaving interest rates unchanged) stance helped lead to a significant rally in credit spreads, which finished lower across the board in the first quarter. Due to their significant sell-off in the fourth quarter of 2018, the riskiest credit sectors recovered the most. Below investment grade corporate bonds led the way, as spreads declined -135 basis points (1.35%). Emerging market debt also had an impressive quarter, declining -67 basis points (0.67%). Other sectors of note include investment grade corporate bonds and non-agency commercial mortgages, which declined -34 basis points (0.34%) and -22 (0.22%) basis points, respectively.

Municipal yields declined in the first quarter, thanks to the dovish pivot by the Fed and record inflows to tax-free mutual funds. For the quarter, 10-year municipal yields fell -43 basis points (0.43%). At the same time, 2-years yields were down -28 basis points (0.28%), which resulted in a flatter municipal yield curve. The riskiest municipal bonds performed the best in the first quarter, as duration and credit exposure were important performance factors. Bonds with longer-dated maturities outperformed bonds with shorter maturities. For instance, bonds with maturities 22 years and longer, generated a 3.85% return, while bonds with maturities between 1-5 years generated a return of 1.33%. Similarly, lower-rated, or high-yield municipal bonds, outperformed AAA-rated bonds, as the categories returned 3.83% and 2.67%, respectively.

Fixed Income Market Comments

Looking ahead, many of the headwinds that plagued fixed income markets in the fourth quarter faded. In particular, the Fed's pivot to a more patient stance significantly lowered the probability of a recession over the short-term (6-12 months). If the Fed is done hiking rates this cycle, and follows through on its announced plans to end the balance sheet run-off in September, it lowers the probability of a recession over the medium-term (12-36 months). However, since monetary policy typically takes 12-18 months to influence the economy, there is a chance the Fed has already tightened too much.

Headwinds also appear to have lifted outside of the U.S. China announced its intention to support growth. Its central bank reduced the reserve requirement ratio by 1% in January, which should lead to credit expansion. It also announced a series of fiscal measures, including a 3% cut on the consumption tax, which should boost the consumer over the coming months. Other central banks have also taken steps to ease policy stances. At the March European Central Bank (ECB) meeting, it introduced additional stimulus by extending cheap loans to banks and also extended a commitment to keep rates low. These developments may support global growth over the short-intermediate term.

Finally, the U.S.-China trade war seems to be de-escalating. The negotiations have started to focus on some of the more difficult issues, including China's practices on intellectual property, technology transfer and non-tariff barriers. This suggests we may be nearing an agreement in the coming months.

U.S. Interest Rates

At the March FOMC meeting, the Fed left rates unchanged at 2.25%-2.50%. Its forward guidance reduced the expectation for hikes in 2019 from two to zero. The Fed left open the possibility for one rate hike in 2020. It also announced an end to the balance sheet run-off in September, earlier than previously expected. This may keep the front end (shorter maturities) of the U.S. Treasury yield curve fairly stable over the short-term (6-12 months). Based on the probabilities we have assigned to likely economic scenarios, we believe fair value for the 10-year Treasury is between 2.80%-3.20%. It ended 1Q19 at 2.41%, which is slightly below our fair value range.

Yield Curve

Due to our belief that the front-end of the yield curve will be relatively stable (over the short-term) and fair value for the 10-year treasury is between 2.80%-3.20%, we expect the yield curve to have a modest steepening (long-term yields higher than short-term yields) bias.

Sector & Quality Management

Overall, we believe we are late-cycle, but not at the end of the cycle, which makes credit investing prudent. However, we believe being careful with our allocation makes sense at this point in time. We favor securities that are higher in quality across asset classes.

In spite of a slowing economy, the municipal market continues to have a solid fundamental backdrop. On the income side, it is expected that state and local tax revenues will continue to increase in 2019. On the liability side, municipalities have not increased their debt burdens nearly as much as other areas of the economy, which makes their balance sheets much more attractive over the intermediate-term. However, we are aware that rising pension and health care costs may present long-term challenges. The pension reform process has started in select areas, but there is still a long way to go across much of the country. To meet these rising fiscal challenges, municipalities will have to focus on both sides of the equation and find additional tax and other revenue sources. On the technical side, demand is likely to remain steady, as the aging U.S. population gravitates toward the relative safety and tax benefits of municipals.

Investment Vehicle Selection

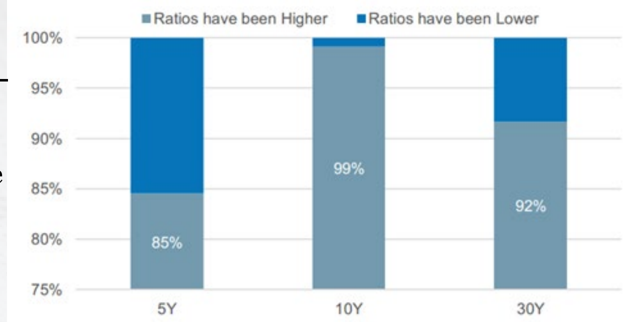
At this point in the economic and credit cycles, we continue to see idiosyncratic opportunities as the best way to add value. Sectors that we believe offer the most opportunity are non-agency mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities and municipal bonds. We are also finding significant value in the illiquidity premiums offered in insurance-linked securities and infrastructure debt.

Client Portfolio Impact

- In early 1Q19, as growth was slowing and yet to stabilize, we added high quality longer-term bonds to client portfolios. This moved client portfolios from having a shorter duration compared to their respective benchmarks to approximately neutral duration. The move benefitted client portfolios as rates continued to decline throughout the quarter. Based on the combination of fair value and being in the late stages of the business cycle, we plan to keep client portfolios close to their benchmarks from a duration perspective over the short- to intermediate-term. Given our

belief in continued yield curve flattening, on the credit side, we continue to favor short duration assets that can benefit from shorter reinvestment windows. As we look to add duration, we will focus on longer maturity U.S. Treasuries. For similar reasons, we favor a more bulleted yield curve posture (a strategy focused on intermediate bonds versus bonds of all maturities). We still like owning credit in the short-end of the yield curve, but now find intermediate maturities more attractive among Treasuries.

- We continue to expect corporate credit to underperform. Within corporate credit, we prefer short maturity bonds from high quality issuers. Within our income seeking strategies, we are underweight to high-yield corporate credit. We continue to like opportunities outside of corporate credit that we believe offer better late cycle diversification and better risk-adjusted value. Broadly, we like emerging market bonds, securitized assets, mortgage-backed securities, insurance-linked securities and infrastructure debt. Overall, we will likely continue reducing credit exposure in exchange for U.S. Treasury bonds.
- In spite of a solid fundamental backdrop, we are more inclined to reduce public market municipal exposure in our tax-aware strategies than to add because of rich valuations. Public municipal valuations are historically rich relative to Treasuries. For example, the 10-year municipal-to-Treasury yield ratio has been higher than it is currently 99% of the time over the last 10 years. See chart below. We currently favor opportunities in the private and direct origination markets, which is where we have allocated the majority of our municipal positioning.
- We continue to partner with active managers that have expertise in the markets we prefer. We are also selectively investing in individual securities in the markets we can analyze and trade efficiently. As a result, we continue to de-emphasize the use of passive index-based mutual funds and exchange-traded funds on the credit side. We believe the best way to take advantage of the illiquidity premiums offered in the insurance-linked and infrastructure markets is to gain access using interval funds. Interval funds do not offer daily liquidity, as a result they can hold a much higher percentage in illiquid securities than open-end mutual funds. In the closed-end fund space, we are exploring opportunities to add strategies that offer value from an interest rate, credit spread and discount perspective.



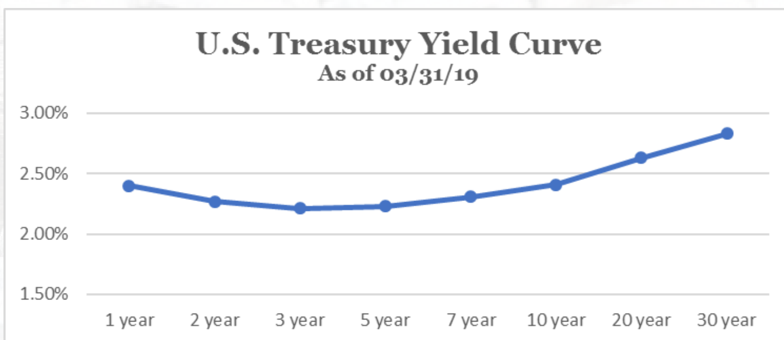
Source: Eaton Vance

Research Focus

The Yield Curve

Did you know that when exposed to toxic gases, canaries and other birds suffer ill effects much sooner than humans? This is because canaries and other birds need immense quantities of oxygen to enable them to fly to heights that would make people altitude sick. Historically, coal miners brought caged canaries into the mines with them. If the canaries stopped singing, or became sick, this was a sign that something was seriously wrong, and the miners needed to get out. In spite of better technology phasing out this practice, the phrase "canary in the coal mine" still lives on as a metaphor for impending danger.

Economists use several indicators to help them predict future economic growth. One of which is the slope of the U.S. Treasury yield curve. A simple description of a yield curve is a plot of interest rates that have the same credit quality, but different maturities. The slope of the yield curve is quantified by taking the spread (difference) between interest rates at different maturities. A chart of the Treasury yield curve as of 3/31/19 is plotted below.



Economists tend to pay close attention to the spread between the 10-year yield and the 2-year yield. The 10-year yield typically incorporates the Fed's overnight policy rate plus a premium for future growth over the period. The 2-year yield typically incorporates the Fed's overnight policy along with expectations for future policy changes. As a result, the yield curve comes in many shapes.

Typically, the yield curve is upward sloping with a spread between the 10-year and 2-year of about 1.00%. This is logical because the difference between growth and the change in interest rates is usually positive. An inverted yield curve occurs when the 2-year yield is higher than the 10-year yield. This happens when the market believes growth will be lower than the change in Fed policy rates.

Mike Peters, CFA
Chief Investment Officer – Fixed Income

Summary

A yield curve is a plot of interest rates that have the same credit quality, but different maturities.

An inverted yield curve occurs when the 2-year treasury yield is higher than the 10-year yield. This happens when the market believes growth will be lower than the change in Fed policy rates.

An inverted yield curve is often referred to as a 'canary in the economic coal mine', due to its accuracy in predicting upcoming recessions.

The Fed's tightening campaign has played a role in economic growth slowing since the third quarter of 2018. The trend has started to stabilize, but since policy typically takes 12-18 months to influence the economy, the "all-clear" signal cannot yet be sent, so we continue to monitor developments closely.

An inverted yield curve is often referred to as a 'canary in the economic coal mine', due to its accuracy in predicting upcoming recessions. Every yield curve inversion since 1977 has been followed by a period of economic contraction. Historically, the average delay between when the yield curve inverts and the first negative GDP report ranges from 10 to 22 months. (See table below.)

Date of inversion	Start of recession	Number of months
09/17/1978	01/02/1980	15.5
09/12/1980	07/01/1981	10
08/11/1989	07/01/1990	11
02/02/2000	03/01/2001	13
02/01/2006	12/01/2007	22

Source: Forbes Recessions and Yield-Curve Inversion: What Does it Mean? 03/29/19

Why is this the case? The data tells us that as the Fed increases interest rates, it slows the use of credit in the system. This happens for two reasons. First, as consumers consider the cost of using credit to make purchases, it becomes less affordable with every increase. Second, as interest rates push higher, financial institutions become less likely to lend due to the combination of lower profits and higher defaults with each marginal loan. As credit growth slows, it weakens demand for goods and services in the economy. It sounds counterintuitive, but this is exactly what the Fed is hoping to do by tightening policy. It is their job to make sure inflation does not get out of control. Their other job is to keep the economy in a steady state of full employment, which is much easier to accomplish with low and decreasing rates based on the logic above. Therefore, they are constantly striving to have policy consistent with a "neutral rate." A neutral rate is defined as one that neither stimulates nor restrains economic growth. Unfortunately, this is a moving target as demographics and technology change. In addition, any changes they make occur at a delay and generally are not felt in the real economy for 12-18 months. This combination of factors has made it difficult for the Fed to orchestrate a "soft landing" once it has started raising interest rates.

Over the last two years, the Fed has steadily increased its policy rate from 0.25% to 2.5%, which has caused the spread between the 10-year and 2-year Treasury yields to fall considerably. As the chart below shows, it narrowed to as low as 11 basis points (0.11%) in December 2018. As of 3/31/2019, the spread was 14 basis points (0.14%). Should we be worried about the yield curve inverting?

Source: Fred.Stlouisfed.org

Despite entering the year with a plan to raise the policy rate by 0.50% in 2019, the Fed is now planning to keep rates where they are for the remainder of a year. This shift in policy should keep the short maturities relatively stable over the short-term (6-12 months). On the growth side of the equation, the Fed's tightening campaign has played a role in economic growth slowing since the third quarter of 2018. The trend has started to stabilize, but since policy typically takes 12-18 months to influence the economy, the "all-clear" signal cannot yet be sent, so we continue to monitor developments closely.

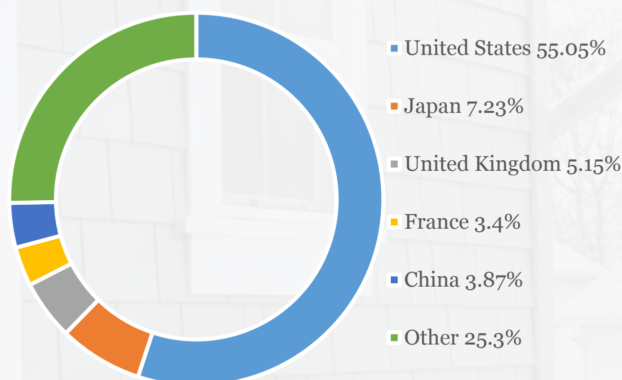
Client Focus

This quarter our Client Focus refreshes a topic we discussed back in 2017 – Home Country Bias.

What is Home Country Bias?

Home Country Bias is the natural tendency for investors to be most attracted to investments in domestic markets. For U.S.-based investors this means having a disproportionately large allocation to investments in the U.S. The general reasons for this tend to be a higher level of familiarity with home markets and an overly pessimistic view of foreign markets.

The MSCI All Country World Index (ACWI) is an example of an equity index that tracks the performance of stocks globally. A quick review of the characteristics of the Index indicates that the U.S. is the largest component of the Index, and it makes up about half of the world's market capitalization.



Our review of a number of historical studies has shown that the average U.S. investor has up to 70% of their assets in U.S. equities – if not more. If you pair this general overweight with our comments in the equity section about valuations and the growth potential of those broad markets, it makes revisiting the topic particularly timely. In short, the average investor is overweight to a market that has outperformed considerably (U.S. stocks have outperformed foreign developed and emerging markets stocks by roughly 55% and 50%, respectively over the last five years), that is more expensive and has lower growth potential. Not an ideal long-term strategy.

What are the general pitfalls of Home Country Bias?

1) Limited opportunity set. Selecting investments should be an exercise in finding the best combination of risk and return potential. Investing based on an arbitrary distinction such as domicile greatly limits the ability of an investor to do that. Consider Apple and Samsung Electronics? Or GM and BMW? Or Proctor & Gamble and Nestle? Or Exxon and BP? Or Wells Fargo and HSBC? The examples are numerous. In each instance, one industry leader is based in the U.S. while the other is based outside the U.S. Limiting the investment opportunity set to one can limit portfolio returns.
2) Reduced diversification. General portfolio theory indicates that blending lowly correlated assets has the potential to reduce volatility and increase return potential. Using the S&P 500® Index as a proxy for U.S. stocks, MSCI EAFE® Index as a proxy for developed market non-U.S. stocks and the MSCI Emerging Markets Index as a proxy for emerging markets stocks, the five year correlations of U.S. to non-U.S. developed and emerging markets stocks have been 0.81 and 0.64, respectively. This indicates an opportunity for diversification benefits.

Understanding these general facts, our approach in client portfolios is to begin with a review of the sub-asset class weights of a broad global benchmark such as MSCI ACWI and then let our fundamental analysis determine if the conclusions are justified, or if we should consider over- or underweighting certain sub-asset classes. This work is what drives our broad portfolio positioning.

Our Team

Bob Batchelor, CFA
CEO
Co-Founder

Bob J. Batchelor, CFA is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 20 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee.

C.J. Batchelor, CFA
CIO – Equity
Co-Founder

Charles J. (C.J.) Batchelor, CFA is Co-Founder and Chief Investment Officer – Equity of Entasis Asset Management. C.J. has 15 years of experience in the investment industry. Prior to founding Entasis, C.J. worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Director of Investment Research. He also served as a member of Cleary Gull's Investment Policy Committee, Investment Committee and Equity Strategy Group.

C.J. holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. C.J. is a member of the CFA Institute and CFA Society of Milwaukee, where he currently serves on the Board of Directors.

Mike Peters, CFA
CIO – Fixed Income
Co-Founder

Mike Peters, CFA is Co-Founder and Chief Investment Officer – Fixed Income of Entasis Asset Management. Mike has 15 years of experience in the investment industry. Prior to founding Entasis, Mike worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Fixed Income Portfolio Manager. In his role he served as voting member of Cleary Gull's Fixed Income Strategy Group and Complement (Alternative) Strategy Group. Before Cleary Gull, Mike worked for several years at Madison Investment Advisors, a multi-billion dollar asset management firm, as a Fixed Income Analyst.

Mike holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. Mike is a member of the CFA Institute and CFA Society of Milwaukee.

David LaCroix
Senior Financial Advisor

David D. LaCroix is a Senior Financial Advisor at Entasis Asset Management. David has more than 45 years of experience in the investment industry. Prior to joining Entasis, David worked at Cleary Gull Advisors, a Johnson Financial Group Company, and Cleary Gull Inc., a prior affiliate of Cleary Gull Advisors, where he most recently served as Vice President, Relationship Manager responsible for high net worth clients. Before Cleary Gull, David worked in a variety of portfolio management and client relationship management positions with A.G. Edwards and M&I Capital Markets Group.

David received his M.B.A. and B.B.A. in Finance from the University of Wisconsin-Madison. He has served as a member of the Archdiocese of Milwaukee Investment Committee, as a Trustee for the Village of Shorewood and as Director/Treasurer of Milwaukee Summerfest.

IMPORTANT INFORMATION

Statements may be forward looking and are not intended as specific investment advice without further review of individual circumstances. Commentary, opinions, analysis, and recommendations may be subjective, do not guarantee future performance, and could change at any time without notice. Under no circumstances does the information contained within represent a recommendation to buy or sell any security. Charts and graphs provided are for illustrative purposes only.

This information is provided for informational purposes only and does not constitute individualized financial advice or create an advisor-client relationship. This newsletter is published for the exclusive use of our clients and friends and is not intended as investment, legal or tax advice. This newsletter was prepared using information from third-party sources, which we believe to be reliable; however, we have not audited the data from these sources and are not responsible for its accuracy.

The **Dow Jones Industrial Average℠** is a price weighted index that measures the performance of thirty component large-cap U.S. stocks. The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. The **Russell 1000® Growth** Index measures the performance of U.S. large-cap companies with higher price/book ratios and forecasted growth values. The **Russell 1000® Value Index** measures the performance of U.S. large-cap companies with lower price/book ratios and forecasted growth values. The **Russell 2000® Index** measures the performance of roughly 2,000 U.S. small-cap companies. The **MSCI EAFE® Index** is a market capitalization weighted index that is designed to measure the performance of developed markets, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a market capitalization weighted index that is designed to measure equity market performance of emerging markets. **The MSCI ACWI Ex USA Small Cap Index** is a market capitalization weighted index that represents the performance of smaller capitalization companies in developed and emerging markets excluding the U.S.

The **Barclays Aggregate Bond Index** tracks the performance of intermediate-term government bonds, investment grade corporate debt securities and mortgage-backed securities with at least one year to final maturity. The **Barclays Intermediate U.S. Gov/Credit Index** tracks the performance of intermediate U.S. government and corporate bonds. The **Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

The **BoAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities in the U.S. domestic market. The **BoAML Treasury Master Index** tracks the performance of the direct sovereign debt of the U.S. Government. The **BoAML U.S. Mortgage Back Securities Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. market. The **BoAML U.S. Corporate Master Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The **BoAML High Yield Master II Index** is a broad based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding of $100 million and maturing over one year. The **BoAML All Convertibles All Qualities Index** measures convertible securities' performance of U.S. dollar denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance. The **BoAML Euro Broad Market Index** gives exposure to euro-denominated investment grade debt publicly issued in the Eurobond or euro member domestic markets including government, quasi-government, corporate, securitized and collateralized securities. The **BoAML Local Debt Markets Plus Index** is a broad composite designed to track the performance of local currency sovereign debt of emerging markets countries.

Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

Investment Terms

Valuation levels are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to $1/100^{th}$ of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

Copyright ©Entasis Asset Management. All Rights Reserved.

To learn more please visit us at
www.EntasisAM.com

CONTACT US
Entasis Asset Management
300 N Corporate Drive
Suite 220
Brookfield, WI 53045
262-794-5299
Info@EntasisAM.com

FOLLOW US

DOWNLOAD OUR APP