VALOR ASSET MANAGEMENT of GREAT VALLEY ADVISOR GROUP

Market and Economy Thoughts

By: Lee R. Johnson, Jr., CFA | Chief Investment Officer | December 14, 2018

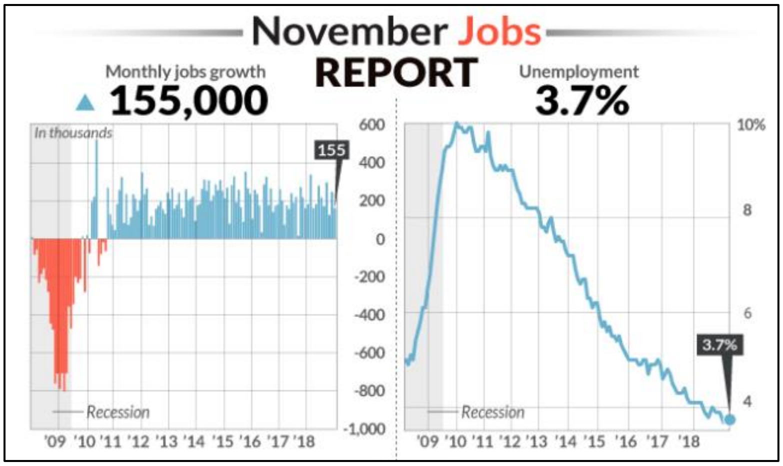
As we approach the end of 2018, I thought it would help to provide some thoughts on the market activity we've been seeing since October. It's been rough to say the least. Last week was another roller coaster and this week has been no different. Here are a few thoughts from my end:

1. **Volatility** – it has certainly shown its face in 2018 and reminds me of the movie Groundhog Day with its pattern of repeatability. It just won't go away! I wrote more on this in the document "Prepare to Surface!" so please take a look at that. In a nutshell, trends on the VIX[1,3] and VVIX[2,3] may be hinting at better days ahead. But we should expect volatility to remain as the trends also show us a market in transition which naturally brings volatility. That said, these trends are showing us signs for optimism, albeit *cautious optimism,* as we begin the new year.

2. **Market Swings** – it's become more of the norm lately to see wild market swings. To me, this simply means the market is trading more on "noise" than the fundamentals. In other words, the market is trading on the news of the day. For example, last week the markets traded up on Monday as news out of the G20 summit was positive. Then on Tuesday, downgrades in the Transportation sector did not do us any favors as the market fell big. On Wednesday, the market was closed for President Bush's funeral. On Thursday, we saw quite a swing in the Dow[4] with it down 800 at the beginning of the day to up 780 intra-day to finishing slightly up for the day. These types of swings in the market can only be explained by algorithms and high frequency trading machines taking over to the tune of a 1,500 point swing in one day! Then last Friday we had a "negative" jobs report[5] but the numbers were not all that bad if you put everything into perspective in terms of the country's historically low unemployment rate[6] at this time. And on Monday stocks tanked on British Prime Minister May's announcement to delay the Brexit vote and then on Tuesday the market opened up on trade hopes until President Trump clashed with Democrats on border security and government shutdown at which point it turned down. But then it rallied into the close which followed through to the open on Wednesday as the Dow closed 150 points up for the day. Then on Thursday the market could not find a direction as it struggled for more news on trade and ultimately finished mixed. That followed through to Friday with the Dow down 400 points as I write this on economic news out of China. As you can see, we are experiencing a roller coaster here but you have to expect that given the volatility we've seen lately, including the volatility we saw at the beginning of the year. You also have to be disciplined enough to put it all into perspective around the fundamentals and economic backdrop of our great country. This is what we do at Valor Asset Management.

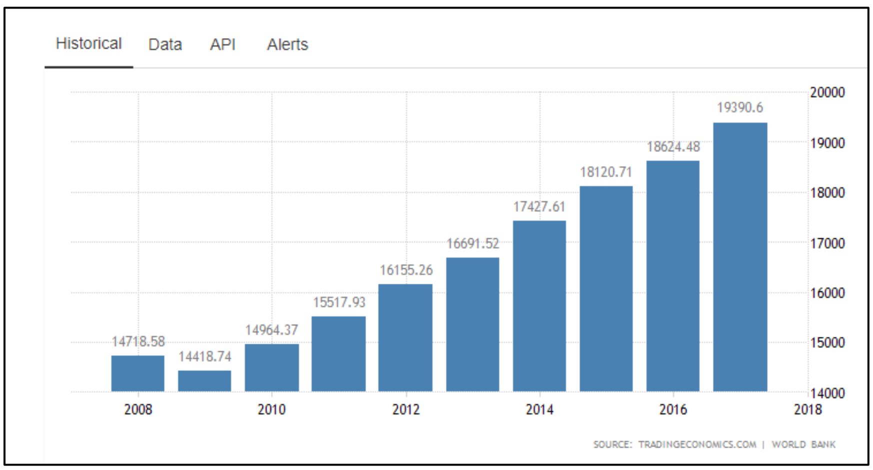
3. **Recession?** - The jobs report[5] last Friday came in lower than expected but let's keep in mind the unemployment rate is still at all-time historic lows (a 49-year low), we don't have any bank failures, inflation[7] and gross domestic product[8] (GDP) growth are healthy, we don't have any subprime disasters[9] and there are no countries on the verge of failure or in desperate need of a "QE bailout" [10]. Instead, we have better capilized banks, we have pre-tax corporate profits up 10.3% from a year ago[11] (and up 19.4% after taxes – the effect of tax cuts) and we have the latest real GDP growth rate growing at 3.5% for the 3rd quarter[12]. As a frame of reference, I point to the following three charts and ask do they make it look like the economy is struggling?

United States November Jobs Report (source: Bureau of Labor Statistics):[5,6]

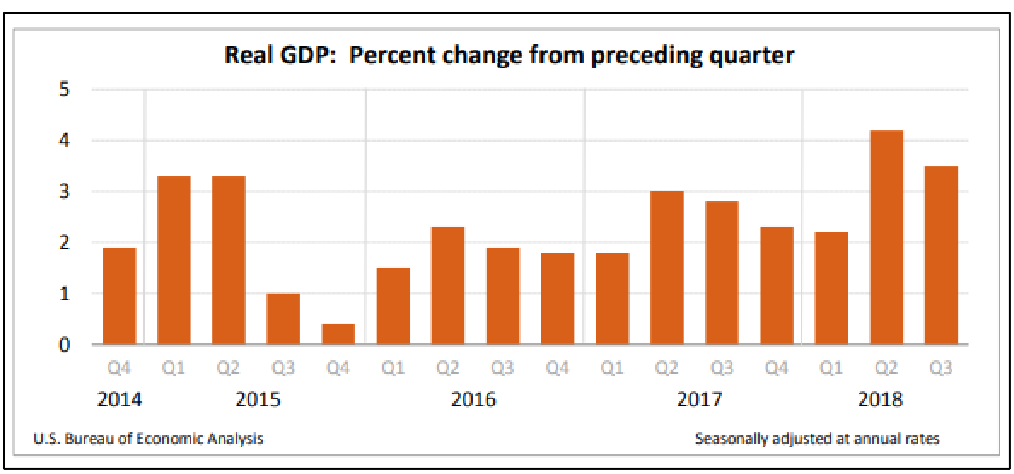


Source: Bureau of Labor Statistics

United States GDP by calendar year (source: TradingEconomics.com):[8]



United States Real GDP Growth (percent change) by quarter (source: US Bureau of Economic Analysis):[12]



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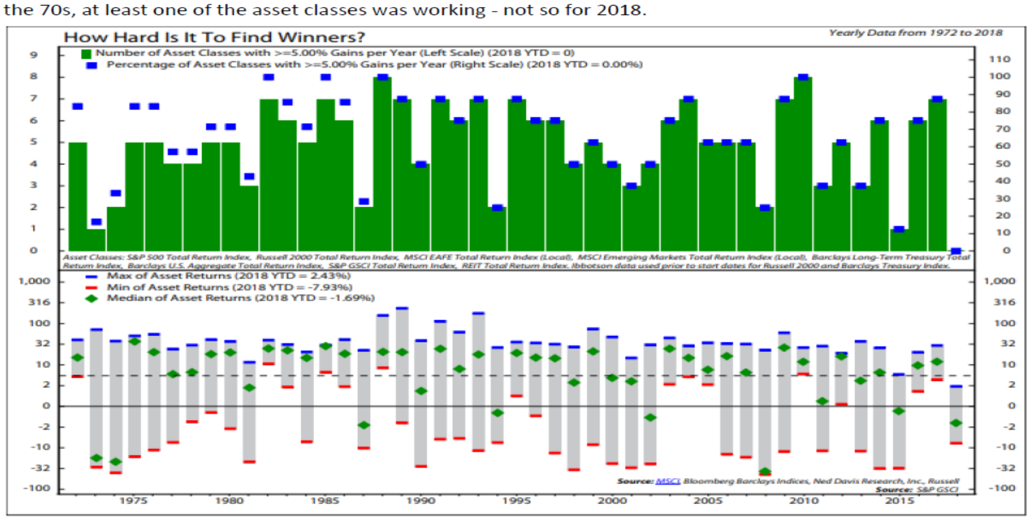
4. **China and the Trade War** – as of December 1, we are on a 90-day truce with China amidst further trade talks. President Trump continues to hint the talks are going well yet the market is still antsy about it. Here is what he tweeted last Friday morning but the market responded in the red closing 600 points down on Friday:

5. **Is it really that bad?** - What does all of this mean? In my mind, this simply means that investors are panicking for really no reason at all and are trying to find something to latch onto daily to find an excuse to sell. Have you ever heard the expressions "don't throw the baby out with the bathwater"? Well it seems like this market is doing just that – it is ignoring all the good this market and the economy have to offer – i.e. tax cuts, deregulation[13], repatriation[14], share buybacks[15], small business optimism remains high[16], ISM manufacturing consistently above the expansive baseline of 50[17]. I am not saying we are all blooming roses as we sit here in December as there are certainly areas of concern like housing, corporate debt and the price of oil in a freefall (which has actually started to rally on supply cuts and falling inventories as I write this). But it seems to me there is more good out there than bad and that nets to good. Only time will tell, but if the economics and fundamentals can hold their own outside of the daily headlines, then the potential is there for good things to happen.

6. **Final Thought** - I saw this chart on a recent "Market Outlook" dated December 7, 2018 and published by Hays Advisory which we subscribe to. It certainly tells the story about diversification in 2018. It has been a challenging year to say the least. Here's to bucking the trend in 2019 and getting those asset classes back on track for our models!

Chart – Diversification Disappointment

While 2018 isn't breaking any records to the downside, it's on pace become one of the most anemic on record for asset classes, without a single asset class exceeding a 5% return. In every other environment going back to the 70s, at least one of the asset classes was working - not so for 2018.



Source: Bloomberg, NDR

Notes and Disclosures:

1. The **CBOE Volatility Index® (VIX®)** is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction. It is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge". Put another way, the VIX® is like the speed of a car.

2. The **VVIX** is a volatility of volatility measure that represents the expected volatility (i.e. the rate of change) of the 30-day forward price of the CBOE Volatility Index (the VIX®). It is essentially the "VIX® of the VIX®". Put another way, where the VIX® is like the speed of a car, the VVIX is like its acceleration.

3. The **VIX® and VVIX** are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

4. The **"Dow"** is short for the Dow Jones Industrial Average. It is an index of 30 stocks of companies that represent a proxy for the US Economy. It is a "price weighted" index meaning stocks with higher share prices are given a greater weight in the index.

5. The **"jobs report"** is a report that is released by the Bureau of Labor Statistics every month. It communicates the status of the employment situation in the United States by identifying the change in total nonfarm payroll employment and the unemployment rate for the country. Nonfarm payroll employment is a compiled name for goods, construction and manufacturing companies in the US.

6. The **unemployment rate** is the share of the labor force that is jobless, expressed as a percentage. It is a lagging indicator, meaning that it generally rises or falls in the wake of changing economic conditions, rather than anticipating them. When the economy is in poor shape and jobs are scarce, the unemployment rate can be expected to rise. When the economy is growing at a healthy rate and jobs are relatively plentiful, it can be expected to fall.

7. In economics, **inflation** is a sustained increase in the general price level of goods and services in an economy over a period of time. For example, a loaf of bread may have cost 10 cents 50 years ago but today it costs two dollars.

8. **Gross domestic product** (GDP) is the value of the goods and services produced by a nation's economy less the value of the goods and services used up in production. GDP is also equal to the sum of personal consumption expenditures, gross private domestic investment, net exports of goods and services, and government consumption expenditures and gross investment

9. The United States **subprime mortgage crisis** was a nationwide financial crisis, occurring between 2007 and 2010, that contributed to the U.S. recession of December 2007 – June 2009. It was triggered by an influx of lending to **subprime** borrowers - individuals with poor credit scores (640 or less, and often below 600), who, as a result of their deficient credit histories,

would not be able to qualify for conventional mortgages. Large declines in home prices ultimately led to mortgage delinquencies and foreclosures and the devaluation of housing-related securities. Declines in residential investment preceded the recession and were followed by reductions in household spending and then business investment.

10. **Quantitative easing or "QE"** is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. It essentially increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

11. **Corporate Profit Data** is a set of data that tracks corporate profits; defined as the net income of corporations in the National Income and Product Accounts (NIPA). Many of the key aggregate variables used to describe an economy are presented in a country's National Income and Product Accounts (NIPA). National income represents the total amount of money that factors of production earn during the course of a year. This mainly includes payments of wages, rents, profits, and interest to workers and owners of capital and property. The national product refers to the value of output produced by an economy during the course of a year. National product, also called national output or the Gross Domestic product (GDP), represents the market value of all goods and services produced by firms in a country. The data is obtained from the Bureau of Economic Analysis at this link:

https://apps.bea.gov/iTable/iTable.cfm?reqid=19&step=3&isuri=1&1921=survey&1903=239#reqid=19&step=3&isuri=1&1921=survey&1903=239

12. **Real GDP growth** is a measure of the rate of change of a country's Real GDP which is a macroeconomic measure of the value of economic output excluding any price changes of that product (i.e. inflation or deflation). For example, if a loaf of bread cost 10 cents 50 years ago and today it costs two dollars, the real GDP does not account for this price increase (inflation). It only accounts for the production of the bread, or how many loaves were produced 50 years ago vs. today. The latest data for Real GDP growth is obtained from the Bureau of Economic Analysis at this link:

https://www.bea.gov/news/2018/gross-domestic-product-third-quarter-2018-second-estimate-corporate-profits-third-quarter

13. **Deregulation** is the reduction or elimination of government power in a particular industry, usually enacted to create more competition within the industry. Over the years, the struggle between proponents of regulation and proponents of no government intervention have shifted market conditions.

14. **Repatriation**, in finance, refers to converting any foreign currency into one's own local currency. Repatriation sometimes becomes necessary due to business transactions, foreign investments, or simply due to international travel. In the US, the Tax Cuts and Jobs Act, signed into law in late 2017, cut the corporate repatriation tax from its former rate of 35 percent. For a

limited time, the new law allows U.S. companies to repatriate money earned overseas at rates as low as 8 percent. For example, at the time that the law was passed, Apple had the largest amount of cash holdings abroad of any US company, totaling $252.3 billion. As a response to the new tax law, Apple agreed to a one-time tax payment to the IRS of $38 billion to repatriate its foreign cash holdings (https://www.wsj.com/articles/apples-tax-payment-could-set-off-repatriation-trend-1516231474).

15. A **share buyback** is a program by which a company buys back its own shares from the marketplace, usually because management thinks the shares are undervalued, and thereby reducing the number of outstanding shares.

16. The NFIB (National Federation of Independent Business) Research Foundation has collected **Small Business Economic Trends** data with quarterly surveys since the 4th quarter of 1973 and monthly surveys since 1986. One of the data points they distribute is the **Small Business Optimism Index** which is a set of data collected from survey respondents that are drawn from NFIB's membership. The report is released on the second Tuesday of each month. The latest report for November may be obtained at this link:

https://www.nfib.com/assets/SBET-Nov-2018.pdf

17. The **ISM (Institute for Supply Management) Manufacturing Index** is based on surveys of more than 300 manufacturing firms by the ISM. The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. The latest report for November can be obtained here:

https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm?SSO=1

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