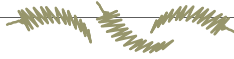
C Y P R E S S

ASSET MANAGEMENT, INC.



MARKET COMMENTARY **October, 2018**

The S&P rose 7% in the third quarter and was up 10% year-to-date through the end of September. Information Technology, Consumer Discretionary, and Healthcare have led the market by a large margin in 2018, while all other sectors are either slightly negative or up low single digits on the year. As a result, a large number of stocks have been lagging the headline index and beneath the surface performance has been uneven. Moreover, the spread between U.S. market performance and struggling foreign markets has been unusually wide.

Market Balance Sheet

POSITIVE	NEUTRAL	NEGATIVE
Interest Rates →	Dollar	
Economic Growth	Energy Prices	Trade Tensions
	Valuation	
Fiscal Policy		Geopolitical Stability
Inflation →		
Profit Growth/Margins		Budget Surplus/Deficit
←	Productivity	
Employment ←	Market Sentiment	
Monetary Policy/Liquidity →		

Positive Economic Milestones:

1. *The U.S. unemployment rate fell in September to its lowest level since 1969 (3.7%).*
2. *The WSJ reported that world poverty has fallen to a record low of 10% of the world population, down from almost 40% in 1990 when the world bank began collecting global statistics.*

October Winds

The sharp market sell-off during the first two weeks of October is not entirely unexpected given the market dynamics described above and is likely not the end of the bull market. The proximate cause of the correction was hawkish commentary from Fed Chairman Powell suggesting a potentially more aggressive path on rate hikes given the strength of the domestic economy. The yield on the 10-year Treasury rose rather abruptly from about 3% to above 3.2%, and stocks followed suit in a broad and one-sided sell off.

We witnessed a similar 9% pull back in early February when bond yields increased 20 basis points on inflation fears. The market is still going through a process of adjusting to tighter monetary policy and higher rates, and it periodically can become fearful that the Fed will over tighten.

The fundamental backdrop for equities remains quite positive: Fed Funds rate still below 3%, bond yields below 4%, and inflation still running below 3%. The recent correction of almost 8% will probably prove temporary. Corporate earnings growth should be strong in both the 3Q and 4Q and supportive of equity valuations. Lower stock prices in combination with increasing earnings has made equity valuations more attractive. The S&P 500 currently trades at about 15.5 times 2019 consensus earnings, broadly in line with the 50-year market average.

Bad News is Good News

The market wants a Goldilocks economy that runs neither too hot or too cold. In other words, moderate growth that is enough to sustain the expansion and that has low inflation, which allows a market friendly monetary policy. Given the length of the ongoing economic expansion and the recent acceleration in growth, together with historically strong consumer and employment numbers, we have reached the point where bad news is actually good news, and vice-versa. If anything, the growth of the U.S. economy is too robust.

A modest cooling in economic data that reduces fears that it will overheat, but leaves earnings expectations largely unchanged, will ease pressure on the Fed. The number one concern of investors today is that the Fed will over tighten and hike rates too aggressively, choking off growth and leading to a potential recession.

The "bad news is good news" scenario was very prevalent in the market from the mid 1980's to 2000. It is a typical characteristic for a mid to later cycle economic expansion. Bad or "cooler" economic news showing the U.S. economy running "cooler rather than hotter" encourages the Fed to moderate. Given Wall Street logic, the normal reaction to strong reports on the economy is to push up bond yields. Again, this is typical Wall Street behavior in the latter half of an economic expansion. A cooler running economic engine will run longer and require fewer rate hikes and carries a reduced risk of a "blow up". All of this is good for stocks and would improve the near-term market backdrop.

In this context, it should be mentioned that recent inflation readings have been generally restrained and bond yields have settled back down somewhat. We continue to believe that the next U.S. recession is a good distance away.

China – U.S. Tensions Rise: A New Global Reality

The U.S., as the world's predominant economic and military power, finds itself increasingly in geopolitical conflict with the rising economic and military power of China. This makes resolution of the trade war, one aspect of the conflict, much more difficult to achieve.

In the western pacific rim and China Seas, China is increasingly resisting traditional U.S. Naval and military aircraft exercises over international space. There are reports of cyber-attacks on the U.S. and spyware implants into tech products sourced from China. Another flashpoint is the China "Belt and Road" initiative involving infrastructure and business development investments in Europe, Asia and Africa. This is a strategic undertaking to push for China predominance in global commerce and a China-controlled trading network and poses a challenge to American global leadership in trade and commerce. By way of illustration, there are now 40,000 Chinese living and working in Kenya in support of local Chinese

companies and investments. A recent NY Times article discusses the increasing discomfort of Kenyans with the growing China presence. Is China becoming a 21st century colonial power…

There is also a developing competition between the U.S. and China for tech dominance. China is rapidly becoming a formidable competitor in software, internet, AI, and aerospace and defense electronics. China continues to be adept at theft of intellectual property and technology, and our companies have been willing collaborators in this process in their pursuit of the huge China market. We continue to supply China with the technology they could eventually use to dominate us with. Even though China is no longer a communist country, the famous quote attributed to Lenin is called to mind: “The capitalists will sell us the rope with which to hang them.”

The result of this growing geopolitical competition between China and the U.S. is an increasingly complicated and fractured relationship. All of this means it will be difficult to resolve the trade war and it may be with us for some time to come, perhaps years. It is a different animal than the trade disputes with our NAFTA and European allies where agreements were reached in reasonably short order. The market has finally accepted that it will not be resolved any time soon.

The growing geopolitical competition between the U.S. and China has important differences with the Cold War. The Soviet Union and its Eastern Bloc of allies operated in an essentially closed system and the global economy was not as interrelated during the years from 1947-1991. And unlike Russia, China has a large and educated population, a dynamic and diversified economy, and is an economic force and full participant in the global economy in every sense.

A better analogy might be a return to the European balance of power that defined international relationships during the 19th and early 20th century. The European colonial powers competed globally for economic and geopolitical advantage. But there was considerable cooperation and mutual shared interests between the major powers, along with a system of shifting alliances to maintain the balance of power, that helped to ensure a long period of both peace and economic progress.