UNCOMMON SENSE

January 2019

Three Surprises for 2019: Wash, Rinse, Repeat

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"I'd rather be lucky than good."

— Lefty Gomez

Each January since 2016, I have forecasted three surprises for the market. These Uncommon Sense articles continue to be the most widely read every year. Odd, because most market watchers claim that investors don't like surprises. But, every investor likes the promise of a hot investment tip. It's the perfect blend of investor overconfidence and optimism. Overconfident in both their own predictive power and the precision of their information, investors believe that they are smarter and have better information than they actually do. And investing based on this perceived knowledge advantage, they tend to be overly optimistic about the potential for positive performance and fail to consider possible negative outcomes.

After my three surprises for 2017 and 2018 went a perfect six-for-six, perhaps I surrendered to that powerful potion of overconfidence and optimism for my 2018 selections. Alas, I am only human. Although my three surprises forecasts have been dead-on seven of nine times over the last three years, I went just one-for-three in 2018.

Keep It Simple, Stupid

Reviewing my track record of predicting surprises raises some interesting questions. How much confidence should investors put in my forecasting ability? Should they put more emphasis on my very respectable three-year history or my disappointing 2018 results? The simple answer to these questions is that neither my longer-term successes nor my shorter-term failings matter much. There just isn't enough information to determine if my record is based on dumb luck or great skill. Many more observations would be needed to determine whether I am lucky or skillful.

In 1971, Amos Tversky and Daniel Kahneman wrote an influential paper, "Belief in the Law of Small Numbers," that found with small sample sizes people have "strong intuitions" that are "wrong in fundamental respects." They noted that we have a tendency to believe that a small sample of a population represents the whole population. This doesn't mean that skill doesn't figure in my ability to forecast three surprises each year. It might very well be skill. It just means that we need a larger number of observations to determine if skill can overcome the influence of luck.

Investors receive hundreds, maybe thousands, of outlooks, predictions and lists this time of year. Woe is me. Despite my own skepticism about predictions, as a chief investment strategist, I'm forced to participate in this vain exercise. But, you dear reader, you are not. So, each January while slavishly writing about the three surprises, I take the opportunity to remind investors of one of the most important investment lessons. Investors can never control investment outcomes, but they can always control the investment process.

As a result, the formula I use to identify potential surprises each year has remained consistent and disciplined. I limit the number of surprises to three. Trying to predict too much is a recipe for failure. The time horizon is short—just one year. Lastly, I look for unloved assets with compelling valuations where bad news is already priced in and investor opinion on the asset is decidedly one-way. Assets that exhibit these characteristics are ripe for surprises. Regardless of an investor's forecasting ability, a consistent, disciplined process is the key to investing success.

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2018 in Review: Better Luck Next Year

Before revealing my three surprises for 2019, let's briefly review my 2018 results. Admittedly, it was more fun bragging about my 2016 and 2017 successes than eating crow for my 2018 disappointments. Now, let me tell you how I snatched defeat from the jaws of victory with last year's predictions:

1. US Retail Stocks Rebound

With just 30 trading days left in 2018, the S&P Retail Select Industry Index was outpacing the S&P 500 Index by 1.5 percent. At the end of August the retail index was besting the broad market by roughly 6 percent. But in the only true measure that matters for our purposes, on December 31, 2018 the retail index trailed the S&P 500 by 3.5 percent. Sadly, neither the retail index nor the S&P 500 provided investors with a positive absolute return for the 2018 calendar year. And, of course, as bad luck would have it for me, the retail index is outperforming the S&P 500 by about 2 percent in the early going of 2019. Thankfully, both have had positive overall returns in the first two weeks of trading.

2. Growth Stocks Beat Value Stocks…Again

At the end of 2017, the performance gap between growth stocks and value stocks reached its highest point since the dot-com bubble. As 2018 began, higher economic growth, rising interest rates, tighter monetary policy and increasing inflation expectations convinced investors that it was value's time to shine. I didn't see it that way and forecasted that growth stocks would again best value stocks last year. Although neither style index provided investors with a positive absolute return in 2018, the Russell 1000 Growth Index, led mostly by technology stocks, beat the Russell 1000 Value Index by 6.7 percent last year.

3. Low Volatility Persists for Another Year

Yikes! Boy was I wrong about this forecasted surprise. Or was I? I did suggest that compared to the incredibly docile 2017 environment, markets were likely to see more bouts of volatility in 2018. Duh! However, I expected the CBOE Volatility Index (VIX), Wall Street's so-called "Fear Gauge," to remain below its 10-year average. The VIX suffered micro bursts in February, October and December last year while remaining mostly peaceful from March to early October. In fact, the VIX Index average of 16.6 for 2018 did finish below its 10-year average of 18.5. Maybe I'm suffering from my own behavioral biases, but it just wouldn't feel right claiming victory on this forecasted 2018 surprise. Perhaps the rate of change from 2017's highly unusual low volatility environment to 2018's more normal volatility backdrop was just too much for investors to overcome. I'll leave it to you to decide if I got this surprise right in 2018.

Good Things Come to Those Who Wait: 2019 Surprises

Here are my three surprises for 2019:

1. US Fiscal Policy Repeat
2. Financials Outperform the Broader Market
3. Junk Bonds Fail to Rebound for the First Time Ever

US Fiscal Policy Repeat: Will You Still Love Me Tomorrow?

My first surprise for 2019 is that Republicans and Democrats will reconcile long enough to pass fiscal policy legislation this year. Of course, that might be tough to imagine given the current state of affairs in Washington. On December 11, President Donald Trump and Democratic leaders Rep. Nancy Pelosi and Sen. Chuck Schumer had a highly unusual shouting match before cameras in the Oval Office over funding for Trump's campaign promise of a border wall. Later that month, after seemingly waffling for months on whether to shut down the government over more funding for the wall, Trump refused to sign a Senate-passed spending bill that would have kept the government funded through early February 2019. As a result, a government shutdown that began on December 22 is now the longest in US history and it doesn't appear likely to end anytime soon.

In early January, President Trump stormed out of a White House meeting with congressional leaders after Speaker Pelosi said she would not fund a border wall even if he agreed to reopen the government, escalating the confrontation. According to *The New York Times,* stunned Democrats emerged from the meeting in the White House Situation Room declaring that the president had thrown a "temper tantrum" and slammed his hands on the table before leaving with an abrupt "bye-bye." Trump called the exercise "a total waste of time."[1] The latest news suggests that Pelosi has asked Trump to delay his State of the Union speech until the government is reopened while several White House officials are privately advising the president to find a way to end the shutdown. In fact, the administration has invited moderate Democrats and bipartisan members of the Problem Solvers Caucus—those elected on promises that they would work to overcome dysfunction in DC—to meet with the president.[2]

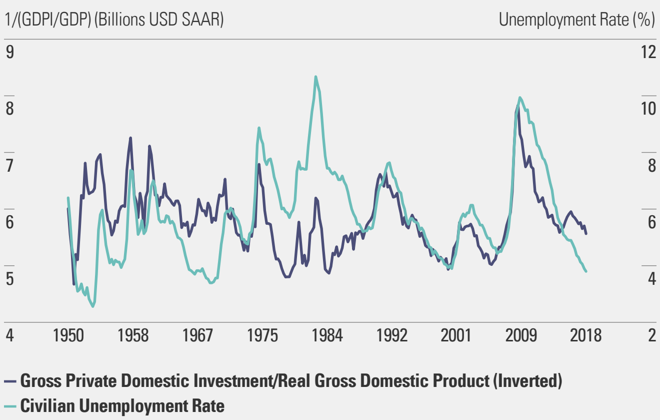
In the face of this ugly political divisiveness, investors are increasingly concerned that the Trump administration, Republicans and Democrats will fail to work together to tackle the country's most difficult challenges. And, who could blame them?

However, I see the Trump administration and the 116th Congress working together before year's end. Disgracefully, it is going to take a slowing US economy and marginally tighter monetary policy just prior to a national election year to unite these scoundrels. They will partner on fiscal policy simply to save their sorry incumbent backsides in 2020.

In fact, it is quite common for the government to grease the skids before a national election. Look no further than the end of 2015. That December, Congress agreed to provide $305 billion to repair and expand highways, bridges and transit over the next five years.[3] In addition, after years of sequestration that capped government spending, a deal between the White House and Congress was reached in 2015 to set spending levels through 2017 to ease budget and spending negotiations ahead of elections in November 2016. That deal included $50 billion in spending increases divided equally between defense and domestic programs for 2016 and an additional $30 billion in spending for 2017.[4]

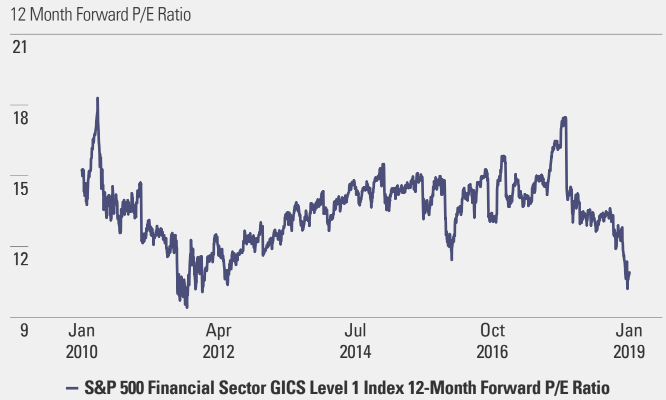
Look for more of the same fiscal policy goodies at the end of 2019. I guess in some ways this surprise should come as no surprise at all. Republicans and Democrats will most likely compromise on increased infrastructure spending. Beyond the obvious winners like materials and industrials, energy is likely to benefit as both parties want to modernize the grid. Here, Democrats will likely focus on clean energy generation and energy storage solutions while Republicans will tend to favor reducing the pipeline backup and increasing power generation. Longer term, greater infrastructure spending also could positively impact real estate by spurring new development.

Figure 1: Sentiment Drives Investment, and Investment Drives the Business Cycle



Source: St. Louis Federal Reserve, State Street Global Advisors as of June 30, 2018.

Figure 2: S&P 500 Financials' Valuations Are at Their Lowest Levels in Years Following Q4's Selloff



Source: Bloomberg Finance, L.P. as of January 15, 2019.

Financials Outperform the Broader Market: Dimon in the Rough

My second surprise is that the financial sector will outperform the broader market. Higher interest rates were supposed to help boost financial companies' profitability last year. The US Federal Reserve held up its end of the bargain by raising the target fed funds rate four times in 2018 and nine times since the end of 2015. Unfortunately, the flattening yield curve spoiled financials' fun in 2018. Most financial companies earn profits by borrowing from demand deposits like savings and checking accounts that pay depositors a low interest rate while lending longer-term at higher rates through mortgages and business and consumer loans. The wider the spread between the interest rate financial companies pay depositors versus the interest rate they collect on the loans, the greater the profit.

Unfortunately, short-term interest rates increased more than long-term interest rates last year, flattening the yield curve and curbing financials' profitability. In addition, attractive relative valuations combined with a less burdensome regulatory environment at the start of last year also led investors to aggressively overweight the financial sector. When things didn't pan out as they planned, investors lost patience with their financial sector positions, withdrawing nearly $9 billion from financial sector exchange traded funds (ETFs) — the greatest outflow of the 11 economic sectors.[5] Financial sector performance wasn't much better, declining 13 percent and trailing the S&P 500 Index by 8.6 percent.

Needless to say, the financial sector is unloved as we enter 2019. Trading at an eye-popping 55 percent discount relative to the broader market based on price-to-earnings multiples, it potentially offers compelling value to investors willing to accept the risk of investing in the sector. According to FactSet, fourth quarter earnings per share (EPS) growth for financials will be more than 10 percent, roughly in line with the market EPS growth rate. Year-over-year net profit margins for financials are likely to eclipse 16 percent, more than 5 percent greater than the year-over-year net profit margin of the market and the third highest of the 11 economic sectors.[6]

As of early January, fourth quarter earnings season is off to a tremendous start for financials in spite of the flat yield curve. Expectations for a flatter yield curve in 2019 will continue to weigh heavily on investor sentiment for financials. However, the Fed has signaled a slowing of interest rate increases in 2019. In fact, 2-year Treasury rates have already fallen from a high of 2.97 percent in November to 2.54 percent more recently. The yield curve may not flatten as much as investors are expecting. Who knows? Maybe it will even steepen some this year and unexpectedly boost financials' profitability.

Junk Bonds Fail to Rebound for the First Time Ever: Ain't No Sunshine

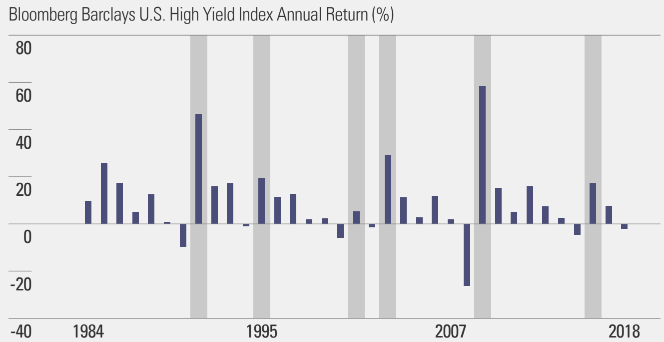
My third surprise for 2019 is that high yield bonds continue to struggle and returns are not likely to be anywhere close to typical results after previous down years. According to Bloomberg, high yield bonds limped into 2019 after suffering from a December selloff that was the worst month for the asset class since 2011.[7] Most high yield experts chalked up the volatility to a liquidity driven event rather than a negative assessment of the asset class' fundamentals. An index of high yield bonds declined about 2.6 percent in 2018.

Despite the losses, strategists have been ratcheting up their forecasts for high yield bonds in 2019. Perhaps they are emboldened because high yield bonds have only suffered an annual loss seven times in the last 35 years and they have never had negative returns in consecutive years. In fact, on average high yield bonds have surged 29 percent in the calendar year following a negative performance year.

A number of additional factors support the positive outlook for high yield bonds. The US economy is likely to grow 2.5 percent this year, corporate profits are rising albeit at a slower pace, the Fed is taking a pause from interest rate hikes, inflation expectations are modest, high yield supply is shrinking and default rates remain low relative to their long-term history. What's not to like?

However, monetary policy conditions have tightened and the Fed may raise rates once or twice this year. Both US economic growth and earnings are decelerating. High yield spreads relative to Treasuries widened last year but remain well below long-term historical averages. This means the

Figure 3: After a Down Year, High Yield Has Rebounded an Average 29%, And Never Declined



Shaded areas represent years following a negative annual return.
Source: Bloomberg Finance, L.P. as of December 31, 2018.

compensation investors receive for taking credit risk is still way below historical norms. And although supply is shrinking, high yield bond issuance has exploded in the post-global financial crisis environment of low rates. As a result, even marginally tighter monetary policy, slowing growth and earnings may have outsized negative impacts on default rates and spreads.

Surprise, There Is No Surprise: Process Trumps Outcomes

In so many ways it doesn't matter if I went nine-for-nine or zero-for-nine with my selection of three surprises over the last three years. And, although you might not like to hear it, in your investing hearts you know it is true. Controlling the controllables is a significant key to investing success because, unfortunately, the outcomes are uncontrollable. So, focus on a consistent, disciplined investment process and live with the outcomes. This is an important reminder in the aftermath of a difficult 2018.

Sure, I've given in to my behavioral biases and the demands of the job to have some fun and forecast some surprises for 2019. However, my formula has been disciplined and consistent since I started this exercise in January 2016. Again, I look for unloved assets with compelling valuations where investor sentiment is decidedly one-way. I'm unofficially seven-for-nine in my predictions, but we might never be able to determine if my record is based on dumb luck or great skill. While you try to determine which it might be, let me remind you that in a year that is sure to have plenty of surprises, I am expecting these three:

1. US Fiscal Policy Repeat
2. Financials Outperform the Broader Market
3. Junk Bonds Fail to Rebound for the First Time Ever

Happy hunting everyone!

[1] Nicholas Fandos, Michael Tackett and Julie Hirschfeld Davis, "Trump Storms Out of White House Meeting With Democrats on Shutdown," *The New York Times*, January 9, 2019.

[2] Peter Nicholas and Kristina Peterson, "White House Looks to Chip Away at Democrats' Resolve as Shutdown Rolls On," *The Wall Street Journal*, January 15, 2019.

[3] Bart Jansen, "Congress approves $305B highway bill," *USA Today*, December 3, 2015.

[4] Kelsey Snell, "Budget deficit set to rise thanks to year-end tax deal," *The Washington Post*, January 19, 2016.

[5] Bloomberg Finance, L.P., January 16, 2019.

[6] Earnings Insight, FactSet, January 11, 2019.

[7] Kelsey Butler, "Junk Bonds Forecasts Are Quickly Going from Good to Great," Bloomberg, January 15, 2019.

Glossary

CBOE Volatility Index, or VIX A real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments.

Gross Domestic Product (GDP) The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Russell 1000 Growth Index A measure of the large-cap growth segment of the US equity universe, selecting from the Russell 1000 Index.

Russell 1000 Value Index A measure of the large-cap value segment of the US equity universe, selecting from the Russell 1000 Index.

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

S&P Retail Select Industry Index A modified equal-weighted index designed to measure performance of the stocks comprising the S&P Total Market Index that are classified in the Global Industry Classification Standard (GICS) retail sub-industry.

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Important Risk Information

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ID15498-2382660.2.1.AM.RTL 0119 Exp. Date: 01/31/2020