Virginia Capital Strategies

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Third Quarter 2018 Investment Commentary

Market Recap

The divergence in global stock market performance continued and even widened in the third quarter with US stocks gaining and emerging-market stocks (EM) falling. The US market was propelled by continued strong profit growth, thanks in large part to the Trump corporate tax cuts. S&P 500 operating earnings per share grew 27% year over year in the third quarter—compared to their 6% long-term annualized growth rate—and a record-high 80% of S&P 500 companies reported earnings that beat the consensus expectation. Record levels of share buybacks (estimated by Goldman Sachs to reach $1 trillion for 2018) were another support for the US market.

Putting it all together, the S&P 500 index hit a new high in late September and gained 7.7% for the quarter. Smaller-cap stocks gained 3.6%. Stocks in developed overseas markets posted positive gains during the quarter but lagged the US market considerably. iShares MSCI ACWI, which provides a total rate of return for all stocks, gained 4.4% for the quarter and is now up 4.2% for the year.

September Benchmark Returns	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	0.6%	7.7%	10.4%
iShares Russell 1000 ETF	0.4%	7.4%	10.3%
iShares Russell 1000 Value ETF	0.2%	5.6%	3.7%
iShares Russell 1000 Growth ETF	0.6%	9.1%	16.8%
iShares Russell 2000 ETF	-2.3%	3.6%	11.5%
Vanguard REIT	-2.6%	0.5%	0.4%
iShares MSCI ACWI ETF	0.6%	4.4%	4.2%
Vanguard FTSE Developed Markets ETF	0.7%	1.2%	-1.6%
Vanguard FTSE Europe ETF	0.1%	0.6%	-2.3%
Vanguard FTSE Emerging Markets ETF	-1.4%	-1.7%	-8.9%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	-0.5%	0.0%	-1.7%
Vanguard Intermediate-Term Tax-Exempt	-0.6%	-0.2%	-0.5%
iShares TIPS Bond ETF	-1.0%	-0.9%	-0.9%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.6%	2.4%	2.5%
S&P/LSTA Leveraged Loan Index	0.7%	1.8%	4.0%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	-0.7%	-0.4%	-1.2%
Bloomberg Commodity Index	1.9%	-2.0%	-2.0%
SG Trend Index	-1.0%	2.1%	-3.2%
3-Month LIBOR	0.2%	0.6%	1.5%

There are always multiple factors behind short-term market moves, but the intensifying trade conflict between the United States and China was an important one for foreign markets and EM stocks during the third quarter. Another factor was the US dollar, which appreciated against other currencies during the quarter, resulting in a further drag on foreign stock market returns for dollar-based investors. For the quarter, EM stocks fell 1.7%. Developed international equities fared better, posting a slight gain of 1.2%.

In the fixed-income markets, the 10-year Treasury yield rose to 3.05% at the end of the third quarter, flirting with a seven-year high (and during the first week of October, the yield shot up to over 3.2%). As such, the core bond index had a negative 0.5% return in September and was flat for the quarter. As one would expect, shorter-term fixed income investments performed better in this rising rate environment, providing a modestly positive return for the quarter. Moreover, credit-sensitive segments performed well, with high-yield bonds, for example gaining over 2% for the quarter.

At the end of September, the Federal Reserve raised the federal funds rate 25 basis points (0.25%) as expected to a range of 2% to 2.25%. The futures market is now discounting a fourth rate hike this year in December. Analysts are presently attempting to determine the possible number of rate hikes next year.

Quarterly Portfolio Performance and Positioning Recap

EQUITIES

Our equity funds have superb track records with long-tenured management. Each fund employs a disciplined process to identify high-quality and attractive investments in their respective categories. Blackrock Equity Dividend, Dodge & Cox Stock, Jensen Quality Growth, Cohen & Steers Realty, American Funds EuroPacific Growth, Dodge & Cox International and Vanguard Strategic Equity are among the best investment products available anywhere.

And as you know, our globally diversified portfolios have meaningful *strategic* allocations to developed international and EM stocks. This positioning was beneficial in 2017, when foreign markets outperformed US markets. But so far this year, it has been a drag on returns as US stocks have outperformed the international and EM markets. Considering this performance divergence, we include further details on our outlook and analysis for EM stocks after this positioning recap.

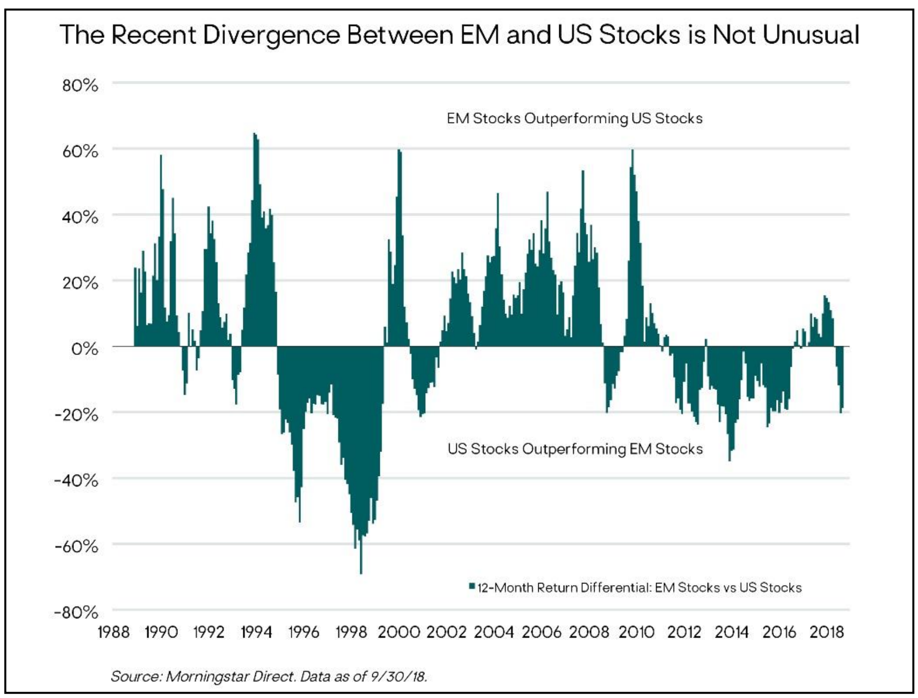
FIXED-INCOME

Our balanced portfolios have a large allocation to actively managed, flexible bond funds such as Weitz Short-Intermediate Income, Templeton Global and Osterweis Strategic Income (in addition to our core bond exposure). In the third quarter, these funds contributed positively to portfolio returns and outperformed the core investment-grade bond index. This is also true for the year-to-date period and the past several years. We expect these products to outperform in the future, particularly if interest rates continue to rise. Furthermore, we continue to be particularly pleased with Dodge & Cox Income, our actively managed,core investment-grade bond choice. Dodge & Cox Income has outperformed the core bond index and other actively managed products over virtually every time-period in what has become a difficult space. We hold core bond funds as risk mitigators in the event of recession or some other shorter-term “risk-off” scenario, even if we believe the likelihood for higher rates is present.

Reiterating our Support for EM Stocks

Given the negative headlines concerning emerging markets in recent months, there are several points worth highlighting based on our additional research and analysis in this area. The primary takeaway is that EM equity valuations continue to look attractive, and their longer-term growth outlook remains intact.

The Recent Divergence Between EM and US Stock Returns is Not Unusual



In 2017, EM stocks gained 31.5% and outperformed the S&P 500 by 10 percentage points. That has sharply reversed this year, with US stocks beating EM by roughly 20 percentage points. This type of volatility and this level of divergence in relative performance is not unusual. It is common for US stocks or EM stocks to outperform the other by double digits over any 12-month period, as shown in the chart on the previous page. In more than one-third (36%) of the rolling 12-month periods from January 1988 through August 2018, EM stocks beat US stocks by a margin of 10 percentage points or more. Conversely, US stocks beat EM stocks by a 10-percentage-point or more margin in another 36% of the rolling 12-month periods. So, over shorter-term periods it’s pretty rare for both markets to perform similarly. However, over this entire 30-year period, the annualized returns for EM and US stocks were an *identical* 10.8%.

A Full-Fledged Trade War is Unlikely

The prospect of an expanding trade war between the United States and China intensified in the third quarter and has caused investor sentiment to turn against emerging markets all year. Uncertainties remain, but our base case continues to be that a full-fledged trade war is unlikely since it's in neither country's interest. It's also not clear that US stocks will be less impacted by a trade war than EM stocks given the former's global presence. At the least, we may be living in a world with an overhang of trade tensions for a while.

US Dollar Strength Is Likely to Reverse Longer Term

A strong US dollar, as we've seen lately, lowers EM stock returns for US dollar–based investors and negatively impacts emerging markets with dollar-denominated debt. Longer term, we believe the fiscal stimulus of tax cuts at a time when the economy is at or near full employment will cause fiscal deficits and debt levels to rise. This should be a longer-term headwind for the US dollar and a positive for EM stocks. Undervalued currencies are also a potential tailwind for emerging markets over the medium to longer term.

The Risk of Broad-Based EM Contagion is Low

Economic crises in Argentina and Turkey have made headlines. However, these economies and their financial markets are very small, and we see the risk of contagion to other more meaningful emerging markets as low. In contrast to the late 1990s EM crisis, most other EM countries' fundamentals are healthier: they have better current account balances, better debt coverage, lower dependence on foreign capital, floating rather than fixed exchange rates, and higher foreign exchange reserves. The rapid growth and high level of private sector debt in China is a potential source of concern. But we have factored this risk into our scenario analysis and modeling and believe EM stocks should outperform US stocks over our multiyear investment horizon even if such a scenario were to play out.

Our EM Product Sidesteps Many of the Aforementioned Risks

Almost 100% of our EM exposure comes from American Funds New World Fund. The fund is mandated to invest only 35% of assets directly into the EM world. The rest is invested into companies who receive at least 20% of their revenues from the developing world, and these companies can be based in established economies located in the Americas, Europe or Asia. This approach results in a portfolio with a much larger market cap, better industry diversification and a higher yield.

Can US Stocks Continue to Move Higher and for How Long?

No one knows exactly when this record-longest and second-strongest US bull market will end. But that doesn't stop lots of investors from fooling themselves into thinking they will see the signs before the rest of the market and be able to time their exit with minimal damage. It's a nice fantasy, but that's not the way markets work in the real world.

As is often the case at turning points in financial markets, it is precisely *because* the recent cycle for US stocks has been so strong and market participants view the United States as the best game in town that our outlook for the *next* phase of the cycle is darkening.

S&P 500 earnings growth expectations are now exceedingly high, and the US economy is operating at or near full capacity and full employment. These are unsustainable conditions, and the direction of their next material move is likely negative for stocks.

The tight labor market has finally translated into wage increases. History and economic theory suggest wages will continue to rise. This could negatively impact corporate profit margins and earnings growth. It could also cause companies to raise prices, which would stoke further inflation and force the Fed to tighten even more. Neither outcome is good for stock prices.

The huge fiscal stimulus which recently took place (tax cuts) was and is during a period of full employment which is unprecedented and may prompt the Fed to raise interest rates even further than initially planned. The Fed is projecting four more rate hikes through the end of 2019. Even some previously dove-ish Fed officials are indicating they are on board for continued hikes. In conjunction with the Fed's plan to unwind another $600 billion in bonds from its balance sheet next year, the table is potentially being set for monetary policy tightening consistent with those that have triggered past recessions. And we know that US recessions have always been accompanied by equity bear markets.

Coming back to S&P 500 earnings, they have been very strong over the past year, supporting the US bull market. But market earnings expectations are now *very* high—likely *too* high for the market's own good. For example, BCA Research calculates that analysts expect the average S&P 500 company to grow earnings at an annual rate of 17% over the next three to five years. In BCA's words, "This is wildly optimistic" and this forecast is topped only by the 19% growth forecast at the height of the tech bubble in 2000, just before that bear market began.

Ned Davis Research makes a similar point. Their analysis indicates that periods of very strong earnings and forecasted earnings growth are associated with poor *subsequent* stock market returns. The S&P 500 is now in the high-expectations/low-return zone. This may seem counterintuitive, but it is how markets operate, particularly at the extremes: when investors are extremely bullish, the market likely already reflects that optimism in current prices and valuations. The potential for actual earnings to disappoint those bullish expectations is high. If earnings growth does fall sharply next year, it may be accompanied by a drop in valuation multiples as well. In other words, a lower valuation multiple on a lower-than-expected earnings number. This would be a reversal of the "double-positive" effect the market has experienced from both strong earnings growth and higher valuations applied to those earnings

Concluding Comments

No matter how we slice it, our analysis suggests the US market, on a relative and absolute basis, is the most expensive major stock market in the world and, as a result, presents a poor return-versus-risk tradeoff.

EM equity valuations are attractive (EM stocks trade at a very large discount: a cyclically adjusted P/E of 13x compared to 30x for US stocks), and their medium- to longer-term growth outlook remains intact. But these positions come with additional shorter-term risk. Poor investor sentiment and capital outflows could potentially trigger an adverse feedback loop between emerging markets and economic fundamentals. However, this has always been a risk with emerging markets, and we take it into account in our portfolio construction and risk management. China debt-deleveraging, trade wars, and a resulting growth slowdown are additional nearer-term risks.

Consequently, you may have noticed we recently reduced US stock exposure in portfolios; we rebalanced portfolios back to target levels, which resulted in a modest reallocation from stocks to bonds and cash.

US stock investments will always be a cornerstone of our portfolios, but it clearly makes sense to take some money off the table, when recognizing the sizable gains which have taken place over the past 10 years.

However, we recognize that many actions taken by President Trump are highly-unconventional and the results can't be accurately measured by anyone in the analyst community. Will resetting trade agreements profoundly and favorably alter US economic activity? Are animal spirits being generated that will meaningfully extend the current business cycle and bull market? It's always dangerous to say "things are different this time", but what if they are? These considerations led us to not reduce stocks as much as we typically would under these market conditions.

But we are longer-term investors. While balancing the short-term risks, we are currently assessing whether the recent EM downturn and divergence with the United States offers an attractive opportunity to increase our allocation to EM stocks. The same holds true for our tactical position in developed international stock markets. As always, we continue to analyze new data and information, and if our analyses warrant a change in our views, we will.

Please note we are also utilizing a new money market fund when possible. The sweep fund we've historically used (labeled "Cash" under the heading of Money Market Fund) is being replaced when possible by Schwab Value Advantage, listed under the heading of "Prime Money Market Fund" on the attached print-outs. Schwab Value Advantage is an exchange-traded fund which must technically be purchased like a traditional mutual fund (unlike sweep products), but pays a handsome yield of 2%, Please watch for this investment to be heavily utilized in the future.

I'm sure you're aware of our proprietary fund selection tool, Performance Checker. We invented and introduced this now nationally-recognized model almost 20 years ago to our clients. In the event you haven't seen the results lately, we've included a report with data as of 9/30/18. This tool has led us to outstanding investment products over the years.

As always, we thank you for your continued trust and confidence.

Sincerely,

Steve Bowery, CFA, CFP