The Standard & Poor's 500 Index fell from a high of 2,925.51 on October 3rd to 2,656.10 on October 29th, before rallying with 3 consecutive days of gains of more than 1% as October came to its merciful end. The decline from peak to trough was less than the 10% threshold that normally qualifies as a correction. Still, investors are left to wonder what comes next following this increase in volatility, especially considering that the sell-off came in the midst of another string of strong earnings reports.

Through October 26, with nearly half (48%) of S&P 500 companies having reported results, 77% of those companies reported positive earnings surprises and 59% reported positive revenue surprises. The S&P 500 year-over-year earnings growth rate is 22.5%, which is the third highest earnings growth since the third quarter of 2010, and marks a significant increase from the 19.3% growth estimate that was the consensus at the beginning of the quarter. The October sell-off can therefore be seen as a warning sign, given the strong performance of actual earnings relative to analysts' estimates and the improvement in earnings growth over the last few weeks. Even those companies that reported positive surprises felt the pain, with their shares declining 1.5%, on average, in the 2 days before and after announcing their results.

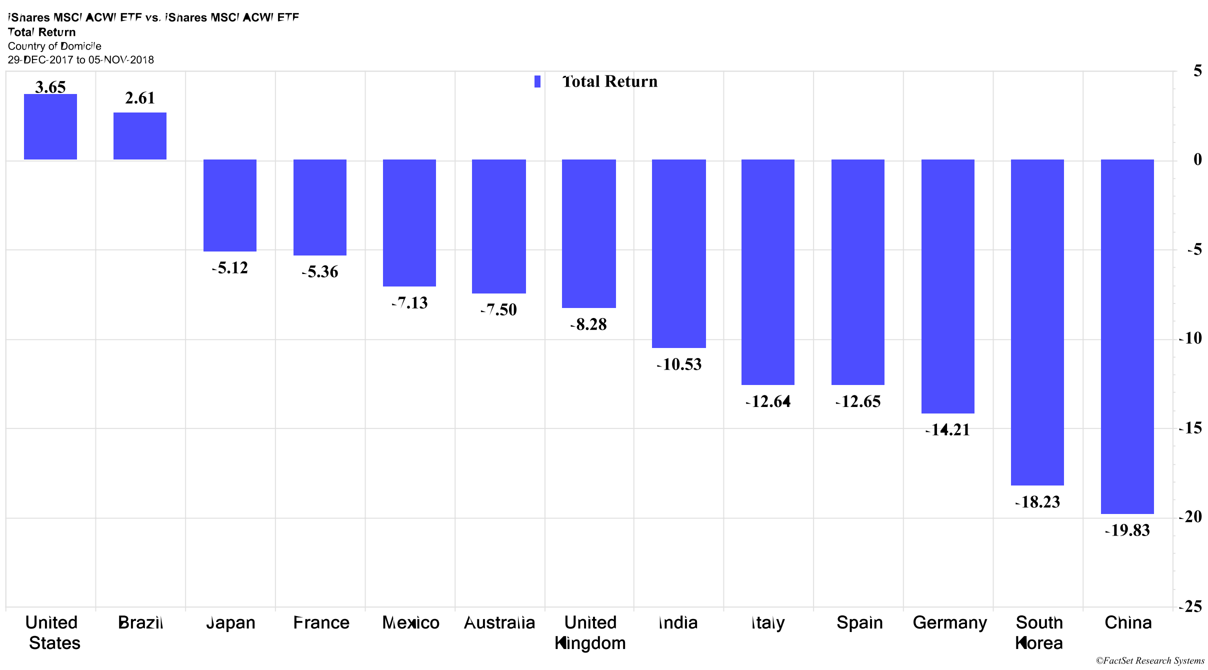
Stock market analysts are, by and large, an eternally bullish lot. To be fair, it pays to be bullish most of the time, and there is much in the current numbers to support a feeling of optimism. In addition to strong earnings gains noted above, real GDP growth rates for the 2nd and 3rd quarters were 4.2% and 3.5%, respectively, the first time growth has exceeded 3% in consecutive quarters since 2015. The unemployment rate remained at 3.7% for the second straight month, the lowest rate since the peak of the dot.com bubble in early 2000. And as a result of the market's decline, U.S. stocks are now trading at 15.5 times forward earnings estimates, which is well below the 18.5 price/earnings ratio that existed following Senate passage of the tax bill in December 2017.

But with stocks apparently fairly valued in an environment that should be favorable to equity investors, it is well to remember that the stock market is *forward-looking*, not merely a reflection of the world that exists at the moment. GDP growth of 3%-4% is not sustainable on a long term basis, and the market is currently discounting slower growth in the future. Indeed, it is estimated that real growth in the U.S. will slow to 2.5% in 2019 and 2.0% in 2020, and those forecasts do not allow for the possibility of a recession during that period. Given that the Fed has imposed seven rate hikes since December 2016, with another likely in December and three to four more widely expected in 2019, ignoring the growing risk of recession is akin to a "whistling past the graveyard" approach to wealth management.

Rising interest rates not only increase economic risk, they also affect equity valuations because interest rates are the basis for the valuation methodologies employed by all money managers. Higher interest rates lower the value of future earnings and increase the uncertainty that future earnings expectations will be realized. Rising rates also increase the relative attractiveness of competing investments, i.e. bonds and cash, particularly on a risk-adjusted basis. In late 2016, when cash was yielding less than 0.25%, stocks were attractive at 18.5 times earnings as there was really no alternative. Today, the 1-year Treasury provides a risk-free return of 2.67%, which represents a comforting alternative to those seeking refuge from an increasingly volatile equity market.

The October decline was concerning from a technical perspective, as well. Nearly 60% of the stocks in the S&P 500 are now trading at prices below their 200-day moving average, a significant loss of momentum. That measure remained below 50% all through the market correction that occurred earlier this year. The S&P 500 Index is still less than 7% below its high, but S&P stocks, on average, are more than 17% below their individual highs. The damage incurred in the broader market is far worse than what is reflected in the Index.

Another concern not widely reported, but worthy of attention in a global investing environment, is the disparity between U.S. and international returns so far this year.



Even after the October decline, the U.S. remains one of only 2 major markets that is still up year-to-date. Weakness in foreign markets almost certainly reflects expectations for slowing global growth in 2019, particularly in China and other emerging markets, which will no doubt act as a drag on earnings of large U.S. companies going forward. But the above chart also evidences the fact that as a result of significant declines in international markets, U.S. stocks are now over-valued on a global basis, which will have a bearing on asset allocation decisions made by institutional investors going forward. U.S. stocks now trade at a 23% premium to international stocks, on average, based on forward 12 months earnings.

For all of these reasons – slower future growth, decelerating earnings estimates, deteriorating market technical indicators, and global uncertainty - we believe that it is prudent to lower the risk profile of our clients' portfolios by reducing their equity exposure and increasing cash and short term fixed income instruments at currently attractive rates. This represents a change in our thinking, and the best outcome is that we are being unduly pessimistic and the current cycle peak is still in front of us, in which case our clients' assets will continue to grow, but at a rate a little less than the averages. But it seems to us that the wise course at this point is to play defense and begin to preserve the gains that have been realized so far during this extraordinary bull market.

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