INVESTMENT PERSPECTIVE 1Q 2019

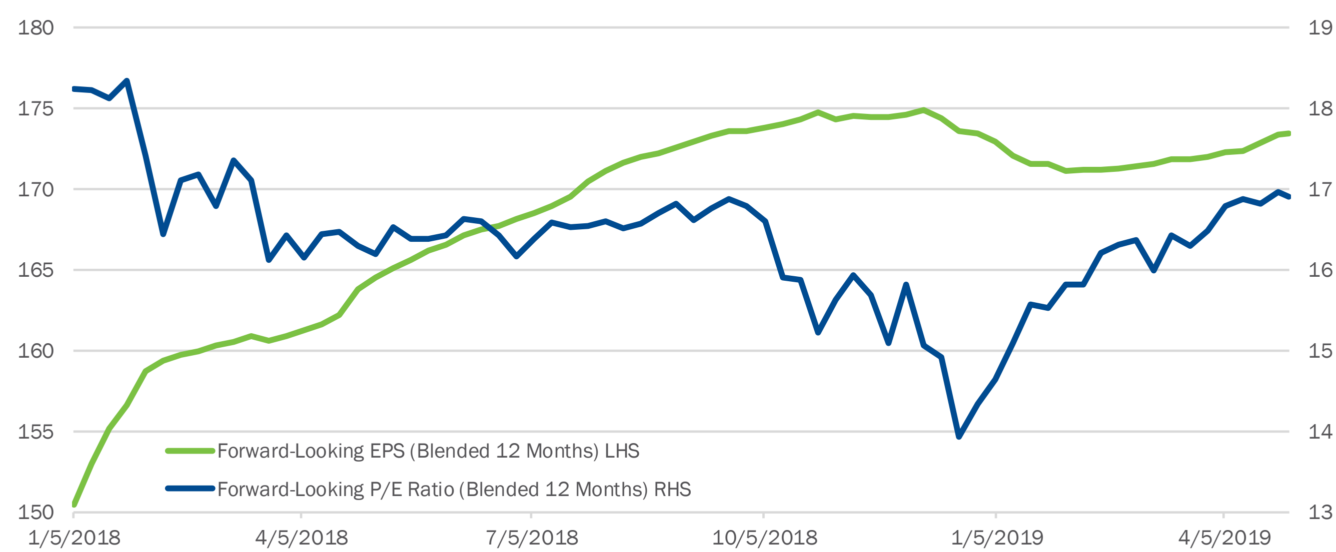
DEUS EX MACHINA

'I cannot heave
my heart into my mouth. I love your Majesty
according to my bond; no more nor less'

King Lear opens with the aging monarch demanding his three daughters for professions of devotion. The two elder sisters, Goneril and Regan, flatter the old man with false affection. Meanwhile, Cordelia, who loves her father most genuinely, can only muster the simple statement of fact above. Lear disowns her and thus sets off his demise. As the father of three girls, I try to bear in mind the warnings of *King Lear* (especially when I am dispensing the wealth of the kingdom.) But I believe the story has kernels of wisdom for investors as well as parents. Fundamentally, *King Lear* is a cautionary tale about how we weigh evidence.

For a moment last December, the U.S. stock market pitched a fit of rage. Concerns over the China trade negotiations, the Federal Reserve's interest rate policy and the outlook for corporate earnings sparked a revulsion of risk. The market's multiple of forward 12-month expected earnings dropped below 14x from approximately 17x at the end of the Q3.

Forward-Looking P/E Ratio and Earnings for the S&P 500



Source: Bloomberg, Hirtle Callaghan.

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As if on cue, the Federal Reserve abruptly changed tack, and the China trade news took a decidedly positive tone. Promptly, the animal spirits of investors recovered. By the end of April, the market traded back at 17x estimated forward earnings. In theatrical terms, deus ex machina. Now, it's worth considering if investors have just fallen for a display of affection as contrived and disingenuous as Goneril's and Regan's. The question is important because the health of U.S. corporate earnings is, like Cordelia's affirmation, something less than effusive. Investors are so enamored with the Fed's policy reversal and the improved outlook for China trade that they seem to have given earnings a giant benefit of the doubt.

Our investment philosophy considers fundamental earnings, the macro environment and the risk backdrop. Our stance on risk has been neutral given the lack of strongly corroborating signals. Naturally, clients frequently ask us which of the many signals matter most at any point in time. Today, it is, to a large extent, how the real economy is translating into the outlook for earnings. As the previous chart illustrates, the earnings trajectory has recently turned up modestly after decelerating from December to March. Our risk posture from this point on will depend critically on how this strand of evidence evolves.

—T. Brad Conger, CFA
Deputy Chief Investment Officer