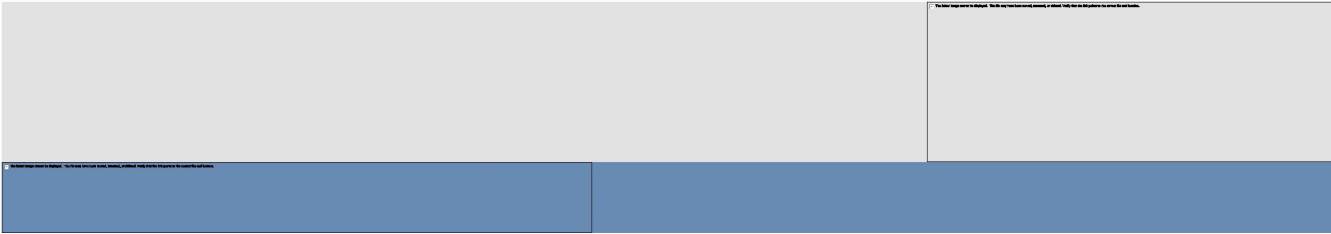

From: Richard Kahn [REDACTED]
Sent: 10/15/2018 6:56:57 PM
To: Jeffrey Epstein [jeevacation@gmail.com]
Subject: Fwd: The Unsteady Undertow Commands the Seas (Temporarily)
Attachments: The Unsteady Undertow Commands the Seas (Temporarily).pdf; Untitled attachment 572865.htm

Importance: High

Richard Kahn
HBRK Associates Inc.
575 Lexington Avenue 4th Floor
New York, NY 10022
tel [REDACTED]
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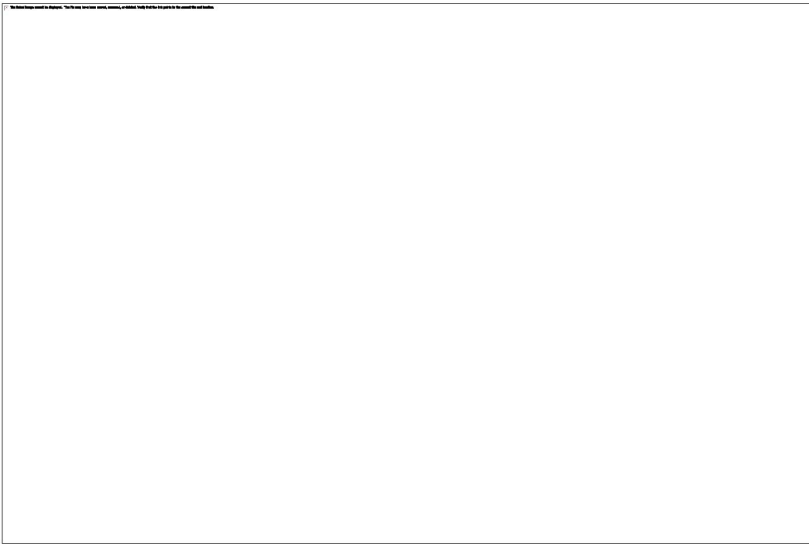
Begin forwarded message:

From: Judie Taylor <[REDACTED]>
Subject: **The Unsteady Undertow Commands the Seas (Temporarily)**
Date: October 15, 2018 at 2:36:30 PM EDT
To: [REDACTED]



Sunday Night Insight
October 14, 2018

The Unsteady Undertow Commands the Seas (Temporarily)



Sharmin Mossavar-Rahmani	Chief Investment Officer
Brett Nelson	Head of Tactical Asset Allocation
Maziar Minovi	Managing Director
Andrew Dubinsky	Vice President
Michael Murdoch	Vice President
Mary Rich	Vice President

The 7.8% intraday peak-to-trough decline in US equities between September 21st and October 11th has rattled investor confidence. Numerous headlines of stock market “carnage” have further eroded their confidence. As a result, some of our clients have asked whether this drop signifies the beginning of the end of a nearly 10-year bull market.

We do not think so. So far, this pullback is actually smaller than the two prior downdrafts we experienced in late January and in mid-March, neither of which derailed the US economy nor the bull market. The steady factors we highlighted in our annual Outlook—such as economic growth, benign inflation, robust earnings, and low probability of recession—have not dissipated. Furthermore, while the investor focus has shifted to the risks around the unsteady undertow, most of these factors are, on balance, less concerning today than they were at the beginning of 2018.

Of course, that is not the case across all geopolitical concerns. While trade tensions with Mexico and Canada have abated, those with China have certainly deteriorated and will continue to do so for the

foreseeable future. But, in aggregate, there has been more improvement than deterioration, in our view.

In this Sunday Night Insight, we will provide a brief update on the steady factors and unsteady undertow. We then conclude with our view that the steady factors will likely continue to win this tug-of-war between the two.

Steady Factors

While the headlines warn of equity market carnage, the facts do not support such alarming headlines. The S&P 500 is still up 5.1% on a year-to-date total return basis and financial conditions remain at easier levels today than they did when the Federal Reserve began this tightening cycle in 2015, despite the recent decline in equities and 0.76 percentage point increase in 10-year Treasury yields year-to-date. Most importantly, as highlighted by Federal Reserve Chairman, Jerome Powell, we are in “extraordinary times” of steady growth and low inflation.

Economic Growth

Economic growth remains firm in the US. Both the Institute for Supply Management leading indexes for manufacturing and non-manufacturing remain at very strong levels. Current activity indicators of real GDP growth average about 3.5% for the third quarter and closer to 4% for the fourth quarter. Forecasts for third quarter real GDP average 3.8% and fourth quarter forecasts are about 2.8%. While growth is slowing from the 4.2% estimate of the second quarter, it is still forecast to be above trend and we believe a modest slowdown is certainly preferable to continued growth at a pace that was likely unsustainable and possibly even inflationary.

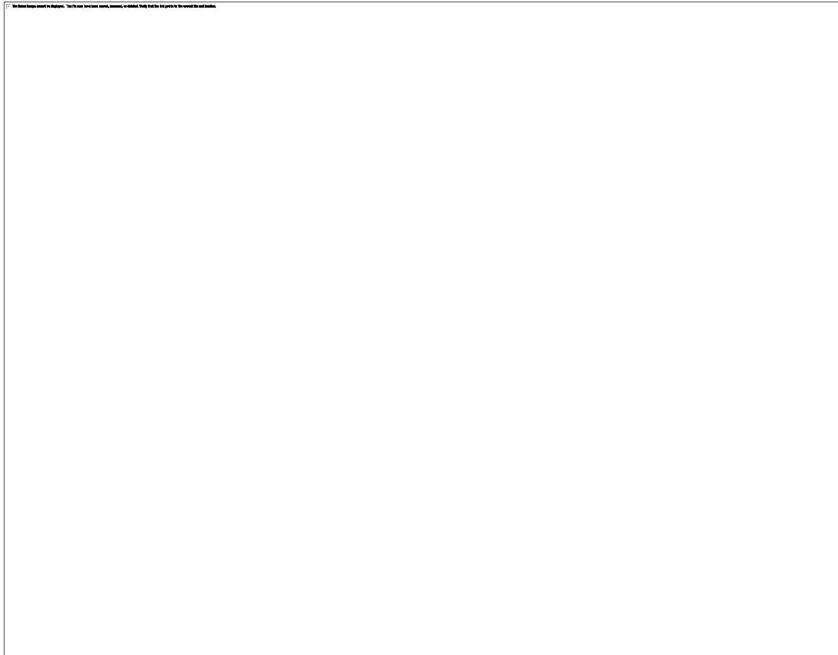
In aggregate, the economic data since the intraday peak of US equities on September 21st does not point to any worrisome slowdown in GDP growth or the pace of employment. In fact, while the recent 134K increase in non-farm payrolls was less than expectations, revisions to earlier months offset the modest headline miss and the unemployment rate still fell to 3.7%. Furthermore, this 134k increase is above the estimated sustainable level of employment growth based on population growth and changes in labor force participation, which our colleagues in Goldman Investment Research estimate is around 96k. Importantly, a modest slowdown in the 3-month average of non-farm payrolls, which currently stands at a very robust 190k jobs, is more likely to keep inflation in check.

Robust Earnings and Buybacks

Continued above-trend economic growth is supporting solid corporate fundamentals. While many are quick to dismiss this strength to US tax reform, it is only half the story. Earnings before interest and taxes (EBIT) expanded by a very healthy 12% in the first half of this year and are expected to grow by double-digits again in the third quarter. This robust organic profit growth is also fueling sizable corporate buybacks—a key source of equity market support. Our colleagues on the corporate buyback desk expect the highest dollar amount for buybacks on record in 2018, with \$1tn in authorizations and \$850bn in executed buybacks.

Even so, such robust earnings growth has begun to foster concern that we have reached a peak in EPS growth. While we do expect the pace of growth to slow next year, a local peak in earnings

growth has not signified an imminent peak in the S&P 500 historically. In fact, about 3/4ths of market peaks occurred more than two years after the peak in the growth rate of earnings. Moreover, stock market returns have remained healthy during this period, with high odds of a positive outcome over the subsequent 6-24 months (see Exhibit 1). In short, the market ultimately follows the path of earnings and while their growth rate may be slowing, their absolute level is still rising.



Source: Investment Strategy Group, Bloomberg.

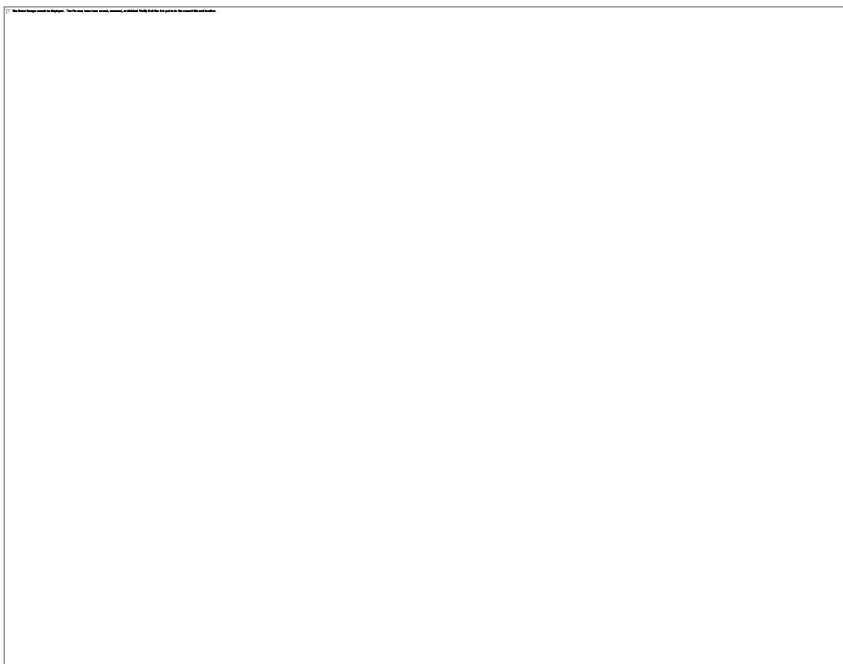
Inflation and Interest Rates

Inflation data has remained at relatively low levels for all of 2018, as shown in Exhibits 2 and 3. In fact, some of the most recent data released in October have ticked slightly lower. Average hourly earnings dropped to 2.8% from the prior month's level of 2.9%. Headline CPI dropped to 2.3% from 2.7% and Core CPI ex-food and energy remain at a low 2.2%, unchanged from the prior month. The Federal Reserve's preferred inflation indicator, Core PCE, also remains low at 2.0% which is in line with the Federal Reserve's target, and unchanged from the prior month.

While 10-year Treasury yields have risen by 0.76% (or 76 basis points) over the course of 2018, we do not think the resulting 3.2% yield is enough to derail US economic growth. Keep in mind that most of the recent increase since late August was due to stronger real growth rather than runaway inflation expectations. We expect interest rates to range between 3.0% and 3.5% in 2019 with a midpoint of 3.25%, barring any major geopolitical conflicts such as one between US and China and or escalating conflicts in the Middle East.



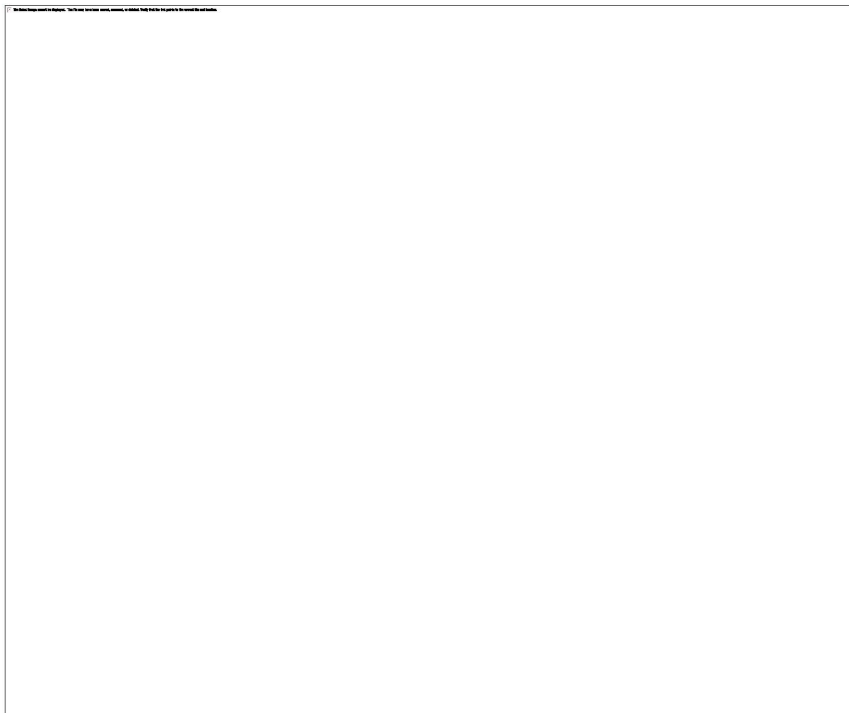
Note: Average hourly earnings is available for the private sector starting in 2006 and is released in the monthly employment report. The BLS hourly earnings data for production and nonsupervisory employees, ~80% of the private sector, is available back to 1964.
Source: Investment Strategy Group, Haver.



Source: Investment Strategy Group, Haver.

Of course, the recent backup in interest rates is providing equity investors with another source of angst. Yet our work suggests there are several reasons why rates could continue to rise before becoming a material headwind for stocks. First, the 4% trend growth rate of nominal US GDP—reflecting 2% real growth and 2% inflation—remains comfortably above the 10-year Treasury yield of

3.2% (i.e. the cost of borrowing). Stocks typically struggle when the cost of borrowing exceeds the nominal growth of the economy (see Exhibit 4). Second, the recent backup in interest rates was driven primarily by improving real growth expectations, not higher inflation. This distinction is critical, because higher rates in response to improving real growth tend to benefit earnings sufficiently to overcome the downward pressure they place on valuation multiples. Finally, it will take a number of years before higher rates meaningfully impact aggregate S&P 500 interest expense, considering 91% of S&P 500 debt is fixed-rate and only 13% matures over the next two years.



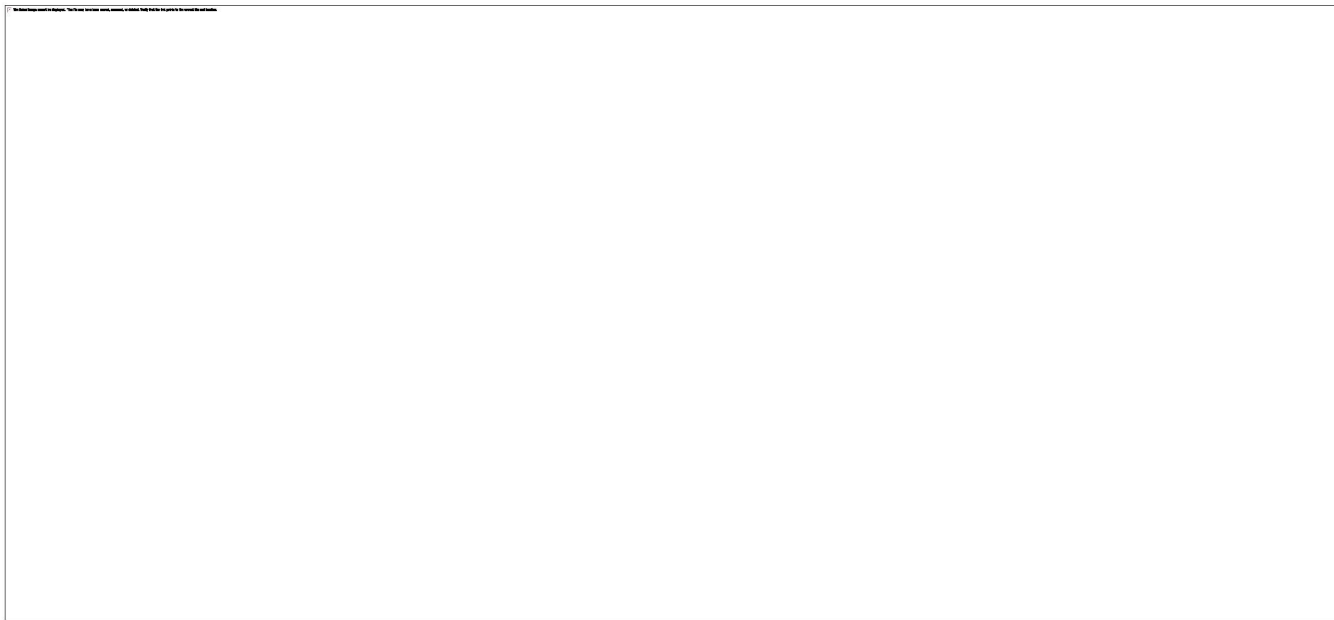
Source: Investment Strategy Group, Bloomberg.

Low Probability of Recession

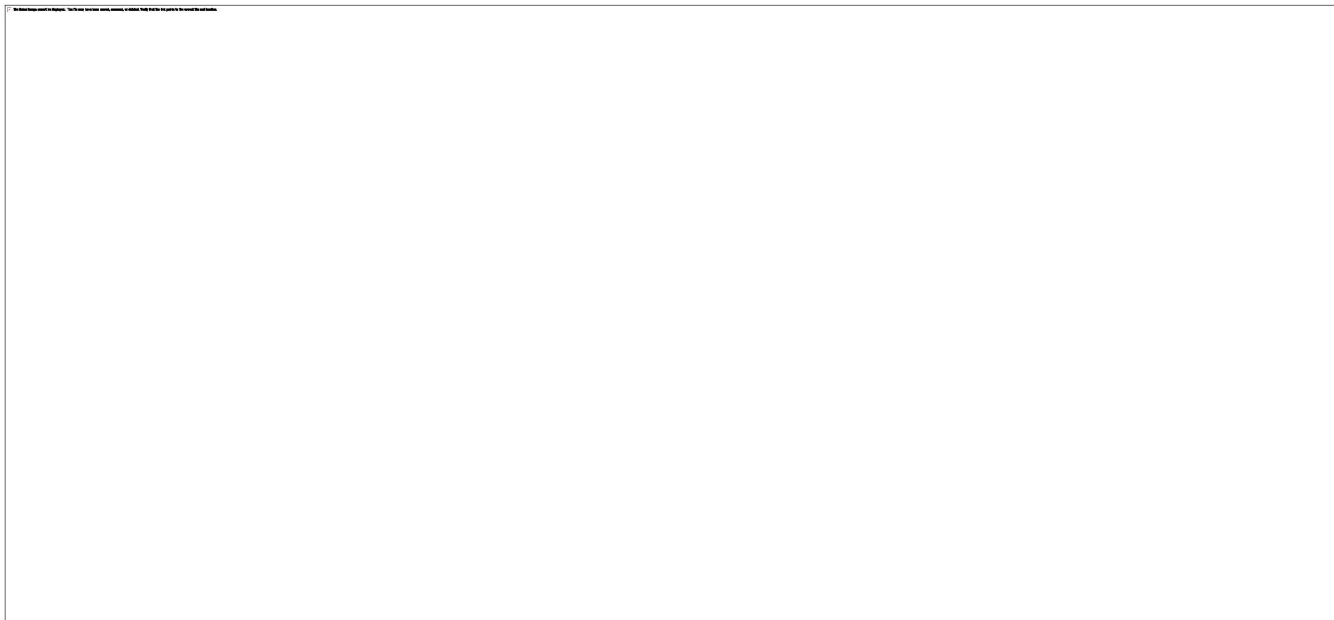
We continue to maintain a low, 10%, probability of recession driven by:

- The positive trend of leading economic indicators
- Low levels of inflation
- The continued slow but steady pace of Federal Reserve interest rate hikes. We believe that Federal Reserve Chairman Powell's recent commentary indicates that the FOMC will continue to be driven by data and financial market conditions. Their stated goal is to extend this expansion "indefinitely."¹ While the Federal Reserve dots point towards four more interest rate hikes by the end of 2019, we do not think that such hikes materially increase the odds of a recession in an economy that continues to grow at levels that are generally regarded as above trend growth in the US.

Recent steepening of the yield curve. We have highlighted two measures of the yield curve as signposts we watch as an early harbinger of a recession. Both have steepened since their lows, as shown in Exhibits 5 and 6.



Source: Investment Strategy Group, Bloomberg.



**“Near-Term Forward Spread” is the implied 3-month forward yield 18-months from now.*
Source: Investment Strategy Group, Bloomberg.

Unsteady Undertow

As market observers attempt to explain the recent drop in US equities, the risks of geopolitical factors have garnered considerable attention. Potential US retaliation over the recent disappearance of a Saudi journalist has only added fuel to the fire of worries given the risk that oil exports could be used as a political weapon in a world with tighter oil supply thanks to impending US sanctions on Iran.

As we review the geopolitical developments of 2018, it is clear that some of the risks have abated while others have increased. With the exception of a significant spike in oil prices due to the impact of sanctions on Iran or any escalation in US-Saudi tensions, we believe that the net impact of these shifts is not material enough to derail the US economic expansion or bull market.

Risks that have abated

Mexico: the election of the left-of-center populist president (Andrés Manuel López Obrador referred to as AMLO) has reduced fear of a reversal of recent reforms. While concerns about fiscal profligacy and reverting to a nationalist energy policy that reduces oil production may reappear, AMLO does not take office until the end of the year.

Brazil: The strong showing of Jair Bolsonaro, a law-and-order former army captain, in the first round of elections and the latest data that points to a 75% probability of Bolsonaro becoming the next president of Brazil has provided a boost to the Brazilian real. His current standing has substantially reduced the election of another left-wing worker's party candidate who would keep the status quo in Brazil.

NAFTA: The agreement on a revised NAFTA deal between the US, Canada, and Mexico on September 30th meaningfully reduced the risk of the US withdrawal from NAFTA. While the new agreement, US-Mexico-Canada Agreement (USMCA), has not been ratified by the Mexican and Canadian national parliaments nor by the US congress, and a divided congress after the mid-term elections may lead to some uncertainty, we believe it is likely to be ratified.

US-EU Trade Friction: Tension between the US and European Union eased significantly after a July 2018 deal between European Commission President Juncker and President Trump to “work together toward zero tariffs, zero non-tariff barriers and zero subsidies on non-auto industrial goods”. The coast is not totally clear given the threat of auto tariffs, but we do not anticipate any significant increase in trade rhetoric in the near future.

Risks that have increased

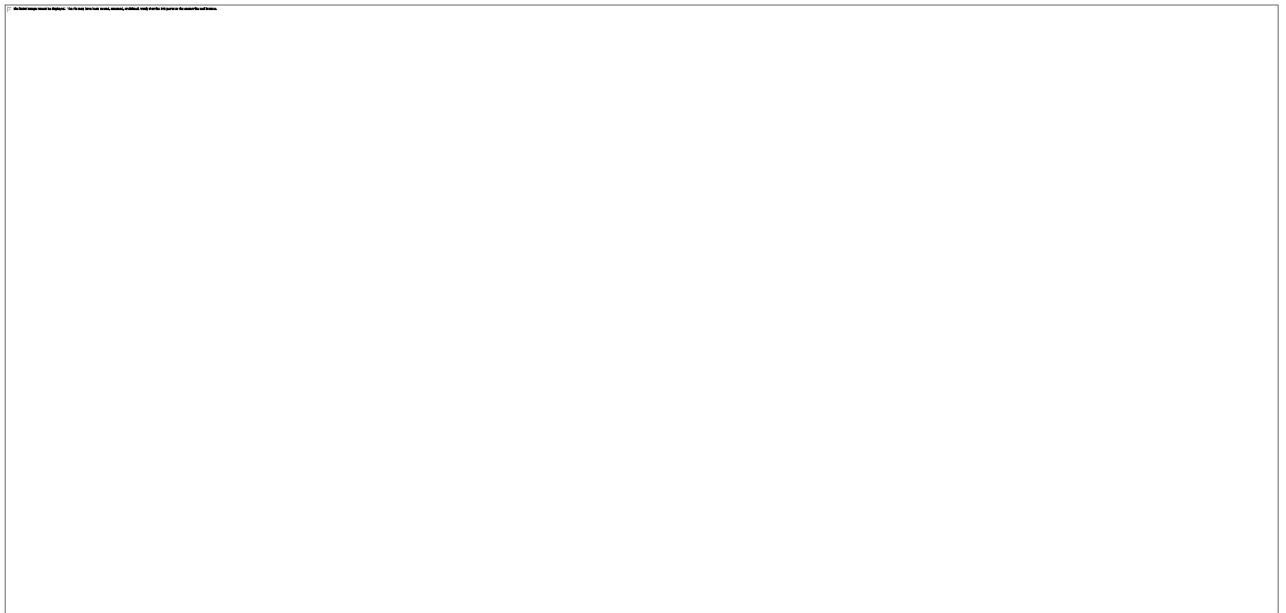
China: The trade war with China continues to escalate and as we have stated before, we believe that it cannot be resolved simply by China importing more US goods. The issues range from:

- A large and growing trade deficit with China
- Industrial policies & unfair trade practices that reduce competition, such as subsidies and “dumping good at below-market prices”
- “Made in China 2025” policies which “harm US companies”

- Uneven tariff rates and the banning of some US goods
- Intellectual property theft
- Forced technology transfer
- Strategic US technology acquisitions
- Outright cyber theft
- Foreign ownership restrictions

Recent headlines that the trade war may be escalating to a cold war are not without merit, as we believe that US-China relations are changing on a more structural basis and will have a longer-term impact. On a short-term basis, however, US exposure to China is limited with merchandise exports, corporate profits and foreign claims at about 1% of GDP. As seen in Exhibit 7, the Chinese equity markets have also deteriorated much more significantly than US markets in 2018.

Of course, specific stocks with greater exposure to China through higher sales have underperformed the S&P 500 by about 6% since the latest tariffs were imposed on \$200bn of Chinese products, as shown in Exhibit 8.



Source: Investment Strategy Group, Bloomberg.



Note: High China sales basket is aggregated and defined by Goldman Sachs Global Investment Research.

Source: Investment Strategy Group, Bloomberg.

Italy: Concerns about Italy have risen to peak levels since the election of a populist government in May and credit default swaps have increased to reflect these higher risks. The government's expansive fiscal plan, with a proposed budget deficit of 2.4% of GDP, may be rejected by the European Union commission and result in rating downgrades. While the EU is likely to manage this situation in its usual incremental and reactive way, the possibility of new elections in late 2019 reigniting euro viability questions will keep Italy on our radar screens.

BREXIT: It is hard to know whether Brexit risks are unchanged, higher or lower given the minute by minute headlines out of the UK. Our base case remains that while the internal politics of the Conservative party will keep uncertainty at elevated levels and the European Union will not compromise on its key tenants of free movement of goods, services, and people, the two sides will agree to a deal that defers the difficult choices on the shape of a final agreement with the EU until late 2020.

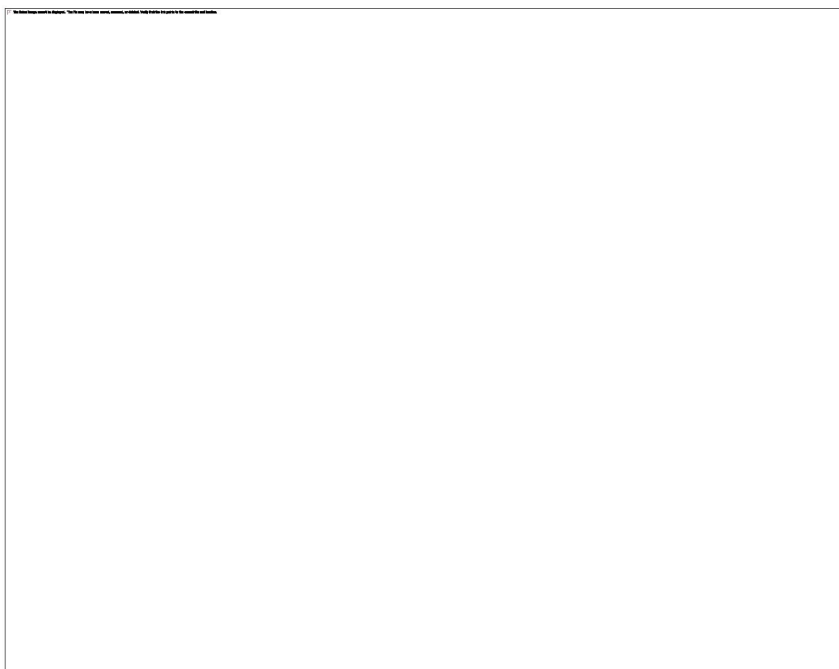
The Middle East: Risks in the Middle East have not changed substantially with respect to Iraq, Syria, or even the impositions of sanctions on Iran. However, the disappearance of the Saudi journalist who entered the Saudi Embassy in Turkey on October 2nd has the potential to raise risks to global oil supply. While there has been a global uproar, it is not yet clear whether the US will impose serious sanctions or Saudi Arabia would retaliate by reducing oil exports if the US finds sufficient evidence regarding the alleged killing of the Saudi journalist. The recession in 1973-74 was partly due to the quadrupling of oil prices due to the Arab Oil Embargo. Later in that decade, the Iranian Revolution and the Iran-Iraq War also led to a 2.5 times spike in oil prices that, along with Federal Reserve tightening by then Chairman Paul Volcker, led to a US recession. While we think it is unlikely that Saudi Arabia would react so aggressively in the face of serious US reprisals, we note that it remains a real risk.

Some Notable Observations

US Equities Have Been Shunned All Along

In both our 2018 *Outlook* and mid-year update, we highlighted the surprising absence of inflows into US equities based on flows into mutual funds and Exchange-Traded Funds. As shown in Exhibit 9, flows into US equities were negative in 2018, even before the recent downdraft. In fact, US equities have seen outflows of \$81 billion through August 2018 (based on the most recent comprehensive data), while non-US developed equities and emerging market equities have had inflows of \$72 billion and \$20 billion respectively. This is further evidence of our view that while sentiment and short term positioning among speculators and hedge fund managers shifts frequently, more stable investors have shunned US equities during this long bull market in favor of other developed and emerging market equities and global bonds.

This steady outflow of assets from US equities has been offset by record levels of stock buybacks by US companies given high levels of profitability and incremental cash from repatriation of overseas earnings, as mentioned above.

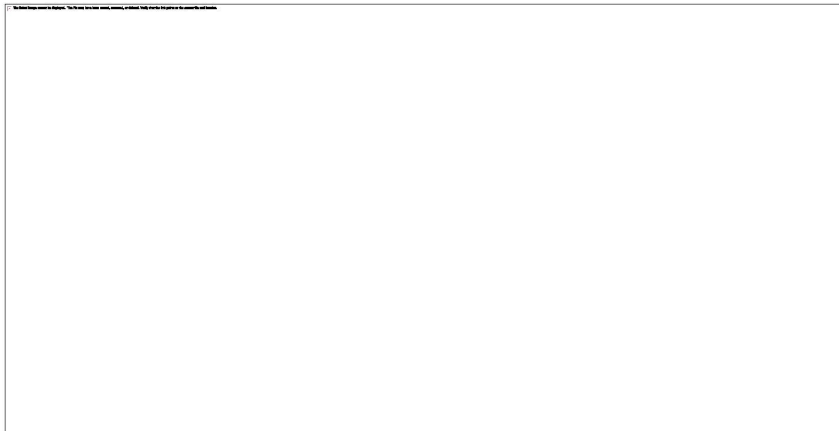


Note: Based on ICI weekly estimates through August 30, 2018. Flows exclude reinvested dividends.
Source: Investment Strategy Group, ICI.

Some Headwinds Facing the FANGMAN Stocks Will Persist

The basket of FANGMAN (i.e. Facebook, Apple, Netflix, Google, Microsoft, Amazon and Nvidia) stocks have dropped across the board from their respective peak price levels, with Facebook's 29% decline the largest and Apple's 4% decline the smallest among the group. Even so, each of the

stocks, with the exception of Facebook, still have positive year-to-date returns and have outperformed the S&P 500, as shown in Exhibit 10.



This is not a recommendation to buy or sell individual securities but rather an assertion that these stocks represent a small portion of S&P 500 earnings. Anyone looking to buy or sell single name equities should consult Goldman Sachs Global Investment Research.

Source: Investment Strategy Group, Bloomberg.

Nevertheless, we believe that some of the headwinds that have plagued this sector will continue. These include:

- Data privacy issues impacting a broad range of companies, including Facebook, Google, Twitter, Alipay and Tencent.
- High likelihood of greater regulatory scrutiny in the US² and Europe as policy makers increasingly believe that these companies will not address “the privacy and security issues of social media users”³ on their own.
- Increased focus by ESG investors (Environment, Social, and Governance) that many of the technology and social media companies are falling short on social and governance issues.

While this basket of stocks may or may not lead the market in the future, it is important to note that they represent only 10% of S&P 500 earnings.

Investment Implications

The recent market downdraft has understandably rekindled fears that the longest bull market in history is coming to an end. While there are no certainties in investing, we do not think the odds support that conclusion based on our read of the steady and unsteady factors discussed above. Keep in mind that about 75% of historical US bear markets—defined here as equity market declines of 20% or more—have occurred during economic recessions. In fact, US equity returns have remained favorable until about five to six months prior to the onset of recession, highlighting the penalty for prematurely exiting the market (see Exhibit 11). With only 10% odds of recession over the next year, we think the economic backdrop remains favorable for stocks.



Source: Investment Strategy Group, Bloomberg.

Of course, none of the supportive factors discussed above precludes further bouts of equity volatility. As we highlighted at the beginning of the year, the historical probability of a 5% or greater correction from current valuation levels was 96%. Yet these statistics alone do not justify underweighting equities, since such pullbacks often occur after sizable equity rallies, as this year reminds us.

Moreover, such pullbacks are quite normal historically. After all, stocks have suffered a median of two pullbacks of at least 5% and one of at least 10% per calendar year in the post-WWII period, leaving both the frequency and magnitude of this year's dips in line with past experience. Most importantly, years that experienced a similar number of pullbacks as 2018 nonetheless ended with a median gain of 6% and had 77% odds of a positive return.

Conclusion

Although we have painted a less alarmist view of recent market weakness, we are by no means Pollyannaish. While bull markets do not die of old age, they do become more susceptible to ailments over time. Yet as we survey the tug of war between the steady factors and the unsteady undertow, we do not think the balance of risks is strong enough to topple the ongoing US expansion and the continued growth of corporate earnings it supports.

That said, this viewpoint does not preclude further market volatility and the market may still make new lows if the current downdraft persists. But history suggests the bull market is likely to continue until about 5-6 months prior to the end of this economic expansion. Thus, it will take a significant increase in the odds of an imminent recession to provide the trigger—that has been lacking thus far—to tactically underweight equities. In the interim, we continue to recommend that clients maintain their strategic allocation to US equities.

Sources: Investment Strategy Group, Bloomberg, Datastream, Goldman Sachs Global Investment Research, Haver.

Endnotes:

(1) Kate Davidson and Sarah Chaney, "Fed Chair Powell Sees 'Remarkably Positive Set of Economic Circumstances,'" The Wall Street Journal, October 3, 2018.

(2) Statement by the Acting Director of FTC's Bureau of Consumer Protection Regarding Reported Concerns about Facebook Privacy Practices, March 26, 2018.

(3) Senator Mark. R Warner, Press Release, September 28, 2018

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