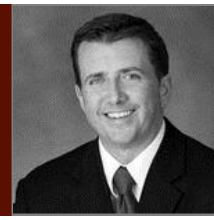
Aviance Capital Partners
Investing for Generations

INVESTMENT COMMENTARY

OCTOBER 2018

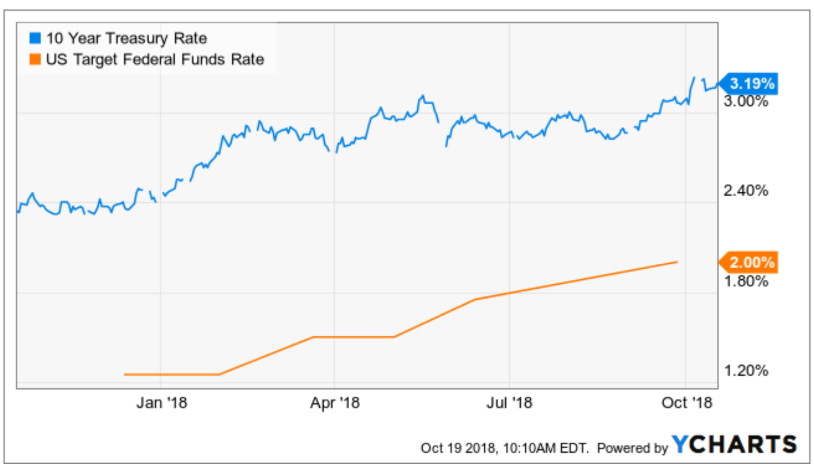


JACK
BROWN, CFA

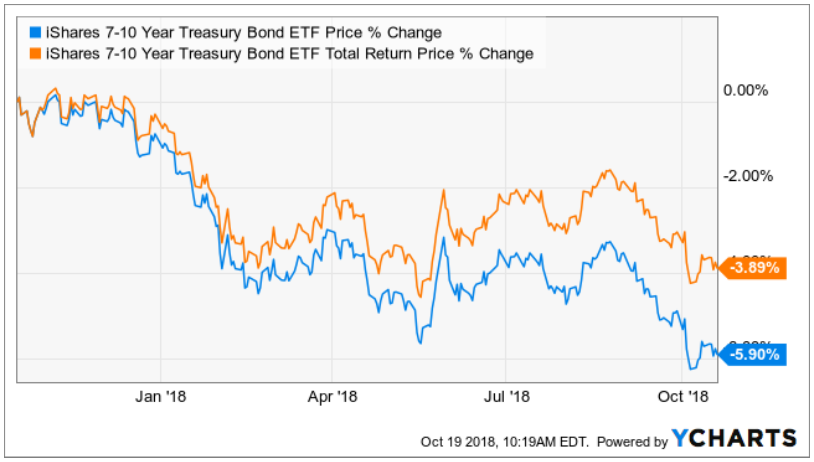
A Narrow Market

Consistent with the past couple years, 2018 has seen the largest U.S. growth companies dominate the broad domestic and global stock markets. The following chart illustrates this point with the largest 200 growth companies in the U.S. (green line) significantly outperforming the S&P 500 (blue line), the equally weighted version of the S&P 500 (red line), and the MSCI EAFE international index (orange line). The equally weighted index (red line) is essentially saying that the typical stock is flat for the year. As a result, 2018 has been a narrow market for stocks – meaning there have been a minority of winners.

2018 has also seen rising interest rates.



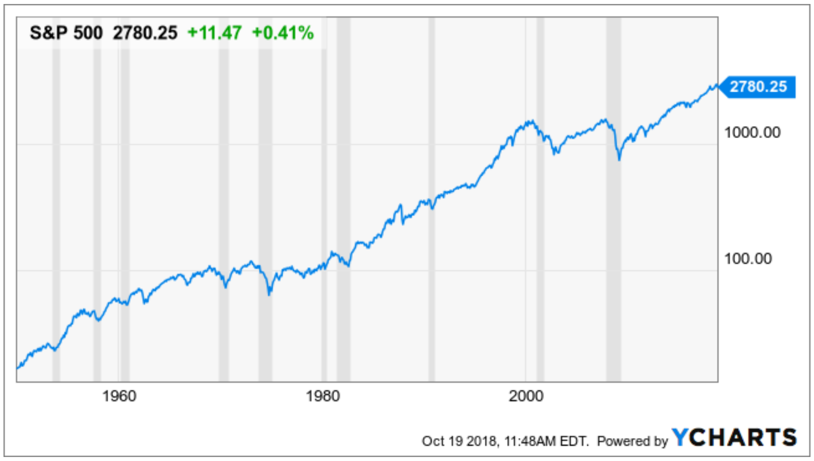
Interest rates and bond prices have an inverse relationship, so when interest rates rise, bond prices fall as is reflected in the next chart. As rates have increased over the past year, the price of the iShares 7-10 Year Treasury Bond ETF has fallen just shy of 6%. However, the total return is down less at approximately 4% when adding back the interest. This is an important detail to mention as it demonstrates coupon payments help offset declining bond prices in a rising rate environment.



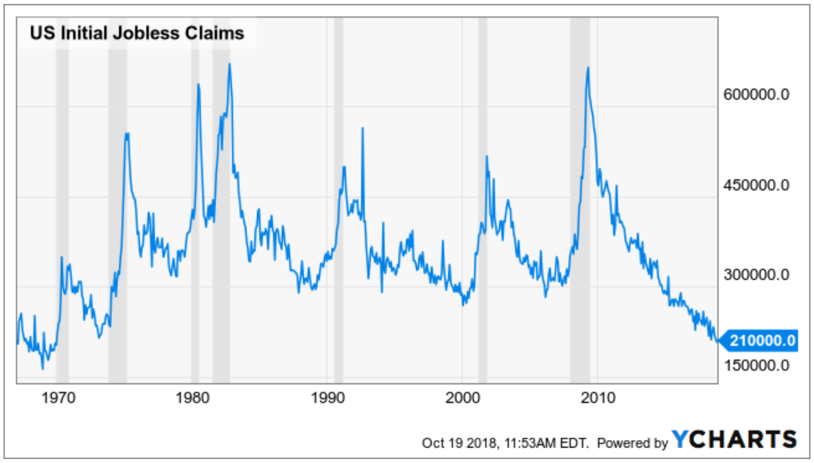
When coupling a narrow market for stock winners and a rising interest rate environment, most investors do not feel like champions in 2018 - in spite of a strong economy. As a result, investor confidence is likely to be fickle for some time.

Inflation on Deck

History demonstrates that periods of longer market declines are usually accompanied by economic weakness. The next chart shows recession (gray bars) occurring with dips in the S&P 500 (blue line).



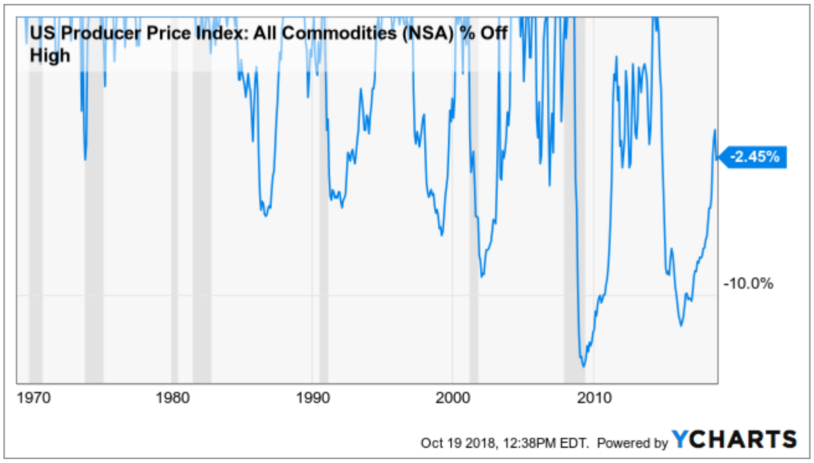
Fortunately, today's economy appears to be strong and improving. In fact, some key markers of strength are approaching historic levels – especially related to employment. For example, the initial claims people make for unemployment benefits is lower than it has been since the 1960s despite a much larger population today. Needless to say, unemployment is very low as well. It is fair to describe the job market as tight when combining these lower unemployment figures with record job openings. Broadly speaking, the employment statistics are outliers relative to history. It would not be surprising to look back ten years from now and say, "of course we have had of a lot of wage inflation – the signs were obvious."



On another note, consider tariffs. In a general sense, tariffs are inflationary because they typically cause the price of imported goods to rise allowing for locally sourced substitutes to raise prices as well. While it is difficult to speculate how the economy will be impacted, it is not a stretch to say the prices for goods are more likely to increase versus decrease based on this year's trade tensions.

Finally, consider commodity prices which include items such as metal, energy, and agriculture products. The following chart shows us the Producer Price Index for All Commodities. Specifically, it shows the percent decline from the previous highs. What is notable is that we have just recently experienced two of the largest commodity price declines over the past 50 years. The most recent one started in mid-2014 and began to recover in earnest in early 2016. Consequently, we have been in a reflationary environment for commodities for the past 2+ years.

2180 IMMOKALEE ROAD, SUITE 301 – NAPLES, FL 34110
(239) 598-4747



In the face of a strong economy, we currently have:

- A tight labor market
- Tariffs
- Rising commodity and input prices

Given these points, it is reasonable, in our view, to expect an increase in the rate of inflation. The Federal Reserve System, commonly known as "The Fed," has been forthright in their plan of strategically normalizing interest rates (i.e. raising rates) and security holdings for some time (see: https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm). It would now appear that 2018 has presented the Fed with sufficient information to act definitively to approach normalization.

While a pick-up in inflation seems likely, we don't have much evidence to worry about runaway inflation. In particular, data points that demonstrate limits on production or the pace of lending, such as capacity utilization and monetary velocity, are still quite reasonable. However, as these items heat up, it will be quite likely expectations for inflation will rise and markets will react accordingly.

Investment Strategy

It is our view the economy is now accelerating and inflation will likely pick up. This presents investors with some considerations. History shows us that stocks generally do well in an inflationary environment with some doing better than others – especially those who can pass along rising costs. In Warren Buffet's 1981 shareholder letter regarding favorable investments during times of inflation: "…favored business must have two characteristics: (1) an ability to increase prices rather easily (even when product demand is flat and capacity is not fully utilized) without fear of significant loss of either market share or unit volume, and (2) an ability to accommodate large dollar volume increases in business (often produced more by inflation than by real growth) with only minor additional investment of capital." Looking forward for the next few years, it may make sense to be a little more selective than what the average index fund allows.

For the lower risk portion of an investor's portfolio, generally higher-yielding bonds with shorter maturities work fairly well in inflationary environments. However, this portion of the bond market gets crowded, and if credit risk increases, corporate bonds can decline quickly. To diversity away some of the risks in this space, investors can look to inflation-protected bonds. The U.S. Treasury is the largest issuer of these "TIPs" bonds, and while TIPs offer lower yields, both the principal and coupon payments are indexed to inflation. Today, TIPs are yielding approximately 1%, so holding a TIP through maturity will generate a total return of 1% per annum plus inflation. Like other bonds, TIPs decline in value when their yields go up. As a result, when yields for traditional bonds go up faster than inflation, TIPs will lag. On the other hand, if inflation exceeds expectations, TIPs will do well.

Asset Allocation

From an asset allocation perspective, risk management is important. One's personalized, long-term, strategic asset allocation should still dominate the makeup of a portfolio. We expect stocks to perform relatively better than bonds over the next year with the caveat that stock investors will be more moody in the next year than the past several. The stock market is positioned to continue gains while the economy remains strong. However, as investor fears about inflation, increasing rates, trade-tensions, and the Chinese economy waxes and wanes, stocks could move sideways until a new economic paradigm is established.

What does seem to be the case though is there are a growing number of shareholder friendly companies trading at attractive values.

More bargains today than one year ago:

Number of S&P 500 Companies	10/19/2017	10/19/2018	Change %
P/E Ratios less than 13	45	100	122%
P/E Ratios less than 15	69	138	100%

Note: Price-to-Earnings Ratios (P/E Ratios) based on trailing 12-month earnings.
Source: YCharts.

Summary

The investment climate is a bit more delicate today than earlier this year. Rising interest rates and other factors have given the market some indigestion. We are somewhat concerned about the potential future level of inflation catching the market off guard. Yet more importantly, the prospects for continued economic growth remain on solid footing – this seems to historically provide a solid backstop to downside market risk.

Market internals suggest some adjustments to an investor's portfolio may make sense – namely (1) over the past year, certain areas of the stock market have become significantly more attractive relative to other areas of the market, and (2) fixed-income allocations may benefit by preparing for a potential pickup in the rate of inflation.

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