

## For the stock market and for the FANGs, is too much ever enough?



**By Michael A. Tyler, CFA**  
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A cardinal principle of investing is that performance is ultimately mean-reverting, whether among or within asset classes. Nothing climbs to the sky, and nothing stays in the dungeon forever. Given time, market darlings are brought to earth, and even “dead cats” will bounce. This year has put investors’ patience with this maxim to a severe test.

The FANG stocks — Facebook, Apple / Amazon, Netflix, and Google parent Alphabet — have been on a tear, outpacing the rest of the market: From year-end 2016 to mid-year 2018, these five stocks have more than doubled, up 106%, on average. In the same period, the RUST bucket — real estate, utilities, staples, and telecom — gained an average of only 4%.

Investors have been expecting “value” stocks (like the RUST bucket) to regain their footing for a long time. Value lagged “growth” by twelve percentage points last year (+16% vs. +28%), leading many market strategists to take a more defensive approach this year; too bad if they did, because large growth stocks have gained 7% this year, while value stocks have lost 2%. As millennial market watcher (and Ethel Merman wannabe) Florence Welch sang, “One thing’s for certain: A year like this passes so strangely somewhere between sorrow and bliss.”

Our client portfolios have outperformed their benchmarks this year in large part because we resisted the lure of value traps. Growth stocks are priced more expensively than value stocks (measured by P/E, book value, or cash flow ratios), but they also have substantially better outlooks. Mean reversion — and the ascendancy of value stocks — won’t occur until FANG stock prices outpace their earnings trajectories, or until the RUST bucket shows signs of earnings improvement.

The same is true of asset classes. Equities have outpaced bonds consistently for many years, begging the question of whether (per Ms. Welch) “too much is never enough.” As with individual stocks, the answer lies in the valuation: While stocks have shrunk the valuation gap with bonds, they are still not expensive. The S&P 500 is currently priced at about 16x year-ahead earnings; stocks have already reverted to their mean valuations, while bonds remain expensive due to persistently low interest rates.

### >> PERSPECTIVES ON THE ECONOMY

## Looking past the warning signs



**By Timothy Garvey**  
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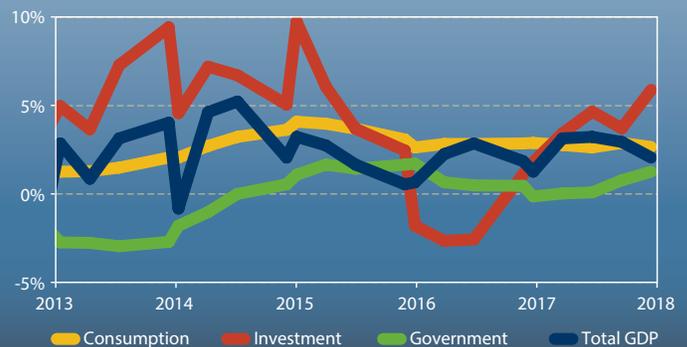
Investors this year have confronted many warning signs that our long economic expansion is near its end — signs such as a minor pullback in GDP growth early this year, slower personal consumption growth, rising inflation, and fears of a trade war with China. Those headlines have led to sharply higher volatility compared with last year.

We take a different view: We remain bullish on the U.S. economy and think that the current near-record-long bull market has some more room to run. The fundamentals are simply too strong.

Monthly payroll gains continue to track at a robust pace, with the six-month trailing average remaining above 200,000 net new jobs. The unemployment rate hovers near 4%, as recent data indicates that many retirees and other non-working people are returning to the labor force. The influx of new and returning workers has kept a lid on employee wage growth, which remains below 3%. Inflation isn’t an issue, despite the sharp increase in oil and home prices.

Steadily rising incomes in a strong labor market, together with the recently enacted tax cuts, point to a sizable rebound in consumer activity as the year unfolds. Meanwhile, private-sector investment has been growing rapidly, fueled by consumer demand; corporate earnings are poised for another year of double-digit growth. While we recognize the warning signs in the market, we remain confident that strong underlying fundamentals can support the aging bull.

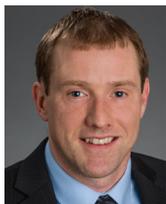
### GDP COMPONENT GROWTH RATES



Business investment has soared recently, while consumer spending has slowed slightly.

>> FOCUS ON EQUITIES

## Stock markets confront global trade challenges



**By Allen Laine, CFA**  
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Despite headlines of trade wars and political upheaval in Europe, the domestic equity markets are holding their ground.

Following an early spike, then a steep plunge, and later a steady recovery, the S&P 500 finished the first half of 2018 barely in positive territory, while the Nasdaq Composite and Russell 2000 indices were close to all-time record highs. Markets have been volatile, to be sure, but ultimately investors have proved to be quite resilient. Perhaps that's because corporate America is doing quite well, boosted by a strong economy and tax reform. Unemployment is very low and yet we have seen few signs of rising inflation: we are experiencing a Goldilocks scenario.

Encouragingly, revenue and earnings growth have been robust; more importantly, management teams across various industry sectors believe there is more runway to further expansion. This is highlighted by the surge in business investment we've seen this year, as companies invest for future growth. Valuation metrics have become more attractive since the start of the year as earnings estimates have been revised higher, while stock prices haven't moved as quickly.

As one market pundit once said, Goldilocks stories end bearishly. As good as the current market environment is, clarity on trade is critical for continued economic expansion. Rhetoric from world leaders has been piercing but action has been limited. President Trump, and his counterparts globally, presumably recognize that all sides would be harmed by an all-out trade war. Difficulties are mounting for some less advantaged firms stemming from protectionist measures. Companies, such as Harley Davidson in the U.S., Daimler in Europe, and ZTE in China have warned about the negative repercussions of these policies.

Unrestricted global markets and resumption of free trade are crucial to economic vitality, while uncertainty related to trade is undoubtedly bad for stock markets. We think cooler heads will prevail; if a path to compromise emerges, markets would be poised to advance again. Still, we are realistic that resolution will take time. Barring any dramatically negative escalation in trade tensions, we still think the domestic equity markets offer the best risk-adjusted return potential. While negotiations continue, however, we need to become accustomed to heightened volatility in the stock market.

>> FOCUS ON FIXED INCOME

## Are the U.S. debt markets telling us to get defensive?



**By Tom Bussone**  
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Investors are always searching for warning signs of the next recession. Fortunately, they have been looking in vain for a long time: The current 108-month U.S. expansion is the second longest in modern U.S. history, trailing only the 120-month run from 1991 to 2001.

The Treasury bond market, however, is indicating that we are likely in the very late stages of this cycle. The spread between the 2-year and 10-year Treasury notes declined to its narrowest margin since 2007 — just 33 basis points (bps) at the year's halfway point. If this weren't worrisome enough, investment grade corporate spreads over U.S. Treasuries have slowly been rising all year; they recently touched 110 bps, an increase of almost 20 bps from last December.

Bears stress that a flat yield curve along with expanding corporate spreads are sure signs that the equity markets are on the brink of some trouble. They argue that an inverted curve has preceded the past seven recessions, and that wider spreads presage weaker profits. We don't overlook these factors, but we don't think it's yet time to get defensive in our investment portfolios. The yield curve remains positively sloped, and developments in Europe may push long-term rates higher to steepen it further. Too, spreads are bouncing off abnormally low levels and are only now beginning to normalize. Instead, we focus on U.S. corporate earnings and strong economic data, which currently suggest that this expansion may turn into the longest one ever.

### CORPORATE SPREAD OVER TREASURY DEBT



The spread between investment grade corporate debt and Treasury debt has widened modestly from unusually low levels.