April 2019

Reversal

The past two quarters have been a strange trip to nowhere for the markets. With US economic growth thought to be still accelerating, the Fed raised rates last October. Despite early signs of weakness in Europe and Asia, they also foreshadowed additional hikes. This commentary caused the initial fourth-quarter pullback in equities. Then, midterm election results induced a short-lived rally in November. The market then began a significant correction that resulted in the worst December for equities since the Great Depression.

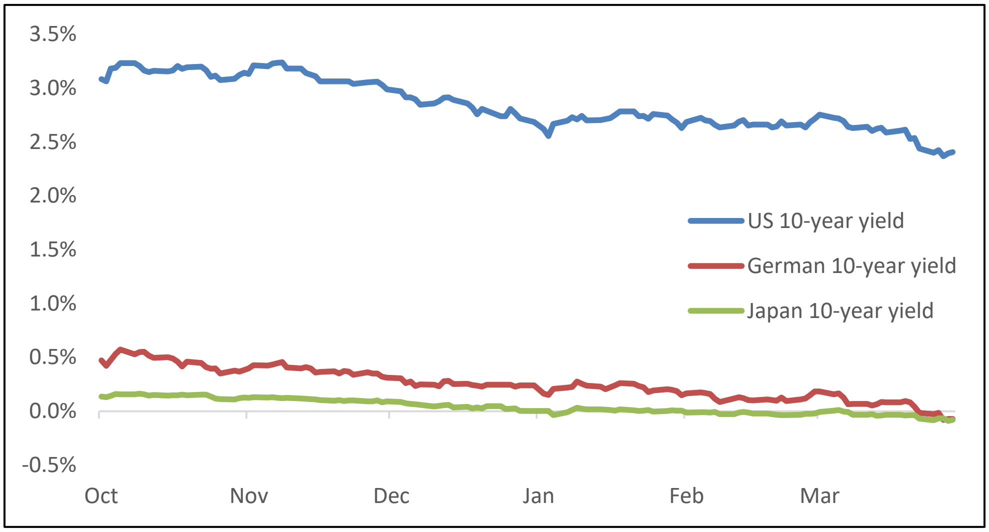
In hindsight, the reasons for the December fallout are very apparent; the Fed signaled even more monetary tightening amid signs of a slowing global economy. Investors also became increasingly concerned that a trade deal with China might not materialize. Now, only three months later, the market has almost fully recovered. The primary causes of this sharp reversal were the Fed's significant pivot regarding future rate hikes and renewed optimism about a peaceful trade accord between the world's two largest economies.

While the amount of media attention devoted to a trade deal with China seems endless, our view is that the US and China have experienced slowing economic growth during the trade battle, and both country's economies would stand to benefit from a resolution. Therefore, at some point before the next US election cycle ramps up we expect they will shake hands on a deal, which will likely catalyze the equity markets.

The title of this letter – Reversal – refers to the Fed and the V-shaped recovery in the market since the December lows. In October and again in December of 2018 the Fed messaged more tightening actions. Further rate hikes were deemed necessary to reach the "neutral" level for the economy, and the plan to continue reducing balance sheet holdings was said to be on autopilot. The Fed viewed the continuation of its tightening efforts as a way to move monetary policy significantly closer to normal, despite criticism from the President and some informed market observers. The Fed also believed that further rate hikes could provide an opportunity to become more accommodative when the next recession arrives.

When looking at US economic data in a vacuum, the policy made sense; unfortunately, this US-centric view failed to account for decelerating global growth trends fully. This misstep significantly upended the markets in December. Concurrent with the declines in the equity market, US economic data started to soften, and monthly data out of Europe and Asia began to decelerate sharply. As a result, the Fed pivoted and communicated a much more dovish stance in early January, noting they would remain patient and data dependent when assessing plans for further tightening efforts. The change in posture assuaged some of the market's fears, and stocks recovered quickly. Most economic data in 2019 has remained soft, particularly abroad, and as a result, investors have run with the idea that interest rates should remain unchanged and balance sheet reduction plans should end in September. The Fed put option was back on the table.

This abrupt change in the Fed's posture helped stocks but also caused yields to plunge below 2.5% on the 10-year US Treasury which caused a slight inversion of the treasury curve. Historically, an inverted yield curve has been a harbinger of a recession. The time between inversion and recession can be as long as two years, and historically equities have generated positive returns in the interim. The interconnected nature of today's global monetary policies allows investors to move capital across borders with relative ease, which is unique versus prior cycles. With yields in other developed countries like Japan and Germany hovering near zero (or even negative), it is not a surprise that our treasury yields are being pulled down as they represent an enormous relative value. As a result, we are reticent to accept signals such as an inverted yield curve as a guarantee of future weakening economic conditions.



US 10-year Treasury Yield Near 2.4%

Germany and Japan 10-year Yields near 0%

US economic data supports this view. Expectations remain for US GDP growth to slow from 3% and hold near 2% in 2019, although the first quarter print may be closer to 1% given seasonal weakness, severe weather and the impact of the government shutdown. We view this as a short term aberration as the US consumer remains healthy given excellent employment trends and rising real wages, and the momentum behind their ability to spend does not change quickly.

The equity market is struggling with how much importance to place on the inversion of the yield curve. If the yield curve is to be believed, the current soft economic data is signaling the onset of a recession. If global flows of capital are driving the yield curve, then investors who use it as their primary economic signal may be misreading this data. We believe that US stocks will continue to be the preferred investment vehicle given our relatively strong economy, and the dearth of yield available in global fixed income markets.

With this backdrop in mind, and the bull market recently reaching its 10-year anniversary – the longest rally ever – we continue to view protecting client capital as our primary focus. Our equity and fixed income portfolios remain defensively positioned. Most of our companies trade at a significant discount to the market and have yields well in excess of 2%, a combination that we believe provides an opportunity for further appreciation while keeping risk levels relatively low. Our bond portfolios have also remained focused on reducing risk by owning short duration corporate issuances and higher yielding preferred securities. We are not comfortable at this point owning longer duration corporate bonds or taking on additional credit risk just to reach for a desired level of yield.

We will continue to focus first on preserving client capital and secondly growing that capital. As noted in January, we believe the volatility that has been re-introduced to the markets will provide opportunities to adjust holdings throughout the year. In this environment, we think value investing may once again be rewarded after taking a backseat to growth strategies when volatility was virtually nonexistent. We stand ready to take advantage of any opportunities.