Pointillism: Fed Chairman Powell Style

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The great investor, Bill Miller, once said that changes in trend appear as a blank canvas upon which, drop by drop, dots emerge to create an image that was previously non-existent or invisible. Enter October and Fed Chairman Powell's clarifying moment for the dot plot image (if you will), "we are a long way from neutral" and just like that, stocks began a relentless sell-off, anticipating that the Fed was far from done raising rates. Price-to-earnings multiples compressed even as companies were reporting record earnings and revenue growth. During the sell-off and amid all the hand-wringing, I penned a commentary (October 1, 2018 "1400 Dow Points Just Ain't What They Used to Be", arguing that corrections are healthy but by no means did we believe this was the beginning of the bear market. A few weeks later, the market sold off 600 points in one day and I gave an interview to The Washington Post where I argued that one of the things affecting the market in October was a lack of buyers—the corporations who have been the marginal buyer of stocks throughout much of this bull market—due to corporate earnings quiet periods. A similar buyer's strike took place in late January, early February when the market corrected.

I also discussed the short-term impact of algorithms on stock price volatility. Make no mistake; in the near-term stock prices are driven by algorithms, which power the sell programs. And once the selling begins it becomes self-fulfilling. But, as we have written in the past, this near-term volatility creates opportunities for long-term investors to upgrade the quality of their holdings at reduced prices.

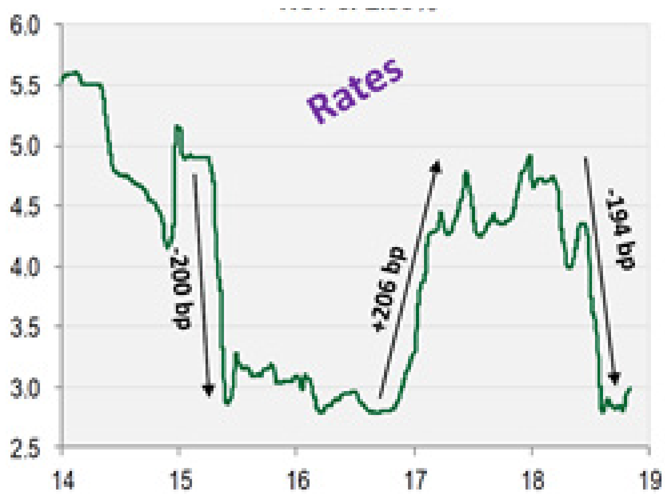
Also looming was the now-settled mid-term election and a Fed under pressure from the President after Chairman Powell set off the recent market sell-off with his now famous comment that the Fed was a "long way from neutral." Scaring investors into the belief that the Fed was going to raise until something breaks. Mitigating the uncertainty is robust GDP growth, consumer and CEO confidence hovering near historical highs and the Conference Board leading economic indicators still (for the most part) signaling a strong and expansionary economic climate.
Of course, the low unemployment rate, worker shortage, jobs report and average hourly earnings give economists and investors pause. When do rising wages end the growth of historically high corporate margins and negatively impact earnings growth?

These are the things being debated on trading floors around the country. Are we in—pick a metaphor—the final act, late innings, the fourth quarter or, worse, overtime?

Below are a few things we are watching:

China: Growth in China has slowed. This is not only due to the trade war but also government policy. The government tightened monetary policy in 2017, which helped slow growth in 2018. Recently monetary policy was eased, which has historically led to stronger growth. Expect to see the benefit in 2019, which will be good for global growth.

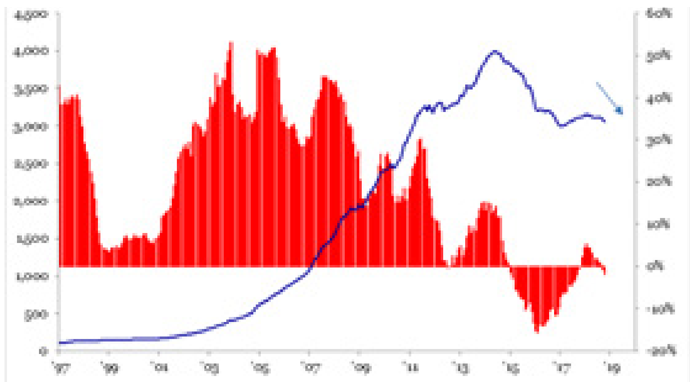
SHIBOR 3-MONTH (NOV 6: 2.99%)



Other recent China easing moves include a weakened yuan to the dollar, more liquidity added to the banking system, auto tax cuts, lower mortgage rates, expanded government borrowing and reduction of VAT tax brackets.

But foreign reserves remain a concern. They are slipping. And this is what sparked the 2015/2016 slowdown that sent global markets into a spin. Given that economic growth has already slowed we are watching. Carefully.

CHINA FOREIGN EXCHANGER RESERVES $BN (LHS) VS. Y/Y% (RHS)

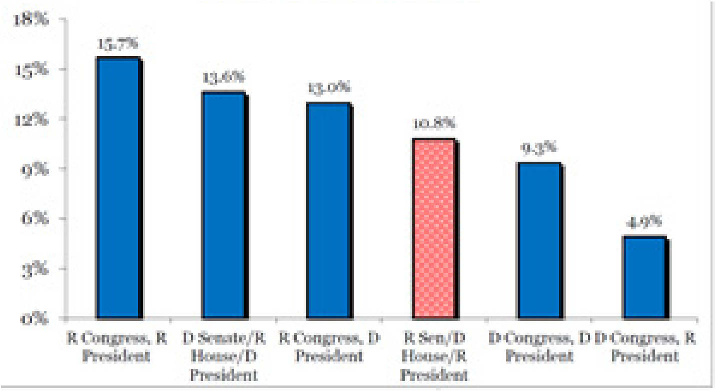


U.S. Corporate Earnings are Decelerating: The TCJA gave corporate earnings a boost in 2018 but are expected to decelerate in 2019. We believe some of the market volatility in the second half of 2018 can be attributed to investors recalibrating expectations for future earnings. That seems prudent. But we do not expect earnings to drop off a cliff in 2019. Top line growth has been robust and growing in 2018 with a majority of companies raising revenue guidance and we do not expect to see that slow much in 2019 except due to an unpredictable exogenous event. If revenues remain in the high single digits we believe 2019 earnings can remain in the low double-digits, high single-digits stocks can provide relatively strong returns without multiple expansion.

SHIFT IN BOTTOM UP CONSENSUS S&P 500 CALENDAR YEAR EPS GROWTH RATES SINCE LATE JUNE

Source: RBC US Equity Strategy, Thomson, Factset, S&P

PARTISAN CONTROL. AVG. ANNUAL S&P PERFORMANCE (1933-2017, EXCL. 2001-02)



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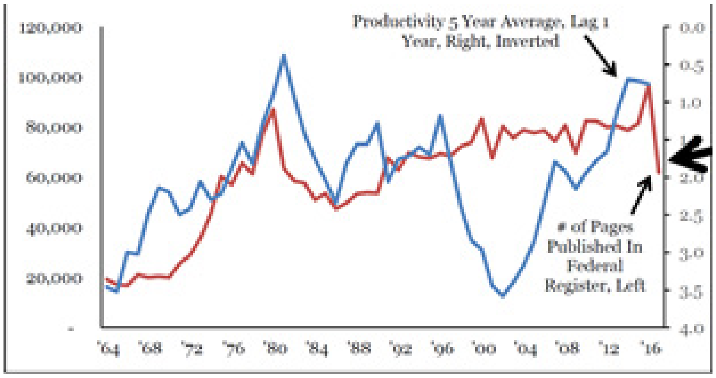


TAILWINDS:

Mid-term Election Results: Gridlock is Good

You have heard us say this a dozen times but the S&P 500 has not declined in the 12 months following a midterm election since 1946, and has averaged a 15.3% increase. We expect stocks to be higher one year from now. And as you can see from the chart top right, stocks perform well in a divided government environment. Much about this administration has not followed the norm but with a robust economy and incentives for both the U.S. and China to come to the table, we are optimistic about stocks for the next 12 months.

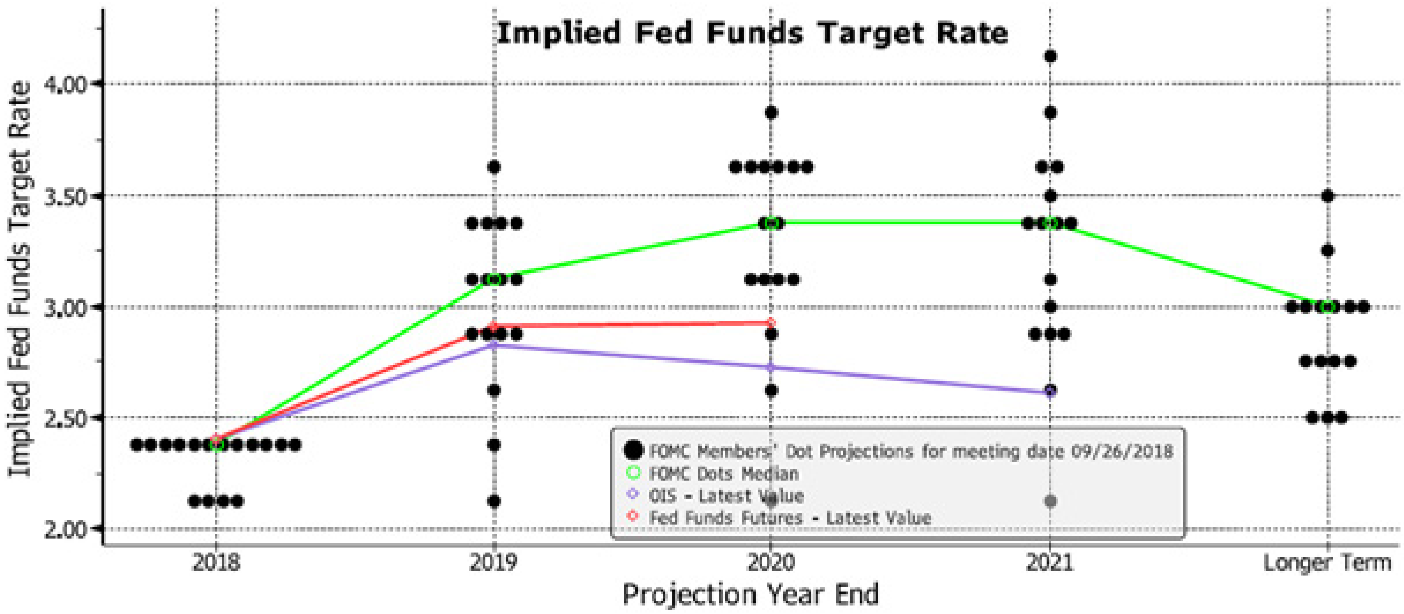
Deregulation: The Trump Administration has reduced the regulatory burden on U.S. corporations significantly. Savings estimates are north of $100B annually. The chart above shows productivity improves when regulations decline. This economy needs improving productivity to sustain margins and earnings growth. Improving productivity may be the antidote to rising wage pressure. If so, this will extend the cycle.

FIXED INCOME REVIEW: THE TONE BEGINS TO SHIFT

Three months ago, there was plenty of skepticism that the Fed would make good on its promise to significantly hike rates along the path implied by the famous "dot plot" of forecasts by members of the interest rate setting Open Markets Committee. We also came to doubt there would be a full four hikes in 2018 with additional hikes in 2019 on the trajectory implied by the Fed's statements. Yet as the quarter evolved and the comments and meeting minutes and all of guidance added up, an increasing number of Fed watchers not only believe they are serious in their hawkish tone, but now might even tighten to an almost excessive degree.

While it is true that economic growth has seen a significant increase and the inflation measure most watched by the Fed has neared the policy target, most observers agree that inflation is hardly running amok and the growth spurt is unlikely to have much staying power given the underlying fundamentals. But if the Fed disagrees with such sentiments and decides to preempt any risk to their goals, the proverbial punchbowl will be taken away sooner than later and short rates will be hiked into the mid 3% area by mid-year 2019.

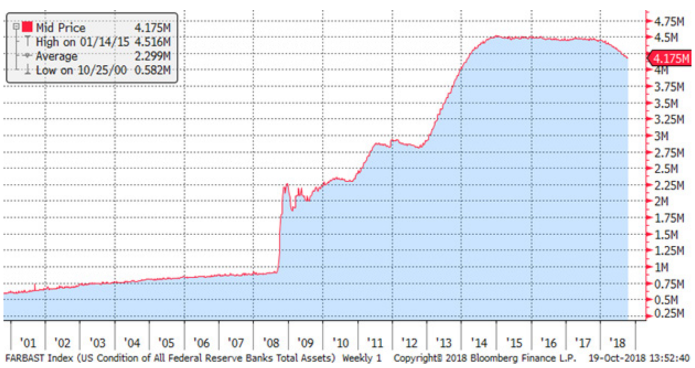
FEDERAL RESERVE FOMC "DOT PLOT" SHORT POLICY INTEREST RATE PROJECTIONS



While the bond market has not fully priced in all the rate hikes implied by the chart (see red line for the Fed Funds Futures) it has moved medium to long rates decisively over the 3% threshold it once considered a ceiling but now may be a floor. This is significant if we wish to avoid an inverted yield curve (short rates actually higher than long ones) that have historically meant recession.

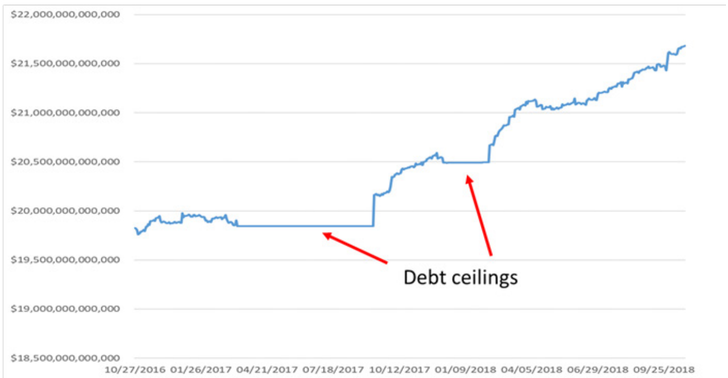
In addition to the Fed's tightening of policy rates the bond market is being pressured by two other significant issues. The first is also the Federal Reserve's doing and that is the unwinding of its massive balance sheet accumulated during three consecutive periods of Quantitative Easing (bond buying to force down long interest rates.). So far the Fed has shed over $300 billion in assets by allowing them to mature without reinvestment. Taking the largest single buyer of bonds puts pressure on the market to take up the slack.

FEDERAL RESERVE BALANCE SHEET: SUM OF GOVERNMENT BONDS HELD BY THE FED.



The other issue of concern for the bond market is the significant new supply of US Treasury debt as the government funds recent tax cuts and spending programs. In two years, the Treasury has added nearly $2 trillion in new bonds. So far this has not meant a dramatic rise in rates, but the worry is that it will at some point.

US GOVERNMENT DEBT

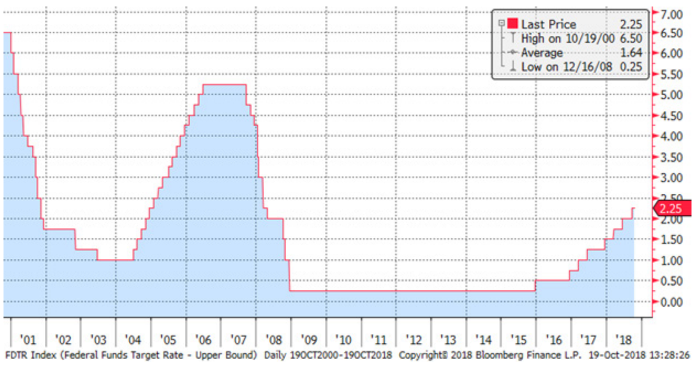


Source: US Treasury

What we Saw on the Way to the Quarter's End

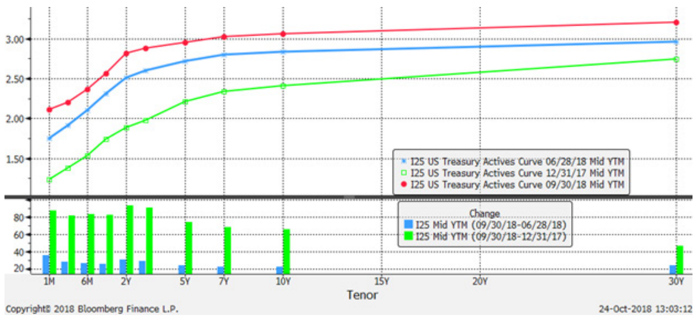
The US bond market in the third quarter saw yields whipsaw quite a bit but end up higher overall. The period started with bonds drifting lower in price and higher in yield, reflecting the view that Federal Reserve policy remained on the somewhat "hawkish" side and additional rate hikes should be forthcoming. In August, however, turmoil abroad, including the sharp decline in the Turkish Lira and general concerns over the emerging markets caused a flight to safety rally in US bonds where prices rose and yields fell. In September, the rally faded quickly as those worries declined, and attention turned to the continued strengthening of the US economy and the decision by the US Federal Reserve to hike rates for a third time this year. Despite some softer language in the Fed's press release, Chairman Powell, among other Fed officials, made it clear that additional rate hikes should be expected and the market has priced in another hike in December. Overall the hawkish tone led to a significant rise in rates with the US 10-year Treasury reaching 3% by the end of the period.

FEDERAL RESERVE'S RED FUNDS POLICY INTEREST RATE (UPPER BOUND)



In terms of the US Treasury yield curve, it has continued to flatten with the Fed hiking short rates once again in September and long rates more-or-less anchored just above 3%. The more medium portion of the yield curve shifted upward uniformly with the 5-year ending at 2.95%, the 7-year at 3.02%, the 10-year at 3.06% and the 30-year "long bond" ending at 3.20%. The move by the 10-year US Treasury above 3% seems to have been important for sentiment as traders now seem to see 3% on 10s to be a floor rather than a ceiling. The resolution of the NAFTA renegotiation, even if it amounted to little substantive changes, has encouraged many participants to conclude that the trade wars will not be as long in duration or as damaging in scope and this has contributed to the rise in rates as good economic news is wont to effect.

US TREASURY YIELD CURVE FROM YEAR END 2017 TO PRESENT



The Barclay's Intermediate Aggregate Bond Index faced a total return during the quarter of 11 bps with a rally in August negated by a sell-off in September. Most sectors of the benchmark had total returns for the period of essentially a few basis points with corporates doing slightly better and Mortgages falling a little behind. In extended markets, outside of the benchmark, US Dollar denominated Emerging Markets had a positive 1.4% return in spite of Turkey's troubles and US High Yield produced a positive 2.4% as investors stretched for yield and believed a strengthening economy would mean better prospects for the sector and lower defaults. The Barclay's Municipal Bond index was down 0.2% during the period with all the losses accumulating in September.

Our Taxable Active Fixed Income strategy outperformed the Barclay's Intermediate Aggregate Index by 31 bps during the quarter with a total return of 42 bps. The outperformance reflected, in part, our duration exposure of more than a year shorter than the index. Our short duration holdings such as the Fidelity Conservative Income Fund (+0.68%) and the Stone Ridge Alternative Lending Fund (+1.37%) along with some short US Treasury bonds helped shield the portfolio from the September sell-off. Despite Hurricane Florence, our Stone Ridge Reinsurance fund also outperformed (+1.17%) even though it has a 2.4% exposure to hurricane risk in the region Florence struck. Year-to-date the portfolio is ahead of the benchmark by 171 bps with a return of +0.85% compared to a loss on the benchmark of -86%

The recent rise in rates has allowed us to reinvest proceeds from interest receipts and maturing bonds in short to medium government bonds at almost 3.5%, increasing our portfolios yield as well as restraining the sensitivity of our investments to rising interest rates.

The outlook appears to be worsening in the near term as the Fed seems increasingly interested in hiking rates in December once again. We had previously discounted such a move but now believe the Fed is planning on overshooting the so-called neutral rate (where the policy stance can be seen as neither tight nor loose) as insurance against inflation and as ammunition for any future downturn. Should rates generally overshoot, we will take advantage and lock in those higher rates.

For the time being, our duration positioning will continue to be significantly shorter than the benchmark as we still see the outlook on interest rates as remaining asymmetrical.