North American Management

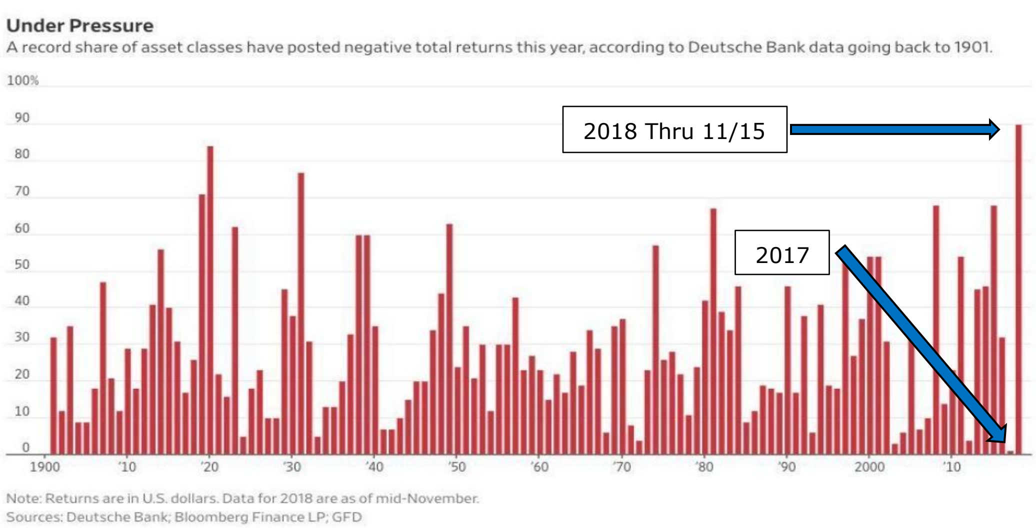
Stimulus Ebbs, Growth Moderates and 2018 Ends Badly

After soaring roughly 40% since the 2016 U.S. elections, the S&P 500 gave back more than a third of those gains in one extremely frustrating quarter. The performance gap between the U.S. and other regions also narrowed substantially, a possibility we foreshadowed in our previous letter without fully appreciating the volatility that lay ahead. While this quarter's sell-off occurred against a backdrop of slowing global growth and tightening liquidity conditions, there are currently few signs of imminent recession, and the U.S. consumer is on sound footing - from both a balance sheet and an employment perspective. However, by late December market participants were discounting a fairly bleak outlook, if not a recession, in 2019. While we think sentiment got a bit overheated amid generally poor trading conditions (see page two), investors were trying to balance slowing earnings growth with a range of possible policy responses, and such price discovery can be volatile.

U.S. equity investors just experienced their worst December since 1931, and their worst quarter since 2008.

First, the numbers: for the quarter, the S&P 500 dropped 13.5% and the small-cap Russell 2000 ended down 20.2%, while the MSCI ACWI ex USA fell 11.5%. For the year, those indexes were down 4.4%, 11.0% and 14.2%, respectively. The MSCI Emerging Markets Index fell 7.5% in the fourth quarter, losing 14.6% this year, while Europe declined 12.7% on the quarter and 14.9% for the year. Most bond index returns were already negative heading into the fourth quarter, interest rates having risen most of the year. As stocks sold off aggressively, interest rates dropped while credit spreads widened to produce a mixed bag of fixed income results for the year, depending on credit quality. U.S. high yield bonds ended the year down 2.3%, for example, while the Bloomberg Barclays Aggregate was flat and municipal bonds and mortgage-backed securities rose 0.9% and 0.8%, respectively. At year-end, one-year Treasury Bills were yielding 2.6%, higher than U.S. inflation rates, and offered the highest total return available in any asset class in 2018, save for a few commodities and emerging markets such as Brazil and India. The graph below puts the record lack of contribution to return in 2018 from asset class diversification in perspective, and shows how easy it was for diversified portolios to shine in 2017 (another record):

Short-term U.S. Govt. bonds outperformed almost all other assets in 2018, a rare occurrence.



In fact, by mid-November, about 90% of asset classes were in the red, a record at least since 1901.

High Volumes Overwhelm Markets in December

Beyond the headline issues of tariff wars and Fed tightening, there were a number of extreme intraday moves in December, at times nearly 5%, in U.S. stock indexes. Market stakeholders are right to question whether the plumbing (large banks) that supports such high volume directional trading is adequate, over-burdened as it was by several structural factors in December: 1) numerous hedge funds, already lagging in 2018 or in many cases liquidating to meet redemptions, either chose to or were forced to deleverage at the same time; 2) intraday momentum trading, some of it programmed to take advantage of poor liquidity conditions, often contributed to volatile price swings; and 3) tax-loss selling increased sharply as investors sought to minimize capital gains in a down year. While all this selling pressure mounted, large banks - mandated to reduce their balance sheets and their risk capital - were less inclined to provide trading support for stocks and bonds. A low was reached by the close on Christmas Eve, at which point the S&P 500 had dropped 16% in just 15 trading sessions. Since then, through January 15, the MSCI All Country World Index has risen 9% and the S&P 500 is up 11%. At a minimum, price signals in times of stress can be suspect, especially if one is trying to avoid behavioral biases that might lead to irrational portfolio decisions.

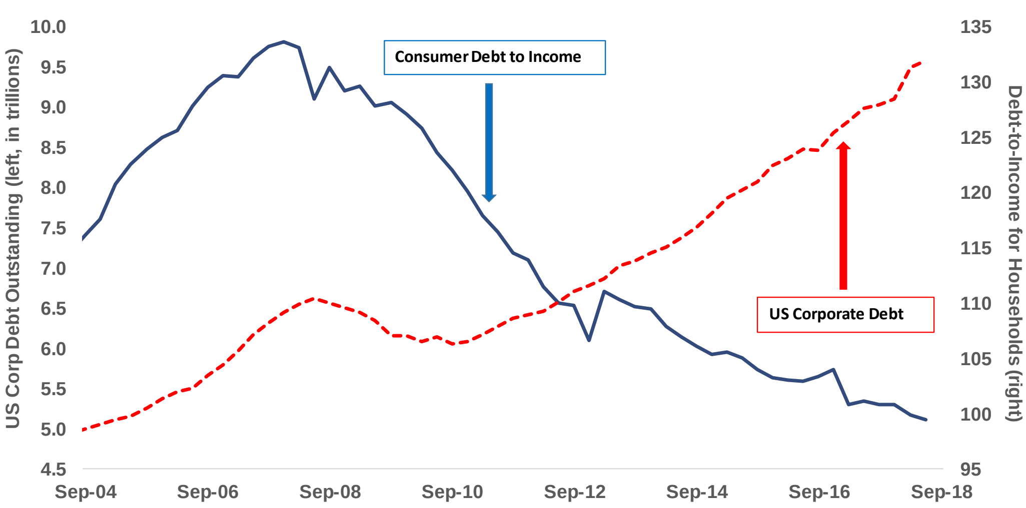
Diminished trading liquidity is arguably an unintended consequence of post-crisis regulatory reform.

Higher Rates and "QT" – How Much is Enough?

The main purpose of liquidity injections through lower interest rates and bond buying is to embolden investors to buy long-lived assets like stocks, long-term corporate bonds and real estate by dramatically lowering the cost of money. Similarly, corporations are encouraged to borrow in order to make long-term investments in factories, people and supply chains. All of these investments and activities are good for the economy, although most involve the double-edged sword of leverage. If the cost of money stays too low for too long, as it arguably has since 2013, excesses inevitably result (see graph below). Once the Fed decides to change course and the tide of liquidity starts to recede (**Q**uantitative **T**ightening), there is no magic formula for calculating the "neutral rate," above which restrictive monetary conditions can cause a recession. In retrospect, however, it is clear the Fed raised borrowing costs enough this year for many investors to simultaneously reverse course, reduce their leverage and buy less risky short-term assets at the expense of stocks and corporate bonds.

Pursuit of yield without regard to other risks, especially leverage and duration, has been a hallmark of this recovery.

Chart of the Quarter: The U.S. Consumer is Healthy[1]



Regulators always solve the last crisis well: While corporate debt-to-income ratios are concerning, the consumer balance sheet looks strong.

We are watching corporate credit markets for signs of further weakness in 2019, as corporate and consumer balance sheets are ultimately intertwined. One of the excesses referred to above has been the use of cheap debt to buy back stock at the expense of other investments, like plant and equipment, that might increase future cash flows – cash flows that one day might be needed to retire debt. We, and others, are also struck by the record amount of BBB rated bonds issued in recent years – far more than the high yield market can digest should the usual wave of recessionary downgrades materialize. Meanwhile, in conversations with managers globally (we have over 300 meetings or calls per year), one common refrain we hear is that many of the equities they own are trading at crisis valuations. While the risks of a slowdown are material, it is important we don't conflate slowing earnings with negative GDP growth or systemic crisis. To quote a London-based manager we respect: "…the markets have the direction right, but may have overstated the magnitude." [2]

We will be watching credit markets closely in 2019, and may rebalance portfolios more frequently if volatility persists.

There are indications that policymakers are taking fourth quarter volatility and corporate debt levels very seriously. While we see this both in Federal Reserve rhetoric and in trade talk progress reports, damaged confidence takes time to repair. The value of the world's capital stock endured quite a painful reset in Q4 2018 and voter unrest has risen markedly. We believe central bankers and politicians will have to respond in 2019 or risk another bout of global deflation.

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Endnotes

[1] Mariner Investment Group, LLC, Federal Reserve, Bloomberg.
[2] Sloane Robinson LLP, December 2018 Investment Manager's Report.
Source of data not specifically cited: FactSet. Referenced indexes in U.S. Dollars, unless otherwise stated. All equity returns include dividends. All return data through December 31, 2018 unless otherwise stated.

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