North American Management

Q1 2019
INVESTMENT
LETTER

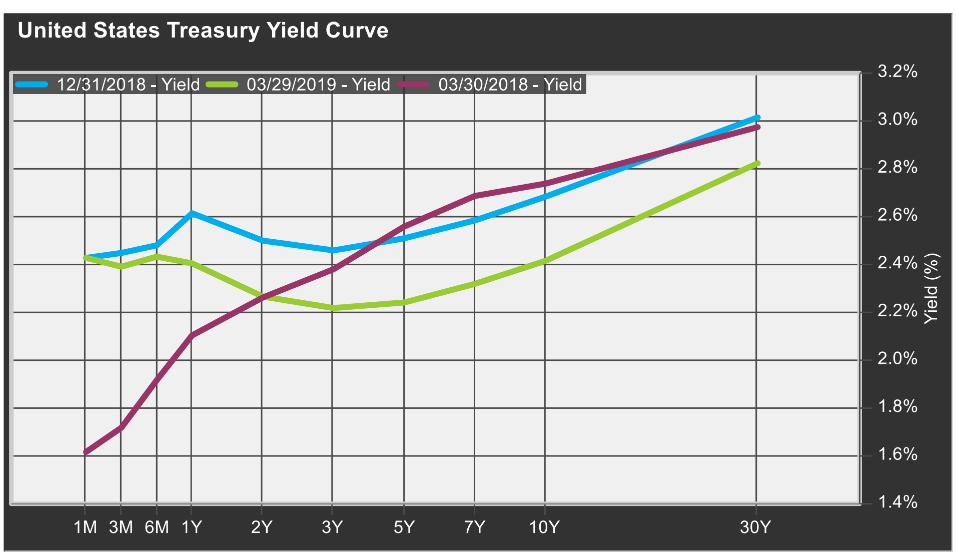
The Fed Pauses, Stocks *and* Bonds Rally

We could write this quarter's letter simply by reversing all the adjectives and most of the performance numbers of last quarter's commentary. In fact, the pace of recovery from the gut-wrenching sell-off that ended 2018 has been both remarkable and rare. After the worst December since 1931, the S&P 500 delivered its best start to the year since 1998, rising 13.7%. The U.S. small-cap Russell 2000 Index gained 14.6%, and U.S. large cap value stocks rose 12.2% this quarter after notably weak performances in 2018. Foreign stock market gains were also impressive. The MSCI All Country World ex USA was up 10.3%, and the MSCI Emerging Markets Index gained 9.9%, while the MSCI Europe Index rose 10.8%. One-year trailing performance is less exciting among foreign equities – mostly flat to down 15% depending on the region versus up 9.5% for the S&P 500. Among equity risk factors, the persistence of Quality (mostly defined by balance sheet health and earnings visibility) as a leader in two consecutive, though wildly different, quarters is remarkable. We are viewing this as evidence of typical late cycle rotation, despite significant easing of interest rate pressures over the past few months.

U.S. equity investors just experienced their best 1st Quarter since 1998. Bonds and commodities also rallied.

Which brings us to bonds. The entire asset class also rallied in the first quarter, after selling off with stocks for most of 2018. While the synchronous rally was helpful to portfolios, it offers mixed messages about the future which are discussed on page two. The Bloomberg Barclays Aggregate Index rose 2.9%, the Markit iBoxx Liquid High Yield Index was up 7.5%, and asset-backed bond markets for residential mortgages (Bloomberg Barclays US MBS) gained 2.2% as thirty-year conforming mortgage rates fell back to 4.4% from 4.8% at year end, a positive harbinger for the spring season (homebuilder stocks rose 19.4% on the quarter). At quarter-end, however, one-year Treasury Bills were yielding 2.4%, only 10 basis points (1/10 of 1%) less than ten year yields. The narrow spread between the two compared to one year ago is not cheering some investors, and rates have dropped further since year end 2018:

Long term interest rates, along with inflation expectations, have dropped – so bonds did well too in Q1, but…



…the U.S. yield curve has flattened considerably over the past twelve months, and inverted curves are a fairly reliable predictor of recession.

Who to Believe?

While sharply higher equity prices are reflecting a prosperous future with minimal inflation, the bond market seems to be signaling an economic slowdown. Whenever stocks and bond yields move in opposite directions, and they often do for short periods, it is tempting to ask which is "correct," or which market is the more efficient futurist. Looking back on the extraordinary fluctuations of the past six months, it seems plausible that both interest rates and equities are more fairly valued today than they were in late December 2018. We offer three reasons for this:

1) Obviously the Fed's decision to pause its campaign of short term interest rate hikes caused equity investors, many of whom were fearing imminent recession, to reassess.
2) While we don't believe they were just a "sugar high," last year's corporate tax reform measures raised inflation expectations. Although wage growth has picked up, inflation data has not and inflation expectations have rolled over (see chart). Pundits are offering the usual secular explanations, but there is also evidence of a more cyclical slowdown, particularly outside the U.S.
3) Large portions of the globe are experiencing sluggish growth at best, and it was disappointing to see German interest rates retreat into negative territory in Q1. Until and unless there is a broader rebound in Europe and China (both of which would be helped by a weaker U.S. Dollar) the case for higher U.S. rates and higher commodity prices is legitimately in question.

Last year financial assets had to adjust to sharply higher yields among risk-free government bonds.

Chart of the Quarter: Is It Goldilocks?

After the Fed put its campaign on hold, stocks rallied, inflation expectations and bond yields dropped sharply.

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Future expected returns, and valuations, are currently more attractive outside the U.S. That said, faster global growth may raise inflation expectations materially from today's low levels. This environment changes the current Goldilocks narrative, where the economy is warm enough to prevent recession fears but inflation is cool enough that central banks aren't compelled to preemptively raise rates. Our approach is to stay disciplined about rebalancing portfolios while emphasizing quality companies with higher profitability and earnings visibility.

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Endnotes

Sources of graphs and data not specifically cited: FactSet and Blackrock. Referenced indexes in U.S. Dollars, unless otherwise stated. Investors can not invest directly in an index. Index returns include dividends. All return data through March 31, 2019 unless otherwise stated.

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