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TAILWINDS

2018: The Sum of All Fears

Why Volatility is Up and How to Position Portfolios

We want to take this opportunity to characterize the first half of 2018 while outlining how we have repositioned portfolios ahead of new market headwinds.

The large profits and minimal volatility that were the hallmarks of 2017 gave way to a first half of 2018 that flipped the script. So why has 2018 been such a stark contrast to 2017? After all, aren't there always new political and economic developments and no shortage of reasons to worry? Yes, but so far this year the reasons for periodic selloffs seem to vary from month to month – February's inflation scare gave way to March's tariffs, to April's fear of peak corporate earnings and most recently to May's debate about the Iran nuclear deal.

While geopolitics is always a risk, most of the recent fear in the market appears to be centered on the economic expansion. Strangely enough, though, it appears to be driven by both ends of the spectrum – on one side those worried about an economy that's trending too hot (inflation scare) and on the other those concerned about an economy that is starting to cool (earnings peak). Whenever investors are confronted with vastly contrasting views of the economy and potential inflection point, bulls and bears tend to battle it out (the textbook driver of volatility). But we believe that in this instance, volatility is simply moving back to normal rather than an omen of something more sinister.

We believe that the more recent concerns are the most misguided so let's address these first. So in reverse order, here are the sum of all 2018 fears that have driven year-to-date volatility:

April Fear - The Economy is Cooling (Peak Earnings):

The selloff in early Q2 centered primarily around investors' concerns that the economy had peaked, corporate earnings had reached their high-water mark, a slowdown was imminent and the sugar high from the tax cuts was just that—a temporary boost rather than a tool to elongate the cycle. We disagreed and published an intra-quarter update in which we stated "virtually all economic metrics point to a sustained expansion. As such, we don't ascribe recent weakness to recessionary fears; instead we believe it's far more symptomatic of 'valuation multiple' fears."

We went on to state, "Some investors are becoming increasingly worried about higher wages and capital expenditures (capex) reducing margins, while others are concerned about the rise in interest rates (the 10-year Treasury Bond yield finally climbed above 3% for the first time since 2011) hurting over-levered, bottom rung companies. But increased wages and increased capex should help the greater economy which will promote growth and extend this cycle. And if higher interest rates remove some of the dead wood from the economy (i.e.

bankruptcies) then higher quality companies should benefit. This is what capitalism looks like. This is what a normal business cycle looks like. This is good."

We then concluded, "So, what's the problem? In this environment, with higher input costs (wages, capex, interest rates via borrowing), the valuations of last year may no longer be as accurate. In short, it is much more of a benign 'in the weeds' math problem rather than a malignant macro global recessionary problem. Perhaps investors shouldn't pay an 18x Price/Earnings multiple for a stock but rather a more palatable 16-17x. Fortunately, that is the extent of the issue we find ourselves facing today as a result of prices having moved down while earnings moved up." Simply put, investors can stay invested in stocks as recent weakness is not a sign of peak earnings or a looming recession but rather a reset to a more appropriate valuation level.

March Fear – Tariffs and Trade Wars.

As stated in last quarter's Insights, "If 2017 marked the passing of the stimulus baton from the Federal Reserve (via low interest rates) to Congress (via tax cuts), then Q1 of 2018 could be summarized, at least according to the stock market, as the White House dropping that baton. Why? Economic expansions don't die of old age but rather as a result of policy mistakes. Potential trade wars reduce global trade which can reduce corporate earnings. Generations of investors have learned that tariffs in the 1930s only exacerbated the Great Depression and since then, the U.S. has staunchly promoted free trade and globalization.

Fortunately for investors, we can sidestep these headwinds. If we are correct that the economy is not cooling, then domestic stocks should continue to do well. Global multinationals, however, may face headwinds if the proposed tweets turn into trade law. Therefore, investors should consider the stocks of companies deriving the bulk of their revenue from within the U.S. (i.e., Small Caps).

Consider the fact that the largest 100 stocks in the S&P 500 generate nearly HALF their revenue from overseas markets versus around 20% for smaller companies. The lack of a tariff headwind should equate to a relative-outperformance tailwind over the coming quarters. And to further drive the point home, consider two additional tailwinds that may help Small Caps outperform. Smaller companies don't have teams of lawyers and accountants to help negotiate regulations and complex tax codes built up over decades. The current deregulation environment combined with the January tax cut passage should disproportionately help small caps companies. In summary, we expect Small Cap stocks to outperform their Large Cap brethren due to a lack of tariff headwind in tandem with a deregulation/tax cut tailwind.

February Fear - The Economy is Heating Up (Rising Interest Rates).

For the better part of the last four years, the yield on the benchmark 10-year Treasury bond was range-bound between 1.70% and 2.50%. But In early February, yields pushed north of 2.60% as investors got wind that the economy was (finally) picking up speed and that wages were heading north. But only on Wall Street could this be construed as bad news. As mentioned in our February 8th blog post, "A single economic data point (wage growth) suggested that rapid inflation was heading our way. The stock market then extrapolated that single data point to the rest of the economic cycle. While good for U.S. workers, economic theory holds that rising wages trigger inflation, as more money in the system chases the same amount of goods (Demand > Supply = Rising Prices = Inflation). Higher inflation, in turn, leads to a more aggressive Fed as they raise short-term rates to try and cool a hot economy." While the epicenter was inflation concerns, the broader fear was higher interest rates – and to us, those fears seem much more justifiable.

Consider all of the tailwinds for higher interest rates. The first, as outlined above, is the normal business cycle. One should expect (especially in Year 9 of a business cycle) that economic expansion would lead to low unemployment which helps wage gains which in turn pushes up inflation—with higher interest rates to follow.

Second (and third), consider what's happening in Washington DC and the supply/demand imbalance of Treasury bonds. On the supply side via Congress, the tax cut will bring in less revenue (at least initially) and the new budget will add to spending. Either one alone would increase the annual deficit, but taken together, the deficit will likely move towards a trillion dollars. This gap must be covered; so the Treasury Department will be forced to issue more bonds to close the disparity. *More supply generally pushes down bond prices which conversely drives yields and interest rates higher*. Meanwhile the Federal Reserve is affecting the demand side. After years of Quantitative Easing in which the Fed was buying Treasury bonds, the agency is now reducing its balance sheet and letting bonds roll off as they mature. This removes a major buyer from the marketplace and thus, reduces demand for the bonds*. Lower demand causes prices to fall, which again drives yields and interest rates higher*. Taken together, therefore, higher interest rates seem inevitable.

If higher interest rates slow our over-levered economy, stocks should be sold. While these concerns are valid, they seem premature. Interest rates need to move materially higher before they become a drag on economic growth. With yields over 3.0% and still well below nominal GDP above 4.5%, we just aren't there yet—thus it's too early to sell stocks. In fact, investors can use rising interest rates to their benefit in constructing portfolios.

Case in point, rising interest rates and increased loan revenues are a boon to banks and financial stocks. Even income investors (for whom rising interest rates are usually a nightmare) have options. Many sectors exist that benefit from rising rates. We call these types of assets "un-fixed income" because they generate yields that aren't fixed but instead grow along with the economy (e.g., rental real estate), grow along with inflation (e.g., distributions from energy pipelines), or move in tandem with interest rates (e.g., adjustable rate mortgages and corporate bank loans).

Conclusion

In our 24-hour news cycle world, there will always be fears and stories of impending doom in global capital markets. And these stories will morph and evolve over time so that they will always appear to be "new" news. Most will be an illusion; some will be real. But even so, there will always be ways to readjust a portfolio to avert these potential headwinds and possibly even turn them into tailwinds.

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