A LUMP OF COAL FOR INVESTORS THIS CHRISTMAS?

December 26, 2018

Global capital markets have swooned over the fourth quarter of 2018. US large company stocks had represented a lone bright spot for global equity investors this year but fell 7% last week (the worst one-week loss since 2008) and are now down 10% for the year. High quality bonds have rallied in a classic "risk off" move but also remain slightly underwater for the year. Virtually no major investment asset classes (see table, right) has generated a positive return in 2018. As we head toward the end of the Holiday Season, investors can certainly be forgiven for feeling as if they have received a lump of coal for their trouble in 2018. But is this really the case?

	2017	2018 YTD	2017-2018	3-Year (avg. annl.)
Global Equity	24%	-13%	8%	9%
US Large Cap	22%	-10%	9%	12%
US Small Cap	15%	-16%	-4%	10%
Devl. Intl.	26%	-15%	7%	4%
Emerging Mkts.	37%	-16%	14%	9%
US Bonds	4%	0%	3%	1%
High Yield	8%	-3%	5%	7%
US Corporate	6%	-3%	4%	2%
Long Term	9%	-2%	7%	1%
Real Assets				
Commodities	2%	-11%	-9%	2%
Real Estate	11%	-6%	4%	7%
Hedge Funds	8%	-3%	5%	2%
Managed Futures	3%	-7%	-4%	-4%
Equity Hedge	13%	-3%	10%	5%
Global Macro	2%	-4%	-2%	-1%
Global 60/40	15.8%	-7.9%	6.0%	5.7%
CPI	2%	2%	4%	2%
Real Return	14%	-10%	2%	4%

PROXIMATE CAUSES. Last week markets reacted to a string of negative stories that included Brexit, an abrupt US exit from Syria and potentially Afghanistan, an interest rate increase by the Federal Reserve, several high-profile departures from the Trump administration, odd comments from Treasury Secretary Mnuchin last Sunday seeking to reassure investors that the banking system remains stable, and a partial government shutdown over a border fence. Furthermore, it appears that automated and momentum-based trading strategies (now reported to represent 80% of all trading) may be exacerbating these negative trends. While these are all important stories, one can reasonably question what has fundamentally changed regarding the outlook for the US and global economies over the past week.

REALITY CHECK. As you may recall from our prior communications, the world entered 2018 in a rare and favorable state for investors. Interest rates were very low—though no longer historically low in the US—and nearly every economy worldwide was in an expansion mode. Foreign stocks had just registered a strong 2017 but remained attractive compared to US stocks. Bonds were expected to struggle in a low and rising interest rate environment, but the overall outlook was very encouraging.

Much of what was expected to drive growth and capital market gains has come to pass. US GDP has exceeded 3% on an annualized basis and the US remains at full employment. US *and* foreign companies have reached double-digit gains in profitability. In the US, much (but not all) of these gains can be attributed to a permanent change in corporate tax policy that should boost earnings indefinitely. Economists have long predicted that US growth would begin to decelerate in 2019 once the initial effects of tax cuts and fiscal stimulus were digested, and that remains the expectation. We feel it is important to emphasize that most foresee above-trend growth of over 3% in 2019—even if such forecasts have been trimmed lately. Put simply, there is little credible evidence of a looming recession. We acknowledge that foreign growth is slowing along with the US, but it remains positive. Recent capital market results simply do not reflect these current economic realities.

THE IMPACT OF FEAR, ITSELF. What has changed? In a word: Uncertainty. Uncertainty has risen dramatically. US trade and defense policies appear to be the primary drivers, but the strength of US alliances, composition of the president's cabinet, increasing member disenchantment with the European Union, and a downswing in energy prices have all played a role. The speed at which these changes have occurred has finally unsettled investors and may be creating a negative feedback loop to the economy itself. Corporate CEOs make investment decisions based on their outlook and we have seen a reduction in capital spending since the tariff spat began. This works its way through the entire supply chain to reduce demand for a wide array of goods and services. Consumers may also become pessimistic and pare spending. All of this will negatively impact profits and stock prices. In this way fear, itself, can bring about the poor results that were only a worry beforehand.

Returns Are Meeting Reduced Expectations. While it may now seem a long time ago, we remind investors that 2017 far exceeded investment return expectations. As the table above illustrates, returns over the two-year period starting January 2017 were modest but positive almost entirely across the board. A moderate portfolio comprised of 60% global stocks and 40% US bonds would have earned about 6% over the nearly two-year period—and 5.7% per year over the past three years. Note the consistency.

As we have discussed in prior communications, it is very likely that investment performance over the short- to intermediate-term will be considerably below what investors may have expected and experienced over the past three decades. This environment is now referred to increasingly as the "low return era" and is reflective of elevated stock pricing (in the US) and low growth in working age populations in the developed world, coupled with low and rising interest rates. The silver lining is that inflation is also expected to be very low (2% or less). What really should matter to investors is the "real return" they earn—that is, investment returns net of inflation. On that count, performance over the past three years has been normal—about 4% over inflation for the moderate portfolio noted above.

Unique Opportunities in Volatile Markets. Market volatility is healthy and even desirable. Equity market corrections are very normal, even in very strong years, and are necessary to bleed off momentum-based trading and reset pricing to more realistic levels. In fact, elevated volatility can create unique opportunities for informed investors. Specific strategies to consider include put-write strategies and structured notes, among others. Structured notes provide the twin benefits of portfolio protection (hedging) and leveraged upside. Tax-loss harvesting strategies can also be exploited to minimize taxable gains and store up capital loss carry-forwards to offset future gains. In these ways, alert investors can "make hay" when the sun isn't shining.

Fundamentally Flawed. One of the characteristics of markets that trade on momentum-based characteristics is that corporate fundamentals are often ignored. This is unhealthy and makes life very difficult for long-term, fundamentally sound investment strategies. Abundant evidence shows that investors demand a higher return from small companies which leads to outperformance for small cap stocks over time. The same can be said for low-priced, value stocks. Yet these persistent market premiums have been absent over the past 24 months—especially hurting active managers and hedge fund returns. Such trends have always reversed in the past, which should provide some encouragement to investors.

The futility of Market Timing. We know and understand that the temptation is high to extrapolate from recent results and act—especially when trends seem to be forceful and negative. The investment managers who have most successfully executed a market-timing approach in the past are Managed Futures and Global Marco hedge fund managers. Examining the performance of these strategies over any of the time periods illustrated in the table above should disabuse any individual investor of the idea that this is anything less than nearly impossible to accomplish. We remind investors that exiting or changing risk posture following a sharp fall is a dangerous proposition that requires making two clairvoyant decisions—one must exit before further declines and re-enter before the markets pass the point of exit. Decades of extensive research has clearly shown that investors get this very wrong most of the time and can do lasting damage to their wealth while trying.

Looking Ahead. Investing is a long-term proposition that requires patience, fortitude and skill. We have—and will always—work diligently to help our clients achieve their goals through the application of all three. To that end, we remain available to further explain our viewpoints and the plans we have for the future.

Happy Holidays,

Sean Cook
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