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CAPITAL MANAGEMENT

I Hate to Burst Your Bubble, But…
Fixed Income Outlook
January 2018

Following several unexpected outcomes in 2016, such as Brexit and a Republican electoral sweep, we opined a year ago that one should expect the unexpected, but that we were constructive on the economic outlook for 2017. We felt at the time that if you believed in the acceleration of economic trends, then the investment choices were straightforward: buy assets that are skewed to economic growth, i.e., risk assets like equities, high yield and convertible bonds. During 2017, we have indeed seen a strengthening economic backdrop and have also seen a concomitant rise in equity and corporate bond returns. We have also seen seemingly bubble-like conditions and excessive risk-taking in other areas. As risk assets rise to new highs while the Federal Reserve (the Fed) is steadfastly normalizing interest rate policy, we could be seeing signs that the seventh inning stretch for this cycle may be near. The question is: What will 2018 bring us based on Fed policy, possible bubble formation and recent legislative actions?

During 2017 there was a steady increase in U.S. Gross Domestic Product (GDP) growth from 1.8% in the last quarter of 2016 to 3.2% for the third quarter of 2017. The unemployment rate has continued to improve, declining from 4.7% to 4.3% in the same period. The fed funds rate has increased from a range of 0.50-0.75% to 1.25-1.50% (for the record, we wish they would revert to a single point, as it is less vague)! On the market front, returns for equities and bonds have also been good. This is typically the case when both corporate earnings and economic growth are accelerating. The S&P 500 Index (S&P 500) returned 21.83%; not only that, it was the first time ever that it was up in each month of the year – a perfect year, as Ed Hyman of ISI Economics calls it. The high yield market (ICE BofAML U.S. High Yield Master II Index) returned 7.48%, following a return of 17.49% in 2016. Even the investment grade corporate market (ICE BofAML U.S. Corporate & Government Index) returned 4.03%. This while the Fed raised the fed funds rate three times and has plans to raise it another three or more times in 2018.

Regarding the Fed, at their latest meeting they revised their dot plot. We have previously expressed our skepticism about using this as a forecasting tool. To review, the dot plot is a collation of the different Fed governors' forecasts of where they think the fed funds will be at various points in the future. For example, at year-end 2014, the average rate was forecast to be over 3.5% by the end of 2017 and slightly higher in the future. Over the course of 2015, the Fed steadily lowered their forecast to slightly above 2.25% on average by year end 2017 but maintained their longer-term estimate of rates above 3.5%. By the end of 2016, they finally had the correct forecast for year-end 2017, but lowered their longer-term forecast to about 3% for years beyond 2019. Currently, the Fed's longer-term forecast averages 2.75% with rates peaking at 3% in 2020. The continual lowering of the dots could imply that the Fed now feels that a recession will most likely begin in 2020 and will require monetary accommodation at that time. What are we to make of this?

First, one can see that they are not very accurate at forecasting longer term interest rates. Second, we believe that the continued absence of inflation, as measured by the Consumer Price Index (CPI), may be causing some hesitation by some members of the Fed, notably Kashkari, that the economy is not on solid footing and that higher interest rates may actually be counterproductive. Our take on this is that as measured by the CPI, inflation remains subdued. While it has been steadily increasing over the past three years, the latest reading in December was 2.2%, above the Fed's 2% target, but not by much. This is also down from the 2.7% reading in February. Coincidentally, Dan Tarullo, a former Fed governor, published a working paper in October of this year titled "Monetary Policy Without a Working Theory of Inflation." While the title mostly speaks for itself, the point he makes is that while the Fed has some very capable economists, his colleagues on the Federal Open Market Committee "…were hardly impervious to the problems with some of the models, correlations, curves, and laws that are the analytic equipment of monetary policy." In other words, they realize that their tools are less-than-perfect, yet they still need to make policy. He further asserts that "…observable metrics are not themselves the most important considerations in setting monetary policy." Rather, "…policy decisions are rightly made based on what those metrics are expected to be in the future." Given their less-than-prescient forecasting abilities, this could give one pause. Dario Perkins of TS Lombard Street research points out that a growing number of academics feel that inflation may be a random walk. While that is a somewhat extreme position, he does give credence to studies that seem to show that U.S. inflation "…fluctuates around a 'slowly moving trend', which follows a random walk and cannot be (fully) explained by things like labour-market slack or inflation expectations." We would agree.

If inflation informs Fed rate policy, then they are at least directionally in sync, as both have been slowly rising. Where economists have questions relates to the absolute level of rates relative to economic growth. This is where it may be helpful to look at other measures of inflation. Janet Yellen has been looking at the Underlying Inflation Gauge Full Data Set (UIG), calculated by the New York Fed. It has been above 2.50% all year and its latest reading is 2.95%, well above the Fed's 2% target. What is interesting about this gauge is that it, like the CPI, was below the Fed's target from mid-2015 to mid-2016, but has sharply increased since then. Perhaps this partially explains the Fed's willingness to stay the course on rate normalization.

Understanding inflation measures is important because if the Fed feels that the odds of recession are low until 2020, then we should expect rate normalization to continue until then. The question follows: At what rate does the economy experience a credit squeeze and start to weaken? If we turn the question around and ask: With rates at such low absolute levels, at what level of rates do businesses begin to suffer? Our belief has been that the answer is much higher than we are today. It is hard to imagine a company being able to easily finance itself in today's low absolute rate environment of 2.5% on the 10-year Treasury, but struggling at say 3-4%. Matthew Luzzetti and Justin Weidner at Deutsch Bank took a stab at it recently and came up with 3.5% as the neutral rate on the 10-year, meaning that above 3.5%, the absolute level of rates would begin to impact the economy. This is not an on-off switch, but rather an indication when we should start to pay attention as it relates to future economic growth. If they are correct, barring any exogenous events, the recovery still has room to grow.

Regarding exogenous events, in our opinion they come in two flavors: those you can't predict (like 9/11) and those you should have seen coming, like the internet bubble or the sub-prime housing crisis. The latter, while obvious post facto, are exceedingly difficult to time correctly. Are there signs of bubbles building today that we should be heeding? Perhaps many, perhaps few. Below is a partial list of candidates culled from various sources. While it is not a full manifest of society's worries about reckless behavior and excessive risk taking today, any of these could haunt us in the future:

- A painting sold for $450mm to a wealthy Saudi Arabian prince (Remember record setting art prices sold to Japanese investors in the late 1980s, prior to Japan's lost decades?)
- Apple's market cap is nearing $1 trillion (now 18 times free cash flow and a shade under 5% of U.S. GDP)
- Passive funds now hold 5% or greater positions in 468 of 500 S&P 500 companies, up from only 3% in 2005 (but own only 3% of the corporate bond market)
- The Bank of Japan owns 60% of the Japanese ETF market
- The duration of the U.S. fixed income market is at all-time highs
- Bitcoin has soared 1500% in 2017, despite numerous exchange hacks resulting in total losses
- Global debt rose to $225T or 324% of Global GDP
- Financially-stressed Illinois sold bonds at 3.75% in an oversubscribed deal
- Argentina, a perennial defaulter, sold 100-year bonds at 7.125% interest
- The market capitalization of the FANG stocks increased by nearly $1T

While none of these on their own are systemic risks to either the banking system or the global economic recovery, they may be symptomatic of the effects of excess liquidity and extraordinarily high risk tolerances following almost 10 years without a major correction.

We would be remiss if we did not comment on the passage of the tax bill. Although the full effects will not be seen for years, so far, estimates are that it will only add modestly to current GDP growth. This is because the effective tax rate (the rate corporations actually pay) is much lower than the current 35% statutory rate, and with some deductions going away, some companies may not be as advantaged as one might think. From what we've read (and the final rules have yet to be written), the tax on untaxed foreign earnings retroactive to 1986, which are payable over eight years, may act as a drag for those companies who have used large foreign operations or complex overseas tax schemes to minimize their U.S. taxes. So far, we have seen some of the biggest winners (high tax payers) announce $1,000 bonuses for much of their workforce as well as increased capital spending plans. No word yet from the technology titans with enormous cash hoards held abroad. As for individual tax changes, we don't see them as a game changer for personal spending or income growth. The one unintended consequence is that the U.S., now among the lower-taxed nations, may see a competitive response from other higher tax countries and regions such as Europe, Japan, India and France. Even countries with lower tax rates, such as Ireland and some eastern European countries, may find their competitive attractiveness challenged. If there were a race to the bottom in tax rates, it would likely increase fiscal deficits, or add to individual tax burdens, but would also presumably be countered by higher corporate earnings. We will be watching to see how this unfolds.

In sum, while there are certainly signs of excessive risk-taking in some areas, we feel that they are not systemic risks such as we saw in 2008. A healthy tailwind to corporate profit growth aided by the recent corporate tax rate cuts means that we will not likely see signs of economic weakness for a few years. Valuations for equities should grow at least in line with earnings growth and high yield bonds should benefit from low defaults and healthy cash flows. Investment grade bonds, which have near record high sensitivity to rising rates, hopefully can withstand the slow and steady rate increases by the Fed, but returns will likely be muted. We still find value in the short to intermediate non-investment grade bonds and select convertible bonds whose underlying equities are deemed to be attractive long-term investments. This bull market is entering its ninth year and bumps in the road are increasingly likely. Our cash position has and will allow us to buy bonds at attractive prices when we see those.

We thank you for your confidence in us and welcome any questions or comments you may have.

Sincerely,

Carl | Bradley | Craig

Carl Kaufman | Bradley Kane | Craig Manchuck

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It is not possible to invest directly in an index.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The ICE Bank of America Merrill Lynch U.S. High Yield Master II Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The ICE Bank of America Merrill Lynch U.S. Corporate & Government Index tracks the performance of U.S. dollar denominated investment grade debt publicly issued in the U.S. domestic market, including U.S. Treasury, U.S. agency, foreign government, supranational and corporate securities.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

Underlying Inflation Gauge (UIG) is a measure that captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data.

FANG represents the most popular and best performing tech stocks in the market which have generated spectacular returns for their investors. The four stocks – Facebook, Amazon, Netflix, and Alphabet – all trade on the NASDAQ, which measures the performance of over 3,000 tech and growth stocks that are considered a reflection of the economy and capital market.

Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.
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