



Taking the Long View

High up in the North in the land called Svithjod, there stands a rock. It is a hundred miles high and a hundred miles wide. Once every thousand years a little bird comes to this rock to sharpen its beak.

When the rock has thus been worn away, then a single day of eternity will have gone by.

– The Story of Mankind, Hendrik Willem van Loon

What is your investment horizon? If it is measured in decades you're like most people—a self-described “long-term” investor.

A long-term perspective is comforting. Time is the catalyst that lets portfolio returns compound exponentially. An investor planning to see Halley's Comet before tapping his 401k will view market swings as immaterial. The long view is a relaxed one.

But long-term is not infinite.

The journey, therefore, matters. During a recession, equity markets can drop 40% or more. Imagine the average

investor holding their positions all the way down. Then pinch yourself and stop dreaming.

Investors can't resist the urge to take action after large drops. They will ignore historical data, their advisors, and their own best interests in order to flee to safety. Losses hurt.

Preparation, however, can remove some of the sting. Investors may gain comfort by holding fewer assets lashed to the broader equity or credit markets. Often that means allocating away from passive indices entirely. 2019 may be the year that active management becomes trendy again.

WHAT CAN INVESTORS EXPECT IN 2019?

Before we look at key market drivers for 2019, we briefly summarize 2018 market performance.

2018 Market Summary

The US Economy had a record year! 2018 was a year of economic superlatives. Unemployment was low (a 17 year low!), business and consumer confidence soared (all time and 18-year highs, respectively!), and GDP chugged along at a 3-4% growth rate. During each quarter of 2018, corporate profits increased to new record levels.

The US Equity Market showed its age and faltered in Q4. After a decade of equity market increases, in Q4 the Bull Market started to get temperamental. The S&P 500 declined nearly 15% in Q4 giving back all of Q1-Q3's gains and more to finish the year down ~7%. Most sectors experienced double digit declines, with energy being hit particularly hard due to declining oil prices.

US Credit Markets were generally flat, with high duration securities declining on rate increases. The treasury yield curve flattened, but avoided the 2-10 year yield inversion that signals a future recession. Interest rates increased throughout 2018. Investment Grade (IG) and High Yield (HY) bonds declined on rising rates, with the longest duration securities hit hardest. Thus far, defaults remain low.

Central bank activity in the US and Europe trended toward normalization. The U.S. Fed raised rates four times in 2018 and continues to allow bonds to roll off its balance sheet. Since starting quantitative tightening (QT) in October 2017, the Fed's balance sheet has been reduced by 8.3%.

The European Central Bank (ECB) is following in the Fed's footsteps by halting its asset purchase program, which has amassed nearly \$3 trillion of assets.

Global equity markets were down across the board. After years of synchronized global growth, 2018 marked the start of a synchronized global slowdown. China is faltering, Europe is contracting, and other global equity markets were down across the board—Asia alone lost \$5.6 trillion in equity market value. China's equity market ended the year down nearly 30% after being hit hard with tariff and debt concerns.

What we can expect for 2019:

A red morning sky greets 2019, portending choppy waters ahead. Broadly positive economic drivers were not enough to prevent late-2018 market turbulence. Economic data and the market returns diverged. Risk assets across the board were down. A Deutsche Bank report tracking worldwide asset classes noted that 93% of them were down in 2018. That number in 2017 was just 1%.

In Europe, equity markets reel, economic growth is slowing, and Brexit negotiations add uncertainty. Withdrawal of stimulus by the ECB is another headwind for asset prices to overcome.

If 2017 was a year for price improvements, then 2018 was a year for profit taking. And 2019 may be the year that high expectations turn into premeditated disappointments.

US ECONOMY: GREAT EXPECTATIONS OR HARD TIMES?

We have experienced nearly ten years of economic and equity market growth. How much longer can that trend continue?

For as long as the data continues to be positive. A great performance sets the bar for future expectations... and future disappointments. Expectations are lofty, but so is the data. 2018's strong economic performance could be matched in 2019 if trends continue. Expect markets to provide buying opportunities if investors overreact to slight disappointments in economic data.

Key US economic drivers in 2019 include wage inflation, trade disputes, and greater political uncertainty.

Wage inflation is the only inflation that matters in 2019. Wages, including benefits and related taxes, account for 70% of business costs and have recently started to tick up. The Fed will be more likely to raise rates if wage inflation ticks up.

Trade issues, mainly with China, continue to simmer but have yet to escalate into an all-out trade war. With the downside of a trade war already priced in, equity markets may get a boost if trade disputes are resolved.

Capitol Hill is divided. With party control split between the House and Senate the result is a legislative stalemate. **This equilibrium, with a lot of noise and not much heat, is typically good for the equity market.** December's government shutdown — the third one in 2018 — resembled a tempest in a thimble. So far, no one is paying much attention.

Positive economic momentum doesn't reverse quickly. Plans are made quarters and years in advance of implementation. A recession, therefore, is unlikely through 2019. Momentum won't shift so quickly. Yet reactive equity markets are already showing weakness.

US EQUITY MARKETS: THE BULLFIGHTERS GET THE UPPER HAND

The average bull market lasts just five years. We are now nearly ten years into this bull market and it's showing some age-related obstinacy. December was the worst month of the year for the equity market, with the S&P 500 dropping 11%.

Although a recession seems unlikely in 2019, a bear market (a 20% or greater decline) can occur without a recession.

(In fact, peak-to-trough a 20% decline happened in December based on intraday data. The decline avoided the label of "bear market" due to the technicality that the range must be based on closing prices.)

The length of time it takes equity markets to recover from a 20+% decline has historically been linked to recessions.

Bear markets that occur outside a recession tend to recover quickly, on average 11 months. If a recession occurs, recovery to the previous peak takes on average 34 months. Temper expectations accordingly.

Like Cousin Eddie in *National Lampoon's Christmas Vacation*, **volatility showed up uninvited in December and brought bedlam.** After a Q1 spike, volatility calmed down for several quarters. Then, as equity markets declined in Q4, volatility came roaring back. As higher volatility begets higher volatility, **a return to 2017's Arcadian calm is unlikely.**

So much seems to depend on the words and actions of the Fed. As December's rate hike showed, **investors can no longer depend on the kindness of the Federal Reserve to support asset prices.**

CREDIT MARKETS: RATE INCREASES WILL SLOW, DEBT LEVELS WILL CONTINUE TO INCREASE

There is a liquidity mismatch between credit-focused mutual funds and ETFs and the securities they hold. Mutual funds are legally required to provide daily liquidity. During times of market stress, asset sales can occur either quickly or at a favorable price, but not both. Daily liquidity allows investors to act in their own worst interest. Liquid product wrappers for holding illiquid assets can result in panicked selling when prices are most divergent from underlying value. These products are now a large part of the credit market.

The number of tradable products holding IG, HY and broadly syndicated loans has exploded since the credit crisis. Since 2007 the amount of corporate debt has increased 250%, mainly in the BBB segment – the lowest investment grade.

Much of that will need to be refinanced between 2019 and 2021, providing opportunity for those with superior underwriting expertise. Normally refinancing is not a problem, but market sentiment can quickly shift.

Here is how a crisis in the liquid credit market could start. A rise in interest rates leads to a decline in asset prices, a decline in asset prices causes lenders to be under collateralized, under collateralization causes lenders to pull back on extending credit, lack of available credit prevents borrowers from rolling over their debt, debt that can't be rolled over defaults, defaults panic investors holding liquid credit products who then sell, simultaneously asset sales cause liquidity issues, liquidity issues further decimates asset prices... and the snake eats itself.

Investors without liquidity pressures will find a happy hunting ground that will reward opportunistic credit pickers. In credit investing, avoiding mistakes is key to preventing losses. And profiting off the mistakes of others is the key to superior returns.

The shape of the yield curve will be a key focus in 2019, as an inverted yield curve signals a future recession. The greater the inversion the more likely a recession will occur. The signal is usually far in advance of an actual recession, which can occur from months to even years after the inversion. Treating an inversion as a sell signal often means missing significant upside.

For European investors, an item of concern is the ECB ending its asset purchase program, which we discuss more below.

FEDERAL RESERVE TO US EQUITY INVESTORS: DROP DEAD!

During a November speech at *The Economic Club of New York*, Chairman Powell stated that rates are "just below" neutral. Interest rates below the neutral rate propel the economy forward, at the neutral rate have no economic impact, and above neutral put the economy in irons.

Thus, the market interpreted Powell's comment as a signal that rate increases would be less aggressive going forward, especially when contrasted with his statement from October that rates were "a long way" from neutral.

As expected the Fed raised rates in December. Powell, an experienced investment professional in his past life, knew how the market would react to his rate increase and accompanying statement. **By raising rates in December the Fed sent a clear message: Equity investors will have to fend for themselves.** The Fed is now focused solely on its dual-mandate of price stability and full employment.

Quantitative tightening will also continue in 2019. The Fed's balance sheet will continue to shrink, albeit slowly, assuming things stay the same. What could change? Rapid economic declines will cause the Fed to once again step in. The Fed's grimoire is necessarily reactive – policy changes will take place slowly unless a crisis occurs.

EUROPEAN OUTLOOK: THE TROUBLES AHEAD

The three headline concerns for Europe are Brexit, the end of the ECB's QE, and increasing cultural fragmentation.

Brexit will dominate financial news in 2019. The complicated withdrawal negotiations continue as the deadline of March 29th approaches. **A "hard" Brexit, i.e., a no deal exit, will occur unless a compromise or deadline extension can be reached. If not, expect market chaos.**

The European Central Bank is pulling back from its own QE and will no longer make net asset purchases. An actual balance sheet reduction will start slowly, take place over a long time, and end without fanfare.

Brexit and the ECB's activities are a change for Europe. And change brings investment opportunity. With greater uncertainty, a passive buy-the-market approach may

underperform. Stock and credit pickers with a deep understanding of their portfolio companies will be in a greater position to profit.

The Brexit vote, protests in France, and the Italian budget disputes are symptoms of people's dissatisfaction with the future being imposed upon them. What governments are selling, the people aren't buying.

The clashes between member states and the EU are, at their core, a question of how much sovereignty the people are willing to sacrifice to advance the goals of the EU. Long before the Bird of Svithjod returns we will know if the bureaucrats of Brussels will be able to hold together the union that defied the will of Charlemagne and the artillery of Napoleon.

As impassive as a Sumerian King, the towering Rock of Svithjod rests at ease in the North. Civilizations will rise and fall, sheets of ice several miles thick will cover North America then recede, and nature will reclaim cities where millions of people temporarily lived... all of that will occur before any visible wear will appear on the great Rock of Svithjod. We don't have that kind of time.

Low-cost passive funds "worked" when the bull market steadily rose with historically low volatility. Passive funds will "work" less well during sideways and down markets. Beta costs provide beta returns. Allocators are shifting more to active management to take advantage of relative value plays and navigate market turmoil. And while low cost index funds have their place, a steady hand at the wheel provides some measure of psychological comforts, if not better returns.

The Rock of Svithjod won't change in our longest long run. Our portfolio *will* change and we have the power to control what that looks like.

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