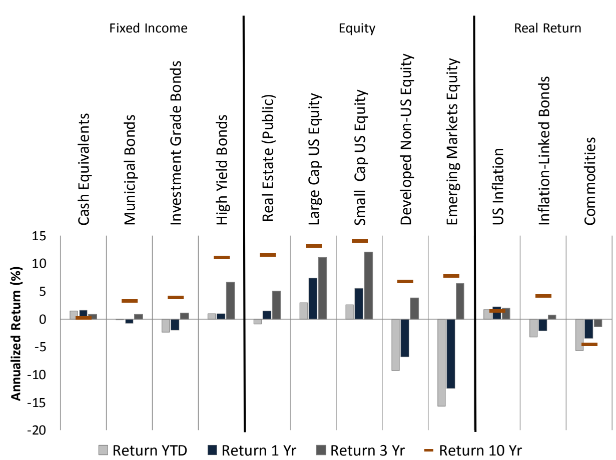
Interest Has Become Interesting
and Other Reasons for Recent Market Moves
Stembrook Investment Commentary – November 2018

Markets Move in Cycles

Recent market moves have ostensibly been triggered by a rise in interest rates, concerns over new tariffs, worries about Italy's debt and most recently, disappointing earnings guidance. In a bull market that is going on ten years old, investors could be excused for focusing on reasons to sell. Perhaps more interesting is that these issues haven't caused a sell-off sooner.

In a recent interview with veteran investor and author, Howard Marks, the audience was reminded that markets move in cycles. We don't know when those cycles start and stop, or when markets have reached their highs or lows until they have already passed. But we can bend the odds in our favor by looking at the things that have indicated when a cycle is closer to a top than a bottom. And thus, when an investment is likely to provide more or less return than normal. Mastering the Market Cycle: Getting the Odds on Your Side - Howard Marks

Chart 1 – Global Market Returns as of 10/31/2018



Source: see endnotes

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Another seminal thinker, Richard Thaler, an expert in the area of behavioral finance, tells us that, among other tendencies, most humans are prone to believe that what has happened most recently is normal and will continue to happen in the near future. With investment cycles lasting years, and in some cases decades, this trait makes the average human a poorly designed investor. Investors who understand this trait and have a process that helps them stick to their philosophy, especially in times of stress, can increase their odds of success. Misbehaving: The Making of Behavioral Economics - Richard Thaler

Background

The U.S. Economy is on Fire

After nearly ten years of unprecedented, massively stimulative, monetary policy by the United States Federal Reserve and other central banks around the world, nearly free money has been poured into the economy like gasoline on an unlit campfire. This condition just needed a spark to ignite the economy—it got two. One in the form of tax cuts, the other in the form of relaxed regulations. Tax cuts produced an immediate spike in earnings (see chart to right), since less going to taxes means more going to shareholders. Reduced regulations mean less money spent on limiting pollution and complying with banking rules and more money going to company profits and ultimately to shareholders. Agree with them or not, these moves have provided two sparks that set the U.S. economy ablaze—at least for now. Global economies have also seen improving conditions, albeit to a lesser extent than the U.S.

Risks

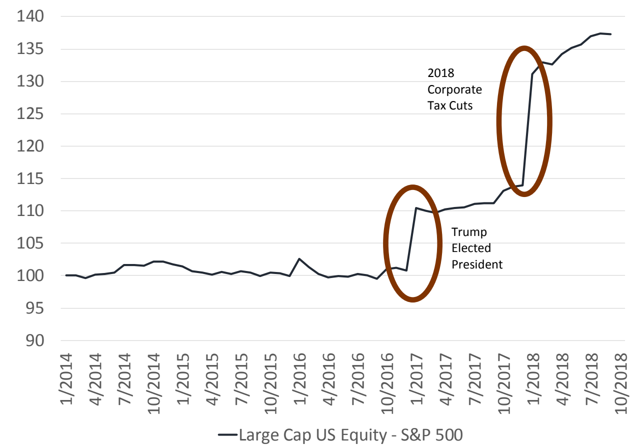
The risks that are currently cited as the cause of recent market volatility are not new news, nor do they come as a surprise to anyone who is paying attention.

Interest Rates

Interest rates are central to our economy and changes in rates can have a very real impact on many things that touch our lives. The tremendous power of global central banks' quantitative easing provided a ten-year tailwind for markets. By forcing interest rates to effectively zero, they pushed investors and savers into riskier assets. Investors reasoned, "If I am going to make nothing in my bank account, then I will go buy riskier bonds or stocks." Both groups were handsomely rewarded with a return on bonds over the past ten years of 3.9% and a return on global stocks of 10.4% per annum.[1] Investors who took risk, even if forced to do so, were well compensated.

As the U.S. Federal Reserve has already begun raising rates and central banks around the world are contemplating the same, changes are coming, some good, some bad for investors.

Chart 2 – Earnings Growth



Source: see endnotes

The Good:

- Perhaps the most obvious benefit to investors from rising interest rates is the fact that they will receive more in the form of interest payments when they lend their money by making deposits in their bank or by purchasing a bond. Today, yields at some savings institutions hover around 2% and the yield on a 10-year treasury bond is up to 3%. This is not high by historical standards, but is a far cry from the 0% and 1.5% of just a few years ago.
- With higher interest rates, central banks have more room to cut rates when called upon to counter the next recession. While central bankers would not raise rates just for this purpose, having a cushion of higher interest rates is a more comfortable position, if you are a central banker.

The Bad:

- Current holders of bonds will experience downward price pressure, as newly issued bonds with higher coupons make their existing bonds less valuable. Remember that the longer the duration (or maturity as a simplified measure) the more sensitive bonds are to rising rates. See the sidebar in my prior note for a more detailed explanation of why bond prices move in the opposite direction of yields. [KEELS, STEALS and NO DEALS (page 6)]

- Higher bond yields will lead to higher mortgage rates, which will put downward pressure on home prices.
- Higher borrowing costs will tend to reduce profits for corporations.
- The cost of servicing government debt will rise. The U.S. and other countries have been able to borrow at historically low rates. Those rates are going up, which means that the cost of servicing that debt is going up. Servicing the debt is part of the federal budget. The more dollars that go to debt service, the less that is available for other things. This leads to cuts in spending or more borrowing (which leads to higher debt servicing costs).
- Higher rates cause analysts to use a higher discounting factor when valuing stocks. This tends to put downward pressure on stock prices and valuations.
- Higher rates will tend to make bonds more attractive than stocks. This could be viewed as a positive for bond investors, but a negative for stock investors whose shares are now competing with bonds for investor dollars.

So, interest is suddenly getting interesting. Whereas before, talking about investing money in the bank elicited a grumble or a giggle, now bank accounts are paying real interest, again.

Political Concerns

It would be an understatement to say that the political climate, both in the U.S. and abroad, is tenuous. Among other things, a movement to protect U.S. manufacturing helped sweep Donald Trump into the White House. Tariffs introduce higher costs to U.S. consumers and greater uncertainty for corporate leaders. Historically, tariffs have not had their desired effect, but it remains to be seen if, as a bargaining tool, they will help the U.S. to create more, high quality jobs.

Politics in Europe are also concerning. The lingering effects of the Global Financial Crisis and the European Debt Crisis combined with a wave of migrants seeking refuge from the south, have caused more citizens to ask if their current system of government and the world order envisioned by the victors of WWII is working for them. Italy is the latest flashpoint where two populist parties have joined forces to run a country saddled with persistently high debt and unemployment.

Higher Valuations

By many measures, the U.S. equity market is expensive. The higher earnings I mentioned earlier are priced into shares and they will need to keep up their earnings growth to justify current prices. This has, so far, not been an issue as corporate profits remain strong.

Why is the Market Reacting Now?

No one truly knows why markets move. In the short run, we can only speculate. That said, it seems that uncertainty about the impact of higher rates, large future deficits caused by tax cuts, tariffs on Chinese goods and the knock-on effects of higher input prices for manufacturers and costs at the register for consumers, will sap dollars from the U.S. economy. This would leave fewer dollars available to be spent or saved. A long list of concerns has markets on edge.

With corporate profits strong, consumers and businesses confident and a positively sloping yield curve, there does not seem to be an imminent threat of recession. It is also important to remember that there is always a long list of concerns that investors face. Investors would do well to remember their history and not overreact when the latest concern becomes top-of-mind in the media.

Back to the Economy

If the fire continues to burn and a virtuous cycle of higher profits, higher capital spending and higher employee compensation—leading to higher consumer confidence and higher consumption, leading to still higher profits and still higher capital spending—then the U.S. economy could be on the verge of a new, higher growth trajectory. If that doesn't pan out, the U.S. will almost certainly be saddled with higher budget deficits, higher debt payments and higher input costs. We work hard to understand and invest in light of these changes and most importantly, we stick to our investment philosophy of seeking out investments with high, long-term return potential. We treat your bond portfolio as a place of safety and a store of value. We are watching carefully and planning accordingly.

How Does This Impact Our Portfolios?

Our portfolios are positioned for growth, but with an eye towards managing risk. Ten years ago, I wrote a note titled [A Little Perspective]. In it, I made the case that the market was in a place where negative sentiment had taken over and the right thing to do was to stay the course, take some risk and invest in equities. This advice worked. Right now, we are seeing more people with a very positive view of the U.S. economy and stock market and that leads to a different concern. If ten years ago the market suffered from a lack of confidence, today, market participants are feeling too much certainty about the positive future for the equity markets. We are positioned to address this.

In fixed income, we hold a common sense, conservative portfolio. We remain shorter duration, which means that we own shorter maturity bonds. These bonds have lower yields, but are much less susceptible to the upward moves in yields that we've seen in the past few weeks. This positioning has been a very strong contributor to our overall performance, even though, at times, the market didn't agree and we looked as though we were missing out. Most importantly, this positioning has protected the part of portfolios we hold for long-term income and stability.

In equities, or stocks, we have addressed the risks and opportunities with a further tilt towards value stocks. We are also diversified in parts of the market and the world where valuations are lower and growth prospects are solid. If history is any guide, these positions will outperform in the long run. In the short run, we have felt a drag on our performance from these investments as almost any investment outside the U.S. has underperformed.

We carefully trade your portfolios to be certain they are in line with our best thinking and are very much aware of the market dynamics at work. We will continue to invest in a way that focuses on protecting your capital from permanent loss, the ultimate form of risk. Our fixed income portfolios have recently shown what patient, thoughtful investing can do for investor returns. In equities, we will not chase performance of stocks that have increased dramatically in value and now sit at high multiples. We will be patient and allow the laws of long-term investing to play out. This takes patience and diligence on both our parts, but this is the key to long-term success.

If you would like to discuss any of the issues we have mentioned, or would just like to touch base about how markets and your portfolio are doing, please don't hesitate to let us know. Also, please let us know if anything has changed in your own personal situation. Your long-term strategic investment plan is a critical part of your overall strategy and changes in your own personal situation could cause us to suggest changes to your plan.

As always, we thank you for your confidence in our investment management and advice and welcome your comments and questions.

Sincerely,

Peter D. D'Agati, CFA
Founder & President
Stembrook Asset Management, LLC
83 Wayne Street, Suite 208
Jersey City, NJ 07302
Tel: 201-484-0063
Fax: 201-484-0070
peter.dagati@stembrook.com

Endnotes and Sources

Chart 1: Source: Bloomberg, Stembrook Research. Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index

Chart 2: The BEst (Bloomberg Estimates) Earnings Per Share (EPS Adjusted) estimate returns Earnings Per Share from Continuing Operations, which may exclude the effects of one-time and extraordinary gains/losses.

Notes:

(1) Bloombeg: Bloomberg Barclays US Aggregate Total Return Index, MSCI ACWI Total Return Index. 10/31/2008-10/31/2018.