Reports of My Death Are Greatly Exaggerated

After a harrowing end to 2018, we’ve had a near complete rebound in equities. U.S. large cap stocks rose over 13% in the first quarter, while small caps roared back by almost 15%. International markets caught fire as well, up 10%. Quite a reversal given 2018 ended with the markets panicking that the Fed was raising interest rates into a recession, while “Tariff Man” (Trump’s self-appointed G-rated nickname) waged war on global supply chains - critical pillars of profits. Well, we weren’t in a recession (we didn’t think so), the Fed stopped raising rates (they, in fact, awkwardly pivoted to dovish) and Trump backed off some. Boom.

But what to make of the violence of the moves? For starters, it seems quite clear that investors have guns drawn, entirely reasonable behavior given Fed ham-handedness, slowing global growth and difficult earnings comparisons. Arguably, the Fed started and ended the shooting - never a comforting thought - but, hey, on the job training is often the best kind. Aside from the cause, though, the amount of blood spilled, apparently pointlessly, is interesting. Markets have always had a tendency to overreact - fear and greed are ancient - but modern investors have more powerful tools to express their views. Large-scale algorithmic trading (Quants) and Exchange Traded Funds (ETFs) have gathered a significant share of trading in the last decade. And while it hasn’t been quantified, it seems likely that the impact of this development on markets won’t be benign in times of stress.

Before we move on from the first quarter, we need to touch on the action in the bond markets at end of March. U.S. and global bond yields fell sharply as the month progressed. German 10-year bond yields are negative again and the U.S. yield curve is flat to inverted (shorter maturity yields equal to or higher than longer maturity yields), depending upon the maturities. For some, these are unambiguous caution flags. Europe’s economies, especially Italy and Germany, have been weak, and China, ever important for global growth, has slowed. And while the U.S. is still growing, it’s certainly decelerated from last year. But this was entirely expected, given higher Fed rates and the anniversarying of Trump’s corporate tax cut and deficit spending boost. Of course trade wars and Brexit aren’t helping, but we still don’t see cause for alarm, at least not here in the U.S. Housing is a bit of a drag, but everything else looks ok. We don’t see a recession this year or next. Are we certain? No. But the last two recessions were triggered by the Fed intentionally popping runaway investment booms, first in technology and then in housing. We have no obvious runaway investment boom, and the Fed isn’t trying to pop anything. The excesses that turn a stall into a dive simply aren’t apparent.

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Truth be told, we’re not sure what, if anything, the bond market is telling us beyond the obvious: growth has slowed and the Fed may need to ease. We spent years after the Great Recession with rates falling below anything ever imagined. Combine that with experimental policies like quantitative easing (massive Fed bond buying, as yet undone), negative interest rates (overseas), and, now, unprecedented debt levels, and we may have an entirely new fixed income environment, a different playing field, so to speak - perhaps different rules, too. As our Gen Z teenage daughters would sarcastically say, “Ya think?”

We’ve cautioned for some time that returns would be lower as the levers of equity prices reach their limits: valuations are average but earnings growth and interest rates are challenges. The famed value investor, Jeremy Grantham (he nailed the 2008 crisis), recently said that he expects equity returns will be in the 4%-5% range for the next twenty years. Quoting, “This is not incredibly painful, but it’s going to break a lot of hearts when we’re right.” If there is any good news in Mr. Grantham’s comments, it’s that he no longer sees a huge decline coming, but rather a slow slog. He had originally been convinced that this long bull market would once again climax in spectacular fashion. Grantham’s apparently backed away from that forecast, though in our mind, predictions about how this cycle will end seem a bit silly. It’s been an unusually subdued cycle, long and mostly without investment excess, so we can see it playing out his way, but, really, nobody knows. We’re certain of that.

This has been a somewhat sober piece, but we’re not advocating major allocation changes. Stocks are reasonably priced on earnings and cash flow and attractively priced relative to bonds. There’s no shortage of good businesses we’d like to own, and we don’t foresee a recession anytime soon. We’ll just have to deal with lower returns and higher volatility. Sobering for sure.