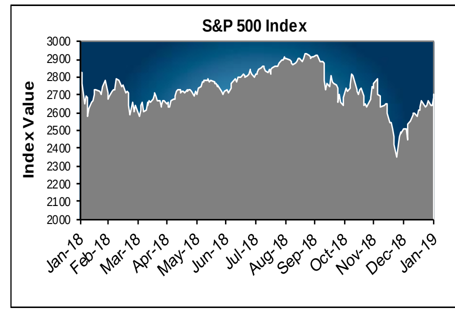
This Month in the Markets

January 2019

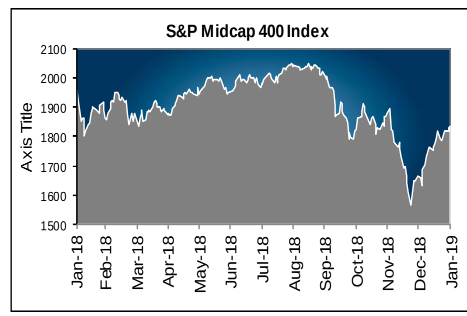
EQUITY COMMENTARY

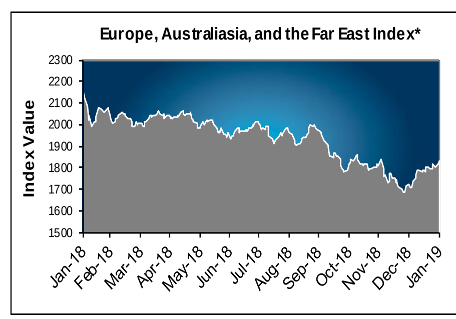
January Jump

Equity markets jumped in January after a horrible end to 2018. The snap back rally was impressive – the MSCI Developed World Index recovered more than half of what it lost in the fourth quarter of 2018. In fact, this was the best January rally since 1987. The rebound was likely triggered on a reversal of extremely negative sentiment heading into the year, the Federal Reserve's more dovish tone and constructive developments on the Chinese trade talk situation. The S&P 500 finished the month up 8% and the MSCI Net Total Return Index climbed 7.8%. The Bloomberg Commodity Index rose 5.2% on the back of gains in Nickel (~16%) and crude (~18%). As a result, the MSCI World Energy Net Total Return Index was one of the big winners – bouncing 10.4%. The MSCI World Real Estate Net Total Return Index was the biggest gainer in the month with a 10.5% return. This was likely due in no small part to the decline in yields and a rebound in REITs after sharp losses in the fourth quarter. Consumer Staples stocks were the worst performers in this risk-on month and recorded a gain of 5%.



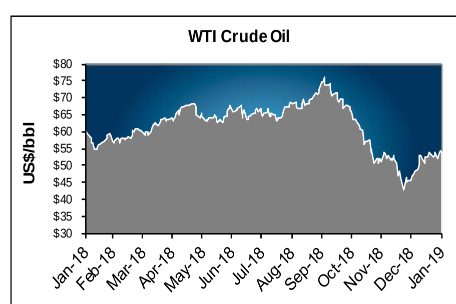
With the decrease in volatility and the snap back stock market rally, we are often asked "what did you do?". The implied query seems to want to gain comfort in the fact that we may have "reacted", in a positive fashion, to the rapid fall in markets and/or subsequent rally. The surprising answer (and maybe disappointing to some) is not much. While extreme market movements may heighten the fight or flight responses of many, we simply acknowledge that this is much more common than many would admit. While 2017 was a period of record low volatility and 2018 was higher than normal we expect volatility to remain elevated due to the uncertain macro and political environment. It may seem glib to say this, but we prefer to focus on what we own and why we own it. Holding companies that have strong secular growth trends at reasonable valuations seems to be much more important to us than forecasting GDP to the first decimal place. In fact, if anything has really changed, we are even more committed to concentrating in these types of companies. Companies that are simply plays on cyclical GDP and economic oscillations are not featured prominently in our investment stable. In fact, we would prefer to focus on companies that can work even in an economic slowdown which is almost assuredly to manifest itself at some point. In doing so we expect to fair much better than trying to time the market by buying highly levered cyclical companies.





Celgene was the biggest gainer in the month with a surge of 38%. Bristol Myers ("BMY") has agreed to purchase the company for $50 in cash plus one share of BMY stock. This gain was somewhat offset by the slide in AbbVie as biosimilar competition concerns on Humira (its major drug responsible for about 60% of sales) resurfaced. We feel their pipeline is essentially being heavily discounted and believe it should overcome erosion from generic competition (we will have additional clarity on this later in 2019).

There was only one portfolio change overall - we sold Bank of New York as it hit our valuation target and we felt the flattening yield curve; consolidation of the hedge fund industry and lower assets prices would mute future returns.



*MSCI EAFE Index

FIXED INCOME COMMENTARY

‘Powell Put’ in Place?

After selling off in 4Q18, risk assets rebounded strongly in January 2019. Credit spreads tightened across the board, most notably in the high yield market, which drove strong corporate credit performance in January (high yield index gained +4.6%, investment grade credit index rose +2.1%). While not the only factor, Fed rhetoric and a more dovish stance played a key role in the January rally in equities, corporate credit and Treasuries.

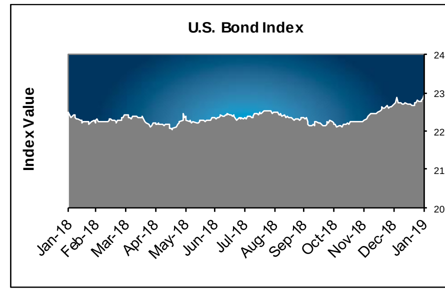
Monetary tightening in this cycle has taken two forms: (1) raising the fed funds rate, which the Fed did four times in 2018, and (2) balance sheet run-off (quantitative tightening). The Fed increased the size of its balance sheet dramatically after the global financial crisis by buying trillions of dollars of Treasuries and agency mortgage-backed securities (quantitative easing). The goal was to keep market interest rates artificially low to drive investment and ultimately growth. By letting the balance sheet run-off (decline in size) the Fed is essentially reducing its support to the market by reinvesting less than the amount that matures. The balance sheet run-off is important because a large amount of bank reserves (generated from quantitative easing) have become an integral part of the economic system since the global financial crisis, both for the Fed and banks. For example, stricter regulation of banks liquidity requirements has led to a certain dependence on bank reserves, while the Fed utilizes interest on excess reserves to influence the fed funds rate.

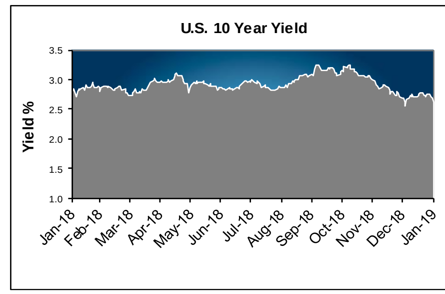
Shown below is the Fed’s stance with respect to the future path of the Fed funds rate and balance sheet run-off at each of the last 3 meetings:

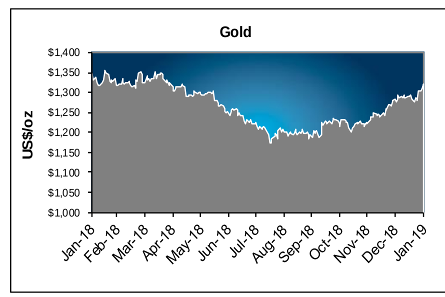
- November 8, 2018: expectation for 2019 rate hikes (3 projected in the median path of the dot plot); balance sheet run-off to remain on auto-pilot.
- December 19, 2018: lowered expectations on the number of expected rate hikes (2 projected in median path of the dot plot); balance sheet run-off to remain on auto-pilot.
- January 30, 2019: Chairman Powell confirmed his comments in a January 4th interview that the Fed could be flexible in the pace of balance sheet run-off – this was widely expected by the market. What was wholly unexpected was the shift in dovish language regarding the future path of the Fed funds rate, which were labelled “adjustments” opposed to “increases” – this indicates the next move in the Fed funds rate could be a hike or a cut; Chairman Powell also stressed the need for patience regarding these adjustments.

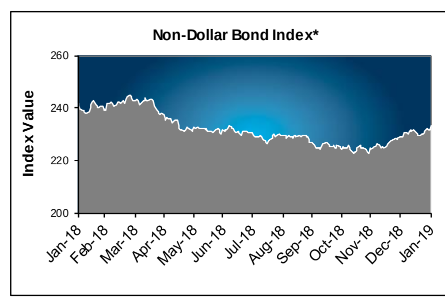
Over the course of just 3 months, the Fed has gone from a very clear monetary tightening bias (rate hikes, steady pace of balance sheet run-off), to a far more neutral, arguably dovish tilt with respect to both future rate hikes and the balance sheet. In explaining his rational behind this, Chairman Powell commented on slowing growth outside the U.S., the U.S. government shut-down, and contained inflation. However, we would argue that the economic data over the period hadn’t deteriorated anywhere near the change in stance would suggest. Perhaps the Fed believes the U.S. economy is more fragile than the data suggests? Or maybe the Fed isn’t as confident in their impact assessment of balance sheet-run off given the difficulty of measuring it– after all, the Fed has never been through this process before, let alone at the same time as raising rates. This would help explain a few of the recent communications blunders. Or perhaps, like in early 2016 when in the face of market volatility, an equity market tantrum and widening credit spreads, the Fed once again blinked and capitulated to the market. The first “Powell put.” If the latter is indeed the case it bodes well for risk assets in 2019, all else equal.

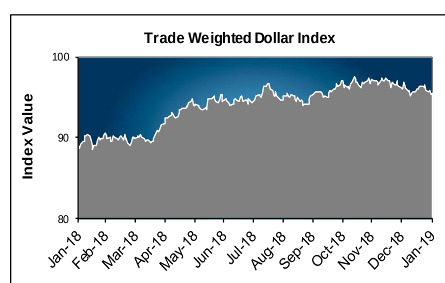
In this uncertain macro environment, we continue to maintain our conservative stance on credit risk. The fixed income portfolio got off to a strong start to 2019 with a 2% gross return in January.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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