Titleist Asset Management
2018 Q4 Market Commentary

December 3, 2018

The year 2018 proved to be a very difficult year for investors. It was the year that everything – US equities/most areas of fixed income, international developed equities/fixed income, international emerging equities/fixed income, precious metals, oil along with the rest of the commodity space – went down. Last year was one of just four years over the last century where cash outpaced both stocks and bonds.

Q4 2018 was the worst quarter for the major market indices since the height of the financial crisis in Q4 2008; last month was the worst December for equities since 1931. That is a pretty incredible statistic given this is all happening during a time when the Federal Reserve thinks the economy is so strong that it has to continue raising interest rates while unwinding the balance sheet.

The capital markets have been enduring enormous headwinds in recent months – most of which are self-inflicted. The two biggest challenges facing markets are Federal Reserve policy and trade tensions around the world. Additional headwinds include slowing global growth, the Brexit disaster, Italian budget issues, White House turnover, and unnecessary statements out of the Treasury just to name a few.

It would be very difficult to find a time since the Federal Reserve Act of 1913 where there was a larger disconnect between the Federal Reserve's assessment of the economy versus the capital markets. US equities have declined 20% from peak to trough, 10-year treasury yields fell from 3.25% to 2.65% and WTI crude is off over 40% during the last quarter.

The capital markets are starting to price in much lower growth with some of the more economically sensitive sectors – regional banks, transports, homebuilders and semiconductors – trading at recessionary valuations. Consensus earnings growth for the overall market has been cut in half over the past month but remains strong at 5-6%.

The Federal Reserve has raised rates 9 times bringing the Fed Funds Rate to a range of 2.25%-2.50%. In addition, they have been unwinding the balance sheet at a pace of $50 billion per quarter over the last two years. Some economists project this has had the effect of an additional 3-4 rate hikes of 25 basis points. The most recent hike of 25 basis points was widely expected by markets as judged by Fed Fund futures; it was the language that accompanied the hikes about future expectations that sent shock waves throughout the markets. The S&P 500 sold off nearly 10% in the following 4 sessions.

Looking ahead, we think it is highly unlikely the Fed will raise rates during the first half of 2019. Inflation expectations have plummeted with the 5-year US breakeven inflation rate falling from 2.16% to 1.52% and financial conditions tightening considerably with equities in a bear market and credit spreads increasing at a rapid pace.

It is far too early to determine whether or not the Fed has committed a policy error. It is very possible that open market operations to date were necessary to contain inflation and will ultimately prolong the economic expansion. We do feel they have unnecessarily punished market participants last quarter with poor communication.

The market sell-off was prompted when Chairman Powell said "we're a long way from neutral on interest rates" on October 3rd. Neutral is an arbitrary number that will change with market conditions but it was a strong signal to the market that we were under an entirely new regime from the accommodative polices of the Bernanke and Yellen eras. Powell walked back those comments the following month signaling "he now sees the current interest rate level just below neutral".

Unfortunately, the damage had already been done by that point. We applaud the Fed for attempting to become more transparent over the past decade but the increased communication feels like overkill. So much so I am starting to become nostalgic for the “briefcase indicator” days of the Greenspan era.

The core of our economic system is founded in having an independent Fed. Ronald Regan was furious with Paul Volker for raising rates in the early 80’s to the point of causing a recession in order to stamp out inflation. He surely wanted to fire him but fortunately let him do his job. Volker was appointed by Carter and it is fair to say his efforts in curbing inflation played an important role in the economic success of the Reagan administration.

Conversely, Richard Nixon successfully pressured his Federal Reserve Chairman Arthur Burns to maintain overly accommodative monetary policy in the 2 years leading up to his election in 1972. Nixon successfully won the election in a landslide but the country suffered enormously for 8 years due to the inflation these polices created. https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.20.4.177

One last thing on the Fed – they almost always take the blame for everything. They get blamed for not slowing things down enough before the tech bubble of the late 90’s or the housing bubble of the 00’s. They also get blame when they curb growth in an attempt to prevent excesses from building up in the system.

The other major issue facing capital markets is trade policy. It is encouraging to see a de-escalation in rhetoric with China and there seems to be legitimate progress being made. It is difficult to say what any final deal will look like but it is in the economic interest of the United States, China and the entire world that there is some form of resolution. Both economies combine for over 40% of global economic output. A solid deal could shift one of the largest headwinds into a tailwind in the years ahead.

It is our opinion that the tax cuts in 2017 were necessary for companies in the United States to maintain an advantage in an increasingly competitive world. It was however a big experiment given we have never had that type of fiscal stimulus near the peak of an economic cycle and more importantly it was not deficit neutral. There will be some form of governmental deleveraging in the future that will curb growth.

There is no doubt that the speed and severity of the declines in equity markets along with decreased liquidity in the credit markets will impact spending at both the corporate and household levels. Whether or not that negative feedback loop will be material enough to dampen economic growth beyond what the markets are discounting is yet to be known.

In the event we do dip into a recession it should not feel anything like the financial crisis. Bank capitalization is arguably as strong as it has ever been. Bank liquidity – defined as liquid assets as including cash, deposits with central banks and treasuries – has increased 39% in large cap banks, 73% in Trust banks and 71% in Regional banks from 2010 to 2018 according to data from Goldman Sachs.

The US economy appears to be on sound footing. Our base case going forward is the economy continues to grow at or slightly above normal trend growth of 2.00-2.25%. Earnings estimates along with GDP growth estimates have been cut severely in the wake of recent market action but remain at healthy levels.

Sentiment as judged by recent AAI data and positioning as judged by fund flows is extremely negative. This is normally a great backdrop for higher equity returns since the bar for earnings expectations has

been lowered by such a large degree. In addition, market fundamentals are now at levels that typically provide outsized returns going forward.

Below are some interesting statistics going back to 1926 recently published in USA Today –

- When stocks fall 10-20% from a recent high the returns over the next 12 months average 34% before dividends.
- When stocks decline 20% or more from a recent peak the average return over the next 12 months is 47%. This statistic is a little misleading b/c it includes three declines in excess of 50% - Great Depression / 73-74' era / Financial Crisis - making it much easier to average such higher returns in this stat.
- There have been three bear markets – defined as losses of 20% or more – that did not result in a recession and equity markets averaged a 29% return the following year.

The stats above should not be the basis for making any investment decisions but do provide some important historical context.

Your portfolio is properly diversified between equities and fixed income and we will continue make adjustments as market conditions change. You own some of the best businesses in the world and should the economic backdrop deteriorate temporarily they will most likely benefit as they take market share from weaker competitors.

Please let me know if you are available for a call this week or next to discuss the account/positions in more detail.

- Byron Fields