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2018 Third Quarter Review

"Keep De Eye On De Ball"

Years ago on Saturday Night Live, Garrett Morris played the character of a baseball star-turned motivational speaker whose entire presentation to rooms full of inspiration-seeking, alpha-type business people consisted of only a few sentences, one of which was, "Keep de eye on de ball." As amusing as the disappointed reactions of the assembled multitude were, I am now reminded of the wisdom of that phrase. As difficult as it may be during all the political controversy swirling in the national consciousness at the moment, we are trying to keep our eye on what the investment markets are doing and what we should be doing in response. Stocks have risen lately, but so have interest rates, and therein lies the story of the ball we need to keep our eye on.

During the third quarter, investors appeared to shrug off the fear of trade wars, armed international conflict, and falling foreign stock markets to send the U.S. stock market on another leg upward. By the end of September the Dow Jones Industrial Average was up 7% and the S&P 500 up over 8%. The Vanguard World Stock index showed that the rest of the planet's markets did not fare so well, with a rise of only 2%. The U.S. economy has strengthened, and unemployment is at lows not seen since 1969. However, bonds have been pummeled as the Federal Reserve has reversed its unprecedented infusion of liquidity (money) into the financial system in the wake of the last financial crisis. As long term interest rates rise, bond prices fall and the longer the maturity, the greater the fall. (That is why we have kept maturities short.) As of today's writing, the iShares 20+ Year Treasury ETF has fallen almost 10% in price so far this year. "Bonds," says Bloomberg News, "are hitting fresh milestones of misery" wiping out $916 billion in value this week alone. We have long avoided any major commitment to longer term bonds for this reason. The plunge in bond prices has just taken longer to materialize than we expected.

Short term interest rates have risen much more than long term rates have, with the yield on the 6 month US Treasury Bill rising to 2.42% from a low of 0.08% just 3 years ago. That is a 30 fold increase in yield since the Fed began to unwind their "ZIRP" or zero interest rate policy. It is no secret that the goal of the Federal Reserve was to inflate the prices of assets (like stocks and houses) to help get the economy out of the financial crisis. In that effort they have been very successful. Our concern is that the reversal of that "accommodation" may result in at least a partial reversal of some of that asset inflation. In other words, rising interest rates and restrictive monetary policy may lead to a headwind (or worse) for stock prices.

"It doesn't matter until it matters." That is an old adage I have heard from my early years on Wall Street. Problems can develop, be discussed, and seem not to affect the market. That is until one day when investors seem to wake up and suddenly focus with consternation on what had been brewing for quite some time. That may be what's happening now with rising interest rates seemingly gaining speed while stocks suffer a sharp sell-off or two.

Another old saying is that “The Fed tightens until something breaks.” That reflects the belief that the Fed governors tend to raise interest rates and reduce money supply until there is some kind of dislocation in the financial markets which scares the Fed governors into more accommodative policy. Already, the debate about another possible rate increase in December has centered around whether the economic expansion can withstand the added pressure of still higher rates.

Howard Marks is a masterful investor in “distressed debt.” He and the folks at Oaktree Capital are good at making a profit buying the risky bonds of troubled companies. He is also a student of economic and credit cycles. Mr. Marks thinks we’re in “the eighth inning” of this economic expansion. However, the baseball metaphor gives him an “out” since he also notes that the game can go to 11 or 14 innings. Legendary (and still active) investor Stan Druckenmiller believes, along with many others, that the most important determinant for stock prices is not earnings but Fed policy and the level of interest rates. Bull markets, like economic cycles, don’t usually die of old age. Something kills them. That something in several historical cases has been the Federal Reserve Board raising interest rates and tightening monetary conditions.

“But the economy is strong,” the bulls will say. “We just saw the lowest unemployment rate since December of 1969.” Few will note, however, that a vicious recession started just one month later in January of 1970.

If interest rates do continue to rise, it would certainly be negative for long term bonds and might also provide a headwind or worse for stocks. There are some businesses like banks and insurance companies that stand to benefit from higher rates, and we will likely continue to position some of those in our portfolios. Perhaps the safest investment to make is to invest in short-term high quality notes and Treasury bills which are now yielding more respectable returns of 2.4% to almost 3% from almost zero three years ago. The short maturities allow us to roll them over into higher yielding investments in the near future if rates continue to rise, while protecting principal in the meantime. That principal can also be redeployed later at better prices if stocks retreat in the face of higher rates. In any event, the actions of the Federal Reserve board and the subsequent levels of interest rates are probably the most important ball for us to keep our eye on for the near future.

Enclosed you will find your third quarter reports for your review. As always, look them over at your leisure and give me a call with any questions or concerns that you may have. It is a privilege to work with you on your investments and we hope to continue to earn that trust.

Best regards,

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