SAC
SMITH AFFILIATED CAPITAL

FIRST QUARTER 2019
INVESTMENT COMMENTARY

High-Risk Investment Environment in 2019

In this Issue:

- **Bubble, Bubble, Toil and Trouble**
- **Households Vulnerability**
- **Fed is on Perilous Journey**

There's a time-honored adage that Wall Street likes to climb a wall of worry. As the curtain rang down on 2018 that wall kept getting higher, resulting in the most devastating stock market plunge for the month of December since the Great Depression. The question is, will that wall come tumbling down or pose a formidable barrier for the economy to surmount in the coming year? As it is, the expansion is getting long in the tooth and showing distinct signs of fatigue. A recent Duke University poll revealed that 50 percent of Chief Financial Officers expect the economy to fall into a recession in 2019. That's more pessimistic than the view held by the majority of economists, but even they are upping the odds of a downturn this year. The latest poll puts the odds at over 20 percent, up five percentage points from a few months ago. While still low, those odds are still higher than the Fed's record of forecasting recessions, which is zero.

Paradoxically, the deepening sense of pessimism among traders and investors reflects a drumbeat of headline-grabbing "what-ifs" rather than what's actually happening. What if trade tensions with China escalate to the point of no return, resulting in onerous tariffs and other trade barriers that hammer global growth? What if the Federal Reserve makes a policy mistake that cuts short the expansion? What if corporations ran up too much debt and households filled their portfolios with too many risky stocks, making them vulnerable to higher interest rates or a steep market correction? These questions, together with the greater than usual amount of political dysfunction in Washington (including a partial government shutdown and the abrupt departure of defense secretary Mattis) buffeted investor psychology as 2018 drew to a close, and continue to linger as the curtain rises on 2019.

No doubt, actual conditions appear to belie the pessimism that is permeating the financial markets. Following sturdy growth rates of 4.2 percent and 3.4 percent in the second and third quarters, the economy is on track to deliver another respectable performance in the fourth quarter, with GDP advancing at an annual rate of 2.5-3.0 percent. The job market remains on a solid footing, as the unemployment rate continues to hover near historic lows. More than anything, solid job and income prospects are keeping the odds of a recession this year relatively low. But the sugar high that has fueled the above trend growth in 2018 – the tax cuts and increased federal spending – is unwinding, global growth is already sputtering thanks largely to a slumping China, and Europe is besieged with geopolitical turmoil, highlighted by Britain's pending exit from the European Union. The happy synchronized global growth story that brightened the economic landscape early last year has devolved into a dog fight of trade wars, political upheaval and disparate central bank policies. The markets' pessimism may be overblown, as some pundits are claiming, but there is fire as well as smoke clouding the 2019 outlook of a definitive deflationary slowdown.

Bubble, Bubble, Toil and Trouble

Wall Street is fretting over an array of potential trouble spots that underpinned the dramatic slide in stock prices over the last three months. Trade policy, concerns about global growth, Fed rate hikes as well as Trump's harsh attacks on Chair Powell topped the list, but analysts that dig deeply into corporate balance sheets are finding other disturbing developments that could potentially have dire consequences. Most troublesome is the huge volume of debt that corporations have taken on during the expansion. Total non-financial corporate debt has grown by an impressive 58 percent since 2010, reaching a record, both in nominal terms ($9.3 trillion) and as a share of GDP (45 percent). The outsize increase has been encouraged by an extremely easy monetary policy, the increased risk appetite of investors and the strong desire to obtain the higher yields available on corporate bonds in a prevailing low-rate environment.

But the favorable backdrop encouraging the debt buildup is in the process of reversing. Monetary policy is tightening, borrowing costs are rising and investors are becoming more discerning, as evidenced by the recent sharp widening of yield spreads between lower and higher-rated bonds. As profits sag under the weight of a growth slowdown and rising cost pressures, debt-servicing issues will become a problem for a growing swath of borrowers. What's worse, the proceeds from this huge volume of borrowing have been mostly channeled into nonproductive uses, primarily to finance mergers and acquisitions, stock buybacks and dividend payments to shareholders. Normally, corporations turn to the capital markets to finance capital spending, something that lifts productivity and enhances the long-run growth prospects for the economy. But business investment spending never exceeded the 13.7 percent share of GDP reached four years ago, and is not likely to do so in the near future.

Importantly, many analysts are becoming increasingly concerned about the financial health of the business sector and its vulnerability to higher interest rates. The fear is that a corporate debt bubble has emerged before our eyes and could be the catalyst for the next recession. This threat should not be treated lightly, particularly as the proximate catalysts of the last two recessions were the bursting of the dot.com bubble in 2000 and the collapse of the speculative housing bubble in 2007, fueled by a mountain of subprime loans that almost brought down the financial system. In fact, the Federal Reserve in its first-ever Financial Stability Report, highlighted worries about the elevated level of corporate debt, with special focus on the rapid growth of leveraged loans. Treasury Secretary's Mnuchin's widely-mocked assurance that banks are in a healthy liquidity position, based on several calls to bank CEOs, only added to suspicions that not everything is alright on bank balance sheets. Keep in mind that the flattening of the yield curve is already squeezing bank margins, and the prospect of widespread loan defaults would surely test the Treasury Secretary's claim of bank invulnerability. While the economy may not fall into a recession in 2019, many analysts believe that an earnings recession is almost inevitable.

Households Vulnerability

Simply put, the capacity of corporations to service debt will depend on a revenue stream that is looking increasingly precarious. A combination of slowing global growth, reciprocal tariffs and a strong dollar is suppressing foreign demand for American goods. It's important to note that the S&P 500 companies derive 45 percent of their revenues from overseas, so this source of cash flow is poised to continue shrinking. Meanwhile, tariffs are increasing input costs for American companies even as they disrupt supply chains that lift costs throughout the production process.

With the global landscape looking less favorable for U.S. firms, the pressure to sustain revenues will fall more heavily on domestic demand. On the plus side, consumers are still in a buying mood, having just completed a festive shopping season. Fueled by a still-robust job market, rising wages, lower gas prices and the lingering effects of last year's tax cuts, personal consumption imparted a sizeable boost to GDP in 2018. Indeed, spending exceeded income growth as households, emboldened by the remarkable upsurge in asset values throughout the expansion, drew down savings during the past year to help finance spending. But there's a dark underside to the wealth effect that could turn into a considerable drag on consumption going forward.

On the surface, the sharp improvement in household balance sheets since the recession is a positive omen for consumer spending. After all, when households feel wealthier they tend to spend more than otherwise. But appreciated equity holdings have accounted for 40 percent of the increase in household assets since the recession and they now account for 25.2 percent of the total, only a tad below the 27 percent record high seen at the height of the dot.com bubble in 2000. This outsize share of stocks once again leaves households vulnerable to a market correction. In fact, the 14 percent tumble in stock prices over the past three months wiped out about $4 trillion of equity wealth. The period is probably too short to have a meaningful near-term impact on consumption — short-term market swings do not generally change spending habits – but if the wealth destruction is not recovered, or worse, continues over the next several months, households will feel poorer and pull in their horns.

Indeed, there's ample evidence that the negative reaction to a market downturn is greater than the positive reaction to a market upturn, reflecting the notion that people derive more pain from a loss than enjoyment from a gain. Hence, there is a real risk that if the market correction intensifies it could have confidence-shattering effects that so impedes consumer spending it becomes a self-fulfilling prophecy, bringing on a recession. Time and the direction of stock prices will determine if that is the case in this cycle. But it is no coincidence that the Conference Board's latest consumer confidence index fell in December for the second consecutive month, lowering it back to July's level.

Fed is on Perilous Journey

Analysts and pundits offer wide-ranging explanations for the recent market turmoil, and all have a kernel of truth. But with the economic expansion in a very mature stage – poised to become the longest on record if it lasts through mid-year – investors are increasingly worried that the Fed is about to make a policy mistake that will short-circuit the upturn, something that has repeatedly occurred in postwar cycles. In the statement following the December rate hike, the Fed announced that it expects to pull the rate trigger two more times in 2019 if its optimistic expectations of growth and inflation are met. While inflation remains stubbornly below the Fed's 2 percent target, policymakers are focusing on the low unemployment rate, concerned that a surge in labor costs will stoke an inflation outbreak that would be too late to contain if they do not move preemptively.

Not only have events over the past two decades rendered the Phillips curve obsolete, the Fed appears to be disconnected from the myriad signals urging it to stand pat. In addition to the global risks – a sharp slowdown in China and Europe, including an Italian economy on the cusp of a recession – the financial markets are sending a strong message that the U.S. outlook is not nearly as promising as indicated in the FOMC's latest

Summary of Economic Projections. The 10-year Treasury yield closed the year more than 50 basis points below its early-November peak, resulting in the narrowest 2/10 year spread since June 2007. One more Fed rate hike would bring about the dreaded inversion that has been an infallible precursor of every postwar recession.

The Fed is also downplaying the turmoil in the stock market, which may be reminiscent of the tightening episode leading up to the 2001 recession. Then, as now, the economy was growing above trend, fueled by the dot.com boom, and the job market was exceptionally tight, with unemployment below 4 percent. While core inflation remained low, hovering around 2 percent, the Fed nonetheless embarked on a rate-hiking cycle in June1999 that lasted until May the following year, lifting the federal funds rate from 4.75 percent to 6.5 percent during the period.

However, following the penultimate move to 6.0 percent in March 2000, the markets turned bearish – just as it did following last September's rate increase – as investors feared the economy was poised to buckle under the weight of previous increases. Instead of listening to the market, the Fed proceeded to hike again in May, lifting the funds rate by another half-percent where it remained until the end of the year. That was the final straw for stocks, which then plummeted by 20 percent, hitting bottom in late December 2000. The Fed finally blinked and in January 2001 slashed the funds rate by half-percent, taking the unusual step of moving before a scheduled policy meeting. Stocks briefly rallied by 10 percent following the move, but by then it was too late to prevent the economy from falling into a recession three months later.

It's an open debate as to whether the Fed was too aggressive in tightening policy or whether the bursting of the dot.com bubble was primarily responsible for the 2001 downturn. No doubt, the two were interconnected, as the collapse of high-flying Internet darlings with zero earnings were doomed to failure once liquidity ran dry. To its credit, the Fed moved quickly after its first rate reduction, lowering the funds rate by 4.75 percentage points within a year, which cushioned the economic downturn that ultimately morphed into a very mild recession. However, if the economy is on the precipice of a similar breakdown, the Fed does not have the ammunition it had in 2000; with the funds rate at 2.25-2.50 percent, there are far fewer rate bullets in its arsenal. Keep in mind that the fiscal stimulus that so catalyzed growth in 2018 will be fading in 2019, reinforcing the growth-retarding moves by the Fed.

The persistence of tame inflation, despite a low unemployment rate, slower growth in 2019, reflecting fading fiscal stimulus and past Fed rate hikes, a likely earnings recession, heightened global risks, highlighted by Brexit, trade tensions and a steeper than expected slowdown in China, and balance sheet vulnerabilities all point to a high-risk environment in 2019 that will perpetuate the extreme market volatility seen in late 2018. Against this backdrop, we see a low-risk defensive posture heavily weighted with quality bonds that now offer positive inflation-adjusted returns as the most rewarding asset class over the foreseeable future.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	12/31/2017	9/30/2018	12/31/2018	Last Quarter	Last Year
6-Mo. Bill	1.53	2.37	2.48	0.62	1.94
2-Yr. Note	1.89	2.82	2.50	1.28	1.40
5-Yr. Note	2.19	2.95	2.51	2.81	1.42
10-Yr. Note	2.41	3.06	2.69	3.87	0.00
30-Yr. Note	2.74	3.20	3.02	4.10	-2.72

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2017	9/30/2018	12/31/2018	Last Quarter	Last Year
Barclays GO Bond Index	2.26	2.75	2.54	1.82	1.33
Barclays State GO Bond Index	2.21	2.68	2.46	1.73	1.44
Barclays Local GO Bond Index	2.33	2.84	2.62	1.92	1.20
Barclays Revenue Bond Index	2.48	2.97	2.81	1.67	1.20

Equities	Levels			US $ Terms (%)	
	12/31/2017	9/30/2018	12/31/2018	Last Quarter	Last Year
S&P 500	2673.61	2913.98	2506.85	-13.52	-4.39
DJIA	24713.22	26458.31	23327.46	-11.31	-3.48
NIKKEI (Tokyo)	22764.94	24120.04	20014.77	-14.58	-8.63

Commodities	US $			Percent Change (%)	
	12/31/2017	9/30/2018	12/31/2018	Last Quarter	Last Year
COMEX Gold Active Monthly	1309.30	1191.50	11281.30	7.54	-2.14
CRB Future Com. Pr. Index*	193.8647	195.1592	169.8018	-12.99	-12.41
West Texas Intermediate Crude ($ per bbl.)	60.42	73.25	45.41	-38.01	-24.84

Currencies	Levels			Percent Change (%)	
	12/31/2017	9/30/2018	12/31/2018	Last Quarter	Last Year
Yen	112.69	113.70	109.69	3.53	2.66
Sterling	1.3513	1.3031	1.2754	-2.13	-5.62
Euro	1.2005	1.1604	1.1467	-1.18	-4.48

Global Bond Markets**	Levels			US Dollar Terms (%)	
	12/31/2017	9/30/2018	12/31/2018	Last Quarter	Last Year
German 10-Yr.Bond	0.27	0.32	0.09	2.02	2.69
Japanese 10-Yr.+ Bond	0.47	0.07	-0.08	1.34	0.94
UK 10-Yr.+ Bond	1.06	1.43	1.17	2.76	1.49
Emerging Market (USD)	4.53	5.83	6.05	-0.18	-2.46

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices

Disclaimer: This publication contains the current opinions of the manager and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This publication is distributed for education purposes only. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Forecasts are based on proprietary research and should not be interpreted as an offer or solicitation, nor the purchase or sale of any financial instrument. No part of this publication may be reproduced in any form, or referred to in any publication, without the express written permission of Smith Affiliated Capital Corp.