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Commentary

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Nostalgia

Across the U.S. a subtle shift has been going on for some time with many Americans appearing to adapt a more European way of life. In towns small and large, you will find sidewalks transformed into trendy outdoor cafes. In many cities, espresso bars are as commonplace as the traditional corner tavern. Even the long running American love affair with the automobile is being reconsidered as urban centers move to adopt public transportation systems resembling those found in many European centers. This marks a 180-degree turn as many U.S. cities dismantled their light rail systems after the Second World War to make way for more efficient buses and proliferating automobile traffic. Only a few cities, like San Francisco and New Orleans, retained their systems largely for nostalgic value. But now light rail and electric streetcars seem all the rage, and this is not merely an isolated costal phenomenon as one can find streetcars across the heartland from Dallas to Kansas City to Milwaukee.

This second-generation streetcar renaissance is largely financed by federal funding. The expense of integrating a streetcar into a modern transportation infrastructure is very costly and impractical. Cities that have taken the plunge have spent hundreds of millions of dollars building streetcars that snarl traffic over very short distances. Initially, to lure riders from their cars, fares are heavily subsidized, often free, again much in following the European model. Subsidies can be effective in the short run in influencing behavior. A free ride will attract a free-rider even if the distance that they want to travel is faster by foot. But experience shows that ridership falls off sharply once the free-riders are required to pay a fee. Charge for the ride and the prudent consumer will evaluate the cost of the ride versus its benefit.

Similarly, when investors get the chance to free-ride on the generosity of central banks, they are rational to do so. The decision by central banks globally to promote a path to higher growth and risk higher inflation proved to be a green light for speculation. Assets of all types moved up in tandem, reversing a highly correlated decline at year end. The markets have correctly interpreted that the central banks are now targeting stock prices. Stock markets no longer serve as a litmus test for economic conditions but rather as a signal for central banks to respond. The tail is wagging the dog.

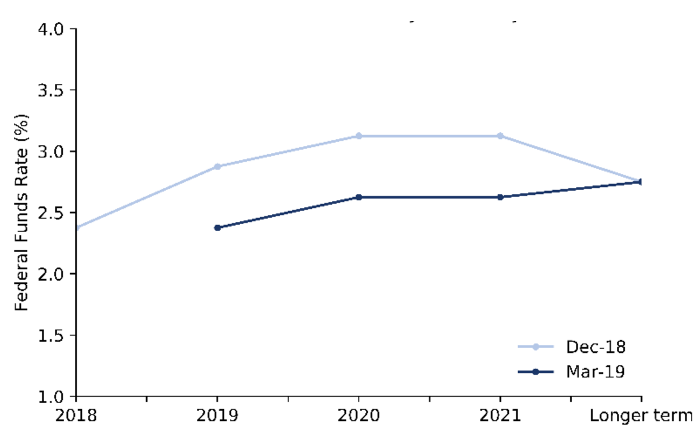

Figure 1. Fed Governors' Median Policy Rate Projections
Source: Federal Reserve

Late last year, the markets incorrectly forecasted that the Fed was determined to pursue a gradual tightening in short-term interest rates despite evidence of a slowing global economy. The "Powell put" became uncertain and the markets became unhinged. Chairman Powell's response to the market's temper tantrum was quick and decisive. He would pause raising interest rates and risk a higher level of growth and inflation than previously thought prudent. He joined his last three predecessors at the helm of the Federal Reserve in acknowledging that deflation is a greater risk than inflation in the current economic cycle.

It is still possible that the global economy will surprise on the upside, but most economists have reduced global growth forecasts. Global bond markets confirmed the path of slower growth. The German Bund once again traded below zero and surprisingly crossed lower in yield than the Japanese 10-Year. The U.S. 10-Year Treasury note fell to under 2.4%. The impact of a friendlier Fed, lower rates, progress on trade talks with China, and Chinese stimulus ignited one of the strongest global equity rallies in history. Spreads on high quality credit narrowed across the board, while high-yield credit lagged. Commodities on average were stronger. Yield curves on the shorter end of interest rate curves inverted while longer maturity bonds steepened.

With the benefit of peering into the rear-view mirror, the Fed was on the wrong path. It remains to be seen whether their policy error leads to a premature recession. Strength in the U.S. employment picture would imply that the risk of recession this year is still low. However, global weakness particularly in Europe would indicate that the risks for 2020 are rising. The key will be the impact of trade on China and the ability of the Chinese leadership to turn around recent economic weakness. A credible trade deal with the U.S. will go a long way to instilling confidence. Failure to reach a deal would be a disaster at this point.

Central banks have been far more effective at driving investor behavior than they have been at generating growth and inflation. Interest rate manipulation has led to further indebtedness and a deterioration in underlying credit quality trends. Growth rates this economic cycle have remained subpar from a historical context. Inflation has been gradually falling throughout the developed and developing world. The trend towards deflation is still a concern throughout the globe.

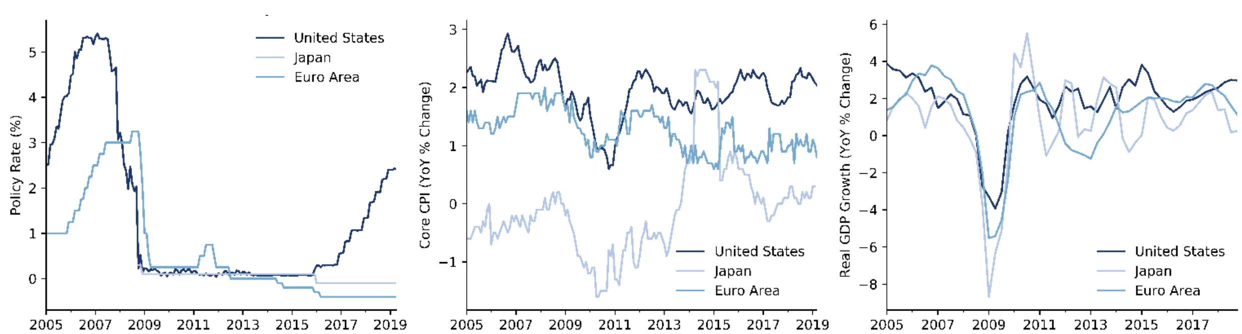

Figure 2. Policy Rates, Core Inflation and Real GDP Growth for the United States, Japan, and Eurozone.
Source: Bloomberg, Federal Reserve

In this environment, high quality bonds still represent value from a long-term view given the difficulty that central banks have had in generating inflation. Market forces have been more forceful than cyclical attempts by policymakers to undermine debt levels. Short-term interest rates in the U.S. are likely not to exceed 3% this cycle. European rates are hovering around 0% and Japanese rates are firmly at 0%. Japanese banks have struggled to recover any of the 90% that they have lost over the last 20 years. European banks while only 10 years into their retrenchment are beginning to look similar. It is just the U.S. banks which have recovered most of the equity lost since the financial crisis.

Figure 3. Performance of U.S., European, and Japanese Bank Equities [1]
Source: Bloomberg

Likewise, emerging markets are beginning to look attractive versus their developed market peers. There was a strong rally in emerging markets across the board in the first quarter, with worries over a stronger dollar and a more aggressive Fed being quickly uprooted. We continue to see the diverse nature of the asset class, as on average, lower debt levels and higher growth rates are important in assessing any emerging market country's credit quality. So too, investor sentiment varies across emerging markets. There was outright euphoria over the Bolsonaro victory in Brazil. His business-friendly attitude has increased investors' confidence in the prospect of achieving needed economic and fiscal reforms. Mexican investors, on the other hand, are anxious over AMLO's leftward leaning tendencies and populist policies.

Emerging market assets rallied across the board in the first quarter of 2019. Stocks were up 9.9%, local currency bonds 2.7%, and hard currency bonds 6.6%%. Despite generally strong markets, there were some signs of divergence. U.S. growth still seems more resilient than other economies, especially those reliant on trade. Additionally, with U.S. interest rates still high in comparison to other developed markets the dollar is poised to break out to the upside. The result would most likely be a drawdown in valuation for emerging market currencies.

We still consider higher quality emerging market sovereign and quasi-sovereign bonds attractive even after the first quarter rally. Absolute returns for the quarter were strongly positive; however, we underperformed in relative terms. Overall, we were too defensive and held too much cash. We also were wrongly positioned on the yield curve, as intermediate duration was the place to be and we were underweighted. The inversion at the front end of the curve and steepening at the long end is unique and adversely impacted our results. We remain confident that if interest rates continue to remain low that the back end of the curve will catch up. We were also hurt by our modest positions in non-investment grade bonds. The fact that the credit curve steepened during the first quarter rally is indicative of the end of the cycle. Our strategy for the rest of the year is to gradually increase the quality of our portfolio and add exposure on pull backs.

Investing is never easy but is particularly difficult as you approach the end of an economic cycle. We are confident that the decade long economic cycle is stretched but are less certain of the timing or trigger for the next downturn. We are also aware that the subpar momentum of growth this cycle has generated few imbalances. Policymakers have unsuccessfully tried to generate inflation and push interest rates up. The U.S has had modest success while Europe has not. The Japanese have outright failed. Each attempt to normalize policy has been met with sharp equity corrections and a reversal in policy. For the U.S., each reversal has led the stock market to new highs. For the European and Japanese equity investors, it has meant rallies in a downtrend.

U.S. investors have been conditioned to believe that monetary accommodation is a free-ride; that each correction is a buying opportunity. The same was true for many European and Japanese investors before them. Ironically, so did the stock market speculators of the late 1930's. Perhaps rather than adopting the lifestyles of our foreign neighbors, we should learn from them. Trends towards managed capitalism and socialism have always ended badly. If a modern streetcar is not economical than we should not invest in it. Nor should we try to legislate bull markets or history could simply repeat itself.

[1]Below is a description of the indices depicted in Figure 3. Investors cannot invest directly in an index. Indices are unmanaged and do not reflect management fees and transaction costs that are associated with some investments.

The **KBW Bank Index**, developed by financial sector specialist investment bank Keefe, Bruyette and Woods, includes 24 banking stocks which represent large U.S. national money center banks, regional banks and thrift institutions. It is a benchmark stock index for the banking sector.

The **STOXX Europe 600 Banks Index** is a sector index of the STOXX Europe 600 which has a fixed number of 600 components representing large, mid and small capitalization companies among 17 European countries, covering approximately 90% of the free-float market capitalization of the European stock market. The countries that make up the index are the United Kingdom (comprising around 27% of the index), France, Germany and Switzerland (accounting for around 15% of the index each) as well as Austria, Belgium, Denmark, Finland, Ireland, Italy, Luxemburg, the Netherlands, Norway, Poland, Portugal, Spain and Sweden. It was introduced in 1998. The composition is reviewed four times a year, in March, June, September and December. The index is available in several currencies (AUD, CAD, CHF, EUR, GBP. JPY, USD) and return (Price, Net Return, Gross Return variant combinations.

The **Topix Bank Index** is the bank sector index of the Toyko Price Index (TOPIX).