HAMILTON CAPITAL

capital markets review

Winter 2019

Economic Outlook

Some Cracks Begin To Show

Executive Summary

Growth remained robust as the year closed. After approaching a 4% pace in the middle of 2018, GDP has been estimated near 2.75% in the fourth quarter. This remains above the 2% average that we've experienced for many years and is temporarily boosted by factors that we previously described – some of which could now actually cause growth to drop below normal for a stretch.

On the inflation front, a sharp drop in crude prices and other factors are pulling inflation back from the 2+% range previously reached to a milder 1.6% rate. This relieves some of the pressure on the central bank and is leading the Fed to signal that it may increase rates less than previously expected...if these trends hold, that is, which is far from a given.

However, though today looks bright, as one looks at tomorrow one could also conclude 'ya got trouble in River City' (yes, we're dating ourselves). Well, some trouble anyway, likely to emerge over the next few quarters unless something is done to prevent it. And, after an extraordinary borrow-and-spend boost last year, our fiscal stimulus tools are worn and dull.

What's the problem? At the core, it's nothing more than the normal excesses that arise when an economy successfully meets much of consumers' pent-up demand built during recessions and uses up its spare capacity. This leads the central bank to do away with the stimulus upon which a recovery is built. More recently, triggers for the emergence of concerns about the future include the slowing of the fiscal boost we enjoyed in 2018 and the likely echo of pre-tariff anticipatory spending. And one, of course, can't ignore the corrosive effect of trade-conflict uncertainty.

Well, the obvious event in the fourth quarter was the stock market meltdown. Does this mean that the economy went into recession?

You'd think so, wouldn't you? But it's more complicated than that.

If we set aside the financial market drop for the moment and focus exclusively on economic growth data, all appears well. In the past.

In the second and third quarters of the year, the economy accelerated from the 2% average pace we've lived through for years, reaching almost 4%! We've explained the factors behind this – and the likelihood that many have a strong temporary nature to them – ad nauseum, so we won't repeat ourselves. But these factors were still at play in the fourth quarter, and the consensus is converging on a growth rate of around 2.75% in the last three months. Not bad at all.

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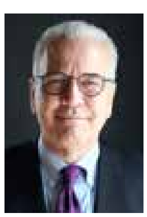

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The Interviewees

The content in this issue of *Capital Markets Review* was taken from an interview with Hamilton Capital Management Chairman & CEO Matt Hamilton, CIO Tony Caxide and Managing Director, Portfolio Management, Srinath Sampath shortly after the end of the fourth quarter of 2018.

Equity Portfolios

And They All Fall Down

Executive Summary

Everything dropped. Or darn near it.

Seemingly impulsively, suddenly and steeply, risk assets (which is a scary label that works well in describing stocks, corporate bonds, many hedge funds and so on – anything with market, credit, convexity or other risk) all came tumbling down in the fourth quarter.

Why? The months and years ahead will see many tomes, and not just a few PhDs, trying to explain it. But the roots of the turn included the previous stellar performance of many of these same assets.

One has to try hard to see the problem. Profits are at record highs and gains in jobs have actually accelerated. But markets look ahead. And the recipe for an adjustment includes several gallons of high prices relative to the underlying cash flows, tablespoons of higher interest rates, a largely satiated consumer who probably isn't craving more cellphones and smart TVs, a few teaspoons of slowing Chinese growth, a few pinches of weaker commodities and, voilà, we've baked talk of potential recession risk and a large drop in prices.

But we think that we're navigating a middle path through the shoals in our portfolios.

All that comes to mind is, what the heck happened there?!

Just when everything was going so well, right?

As one peruses the performance tables, red suddenly prevails. Everything fell and fell a lot in the fourth quarter! Certainly for equities everywhere. And bonds, be they investment-grade or high-yield. For U.S. and non-U.S. markets. And seemingly everything else. Even hedge funds, which are supposed to be absolute return vehicles that seek to manage losses – and get paid extraordinary sums of money for it, including up to 20% for gains over T-bills, no less – generated losses, continuing to erase some of the perceptions of strong magic in this field.

So "everything" is down – not just in the quarter but for the entire year – and quite a bit. OK, so cash and short-terms actually generated positive returns in 2018, but that's about it.

And what brought that about? How can things change so much so suddenly?

We've found it curious to observe, particularly in the most recent 15 to 20 years, that even the most seasoned institutional investors have come to increasingly criticize the central bank and the Treasury, demanding clear guidance on future public policy, assurance of stability, and even a sense of where markets are going. As if it was their job to do our job. And like they can overcome our instinct, as human beings, for excess.

They can't. So what happened? Greed, in its common, garden variety.

After suffering through the punishing stock market performance of 2000-2001 and 2007-2009, investors learned the lesson of yesterday and grew guarded, waiting cautiously from 2009 until recently, through a major bull market, "…until things were clearer." But as time passed and nothing scary ever appeared around the corner, investors eventually came to grow confident and think that things were clear now. Which is generally when things go wrong.

As Georg Hegel said: "We learn from history that we do not learn from history."

So in hindsight it's obvious the market was vulnerable – otherwise it wouldn't have fallen this badly. Why?

The first why, in our opinion, was "valuation" – i.e., prices were expensive. Further, as we alluded to earlier, sentiment had gradually (and, early on, begrudgingly) come to shift to a position of confidence. Some astute investors have even labeled it euphoria. And some sectors of the corporate universe are highly leveraged, which reduces the margin of error. Volatility is just a word when things are going well, but when prices fall, it becomes more than a word – it's losing money, it's catching falling knives…and it's a disconcerting emergence of doubts and, really, fear of dashed dreams for many investors.

Factors that had previously been felt as strengths (like the large government boost and pre-tariff demand) suddenly were interpreted as liabilities – built on several years of over $1 trillion of annual borrowings and temporary in nature, with a costly payback.

For all the causal factors we've described before, this kind of thing is bound to happen when you own risky assets, though not always this sharply.

What now?

Stocks typically seek to look through the windshield, though human frailties sometimes temporarily obscure our vision. In the fourth quarter the market decided that a combination of higher U.S. rates, slowing Chinese growth, trade conflicts, suddenly weaker commodity prices, and the waning positive impact of the large borrow-and-spend fiscal stimulus (and the rapidly approaching tab for that policy) threatened profit growth and were inconsistent with the level of prices. And prices adjusted down.

As the year begins, the equation is shifting. Investors are struggling with new questions. Are the lower prices now fully reflective of the policy environment (i.e., is the market fair, or even cheap)? And might public policy become more market-friendly? We've identified the three most impactful ways in which policy could shift to supportive: "Looser" U.S. monetary policy, extraordinary Chinese stimulus, and a move-the-needle trade agreement between the U.S. and China.

Ups and downs will continue as investors assess "buying the dips" or "selling the rallies." For us, well, we're keeping our eyes firmly on the fundamental forces that ultimately matter most.

Fixed Income Portfolios

A Seesaw Bond Market And A Stoic Fed

Executive Summary

With risk markets capitulating in the fourth quarter, treasury bonds appreciated while credit suffered. The Fed continues to remain dispassionate, nudging its policy back to normal while demonstrating the needed flexibility in the face of evolving data. In our portfolios, we continue to be cautious about both duration and credit risk.

We saw quite a lot of turbulence in equities as 2018 closed. How did treasury markets react?

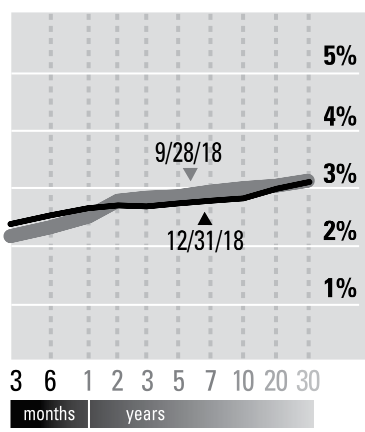
It should come as no surprise that they gyrated in lockstep with the equity markets, benefiting from the decline in equity prices. As risk assets declined, investors fled to the safety of treasury bonds. The 10-year treasury appreciated in price and saw its yield decline from about 3% to about 2.7% during the quarter; this terminal yield was previously seen last January. The 2-year treasury also gained value, reaching a near 2.5% yield at year-end that was last seen in June. So a year where the themes were flat-to-gradually-rising yields and the potential for curve inversion (where the 10-year treasury yielded less than the 2-year treasury – an imperfect foreshadower of recessions) was upended by a flight to safety at the end.

How does the Fed propose to return the economy to 'normal' in 2019 and beyond?

In its December meeting, the Fed raised the federal funds rate to a range between 2.25% and 2.5%. This was anticipated. What did change, however, were the Fed's projections for interest rates, economic growth, and the number of rate hikes in 2019 – all of which were reduced. Earlier last year, when both the U.S. and world economies appeared more robust than they do today, the Fed dot plot showed four rate increases in 2019. Today it projects only one to two hikes for the year.

Treasury Yield Curve

Yield to maturity of current bills, notes and bonds.



How did the Fed – and Jay Powell – fare last year?

Really well, all things considered. The Federal Reserve's dual mandate, as prescribed by the U.S. Congress, is to maximize employment and stabilize prices; the latter is typically achieved by modulating inflation. Today, U.S. unemployment sits at a low 3.9%, a far cry from the peak of 9.9% during the Global Financial Crisis. Inflation is moderate, with core inflation ranging between 1.5% and 2% in the last decade. Through its toolkit of rate increases and balance-sheet reduction, the Fed, most recently under Jay Powell, continues to govern with a steady hand. That it's impervious to criticism and hews close to its dual mandate is very much to its credit.

How is Hamilton Capital's fixed income portfolio positioned to respond to this environment?

The concern that duration risk – the risk that rising interest rates will depreciate longer bond portfolios more than shorter bond portfolios – could hurt our fixed-income portfolios and our clients' wealth is very much on our mind, and we continue to maintain a short-duration stance relative to our portfolio benchmarks. Our credit exposure is of a very high quality, as we are loath to move up the credit risk curve in an environment where monetary stimulus is gradually being withdrawn.

Want To Learn More?

If you'd like to take a deeper dive into Hamilton Capital's proprietary research or better understand our top-down, forward-looking investment process, join our Investment Team for one of our upcoming market briefings:

February 14
Lunch, Scioto Country Club

March 14
Lunch, The Refectory

April 18
Lunch, Scioto Country Club

Space is limited, so contact Laura Hamilton at lah@hamiltoncapital.com or (614) 545-4013 to RSVP.

In Other Words

"Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."

— Warren Buffett, Investor

"It takes character to sit there with all that cash and do nothing. I didn't get to where I am by going after mediocre opportunities."

— Charlie Munger, Investor

Economic Outlook (Continued)

But you're still sensing that things may not all be as robust going forward?

Yes, and investors are coming to see it our way. That's one of the components behind market nerves.

Again, if we focus here on the economics, signs of concern are becoming easier to notice. Of course, we'd argue that some of the weaker, underlying causal factors were observable many moons ago, such as higher interest rates and central bank balance sheets going in the wrong direction, which we've described as Quantitative Tightening. But their impact is becoming more evident now.

Give us a couple of examples.

Well, housing sales have been falling for two years, as affordability has worsened sharply and new-home inventories are suddenly exceedingly high. Auto sales have shown weakness since 2017 and have held up since due only to temporary factors. Manufacturing sentiment just fell noticeably. Oil prices dropped sharply, which, though a positive eventually (say, in 2020), reflect disappointing demand growth and represent a clear and present danger to profits for the next 12 months. And stresses are emerging beyond our borders as well.

One additional thought here: This is neither unusual, nor unexpected. During recessions, central banks try to overcome negative sentiment by goosing lending and borrowing, partly via lower interest rates. As the economy comes to meet all the built-up and pent-up demand, and the excess capacity in the economy is used up (like putting millions of unemployed people to work), the room for future growth naturally diminishes.

So everything is weak now?

No, no, not at all. For example, payrolls have actually improved. Overall, the consumer has been spending at a healthy pace and manufacturing has held up quite nicely. And, although some signs point to a risk of higher inflation – such as rapidly accelerating wage growth, now near a 3.6% pace – many other factors are pulling the other way, making this a tricky environment for policymakers.

The fact is, however, that the perceived risk of recession has increased materially, to around 25% in the next 12 months and over 55% in 2020, as we write this. This is much higher than just a few months back and certainly in the spring of 2018, when we first penciled in a rather higher risk in mid-2019. Since then, the tax-cut stimulus has worked as a sustaining and delaying force but one that won't last forever. Neither will the pre-tariff demand we've seen this past year. And commodity prices, which supported profitability and capital investment while elevated, are now decidedly weaker. Lastly, another vague but meaningful negative has been the impact of the various trade conflicts that the U.S. has triggered across the world. Founded on legitimate American grievances, they nevertheless are generating uncertainty, delaying some capital investment, and, thus, acting as a headwind to growth.

What can be done to manage this, and what are you watching?

In our view, the most significant factor most of the time is monetary policy. That remains the case today, particularly as we've already pushed the fiscal throttle very hard, leading to record levels of government borrowing and debt. So, should the Fed change its stripes materially on interest rate policy, away from tightening, it would make a difference.

We would highlight two further other areas to watch that could swing either as positives or negatives:

Will China decide to engage in a big-stimulus program? It's telegraphing a strong bias toward doing as little as possible and only as much as necessary. But should it capitulate and stimulate, this would help growth while aggravating its already serious debt excesses. That's not so different from the conundrum the U.S. faces.

Further, and not unrelated, will the U.S. and China reach a trade agreement – one through which China rolls over on intellectual property protections, subsidies to state corporate champions, forced technology transfer, and outright pirating and looting of data/tech trade secrets? Though less significant near-term than the former, it could provide some temporary relief.

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Form ADV: If you would like to receive a copy of our current Form ADV, Part 2A and 2B, please contact us.