HAMILTON CAPITAL

capital markets review

Spring 2019

Economic Outlook

Stimulus Emerges From China, Lower U.S. Bond Yields

Executive Summary

At the turn of the year, the Federal Reserve changed its assessment. Previously inclined to increase interest rates further during 2019, it suddenly moderated its views and tacked to a "hold for now" position.

Its stance through much of 2018 was the result of robust growth, a record number of job openings and unemployment at very low levels, suggesting we had used up a good portion of the available labor force and were triggering acceleration in wages while also pressuring general inflation above target.

The Fed's volte-face was a logical outcome of new information in the fourth quarter. Economic health suddenly seemed less certain. Globally, trade conflicts were beginning to reduce global trade. Actions in China to contain its rapidly growing debt were also eating into global exports and leading commodity prices sharply down. And, of lesser importance to the Fed but relevant (since it can impact Main Street), the stock market experienced a dizzying fourth quarter that delivered full-year losses to stock investors.

Which brings us to today, when the Fed is likely observing two key changes. The financial markets wobble of the closing months of the year sharply lowered bond yields, which have translated into lower mortgage rates and higher affordability in housing. China has also taken additional steps it views as necessary to deliver enough growth for social stability. If sustained, these could extend global GDP, but also risk re-accelerating inflation. It's a fine balancing act, but one that near term seems to be helping growth a bit.

We read that the central bank has stopped talking about increasing rates, and we gather that growth may be slowing from much of 2018's pace. How are these tied together?

You're right on both counts, and the sequence of events has ebbed and flowed.

During 2018 we saw a bump in U.S. growth, which led to higher interest rates. Although we felt that some of the faster economic pace may not linger (and we've discussed that before, so we won't belabor the finer points), it nevertheless did accelerate GDP.

But the temporary aspect of some of the stimulus also was sowing the seeds of the faster pace's "destruction." Stimulus in a setting of near-full employment also was leading to faster wage growth and was triggering higher commodity prices the world over, which in turn contributed to inflation that was exceeding the Fed's rough target of near 2%. That was leading to meaningfully higher interest rates, which caused borrowing costs for mortgages, auto loans and other credit to rise.

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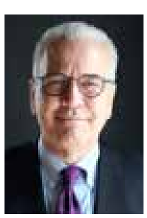

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The Interviewees

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, Jeff Liu shortly after the end of the first quarter of 2019.

Equity Portfolios

Sharing In The Good Times

Executive Summary

And then everything rose.

The last two quarters have been a study in contrast and volatility. The fourth quarter of 2018 was about doom and gloom, more than reversing the gains of the first nine months and handing equity investors a full year loss and making cash and short-term bonds the best-performing assets. The first quarter of 2019 then saw markets rebound, as the Fed turned "dovish" and the Chinese increased emphasis on stimulus and engineering a "soft landing."

We are partaking in stock market gains. At the same time, every day we're compelled to ask ourselves whether we currently have the components for the beginning of sustained stock market strength. To help us in that regard, we find it useful to compare today to circumstances like 2009, 2002, 1991 and other periods when we saw the beginning of prolonged and sizable stock-price recoveries. Conditions don't even need to be as fertile as then to lead to a positive stance. But is the current general environment anywhere near it? The answer is that we're missing some ingredients, so it doesn't look like we have quite the recipe we had back in those settings.

Further, a recent study points to stock buybacks by corporations as the only source of positive cash flow into stocks over the last several years. And, finally, we're seeing many leveraged-up, private companies come to market successfully despite losses.

So we don't entirely buy in to the recent strength. We've retained material exposure to "risk assets" like stocks in our portfolios – sharing in the growth that markets afford us and helping our clients move toward their goals – while also positioning them for a less-supportive environment, a strategy that worked very well in 2018. And this year has only just begun.

An awful fourth quarter followed by a partial-but-strong rebound: what's happening?

We went into some detail on the ebbs and flows of economic expectations in our Economic Outlook, which also helps explain the vicissitudes of stock markets. In essence, though, recently improved investor sentiment has arisen thanks to better expectations for future interest-rate moves by the Fed and a new, more benign posture by Chinese authorities that emphasizes growth and stability at the margin, while deemphasizing debt reduction.

And how did that work to improve markets?

Starting in the U.S., our central bank's new, "dovish" view led bond markets to rally, which drove down interest rates for many maturities. This directly helps demand for stocks, since lower yields are less appealing to investors and drive many into instruments of greater risk. But there's also a more indirect mechanism at work. Even though the Fed did not change the short-term rates it manages, its view that a softer economy does not warrant additional increases for the time being also brings the hope of possible decreases. Removing the threat of higher rates has made the future stream of earnings from companies worth more today, too.

Finally, as bond yields fell, some of the cost of borrowing improved. Mortgages on residences, for example, have seen a sharp drop in a few short months. Even if it doesn't lead to sharp increases in sales and construction activity, this should help at least stabilize this sector, which was seeing widespread weakness. But the impact is spotty. Interest rates on loans for autos, for instance, have actually increased because of concerns with defaults.

And what about China?

Investors have joked for many years that when the U.S. sneezes the world catches a cold. Though still rather smaller, as the Chinese economy grows, it is beginning to have a similar impact, particularly when there are sizable events out of Beijing.

In recent months, rather than sneeze, Chinese authorities made clear that their concerns for growth were leading them to postpone emphasis on controlling debt to the long term and instead give a big dollop of Vitamin C to their economy. They're placing greater near-term weight in stabilizing what increasingly looked like a big problem, with large drops in industrial profits and economic activity in many sectors.

This led local investors – who give tremendous deference to the wishes of the government – to conclude that Beijing wanted markets to rise. And rise they did, helping the global stock rebound.

So it's back to the races?

We have retained material exposure to "risk assets" like stocks in our portfolios, even as we also positioned them for a less-supportive environment – a strategy that worked very well in 2018 and continues to help our portfolios' growth this year.

But as changes in early 2019 are evolving, we continue to assess whether conditions paint a picture similar (if not identical) to what we observed in, say, 2009, 2002 and 1991, when, through investor fears, we eventually came to see that the soil was fertile for strong and sustained future returns.

And we find that conditions are rather different. Though we do not yet know how the various trade conflicts will end, whether OPEC and Russia (and Venezuela, Iran and Libya, among others) will keep oil prices elevated, and whether the Federal Reserve will materially ease monetary conditions, we find that the environment, both monetary and economic, isn't nearly as supportive as it would be in the early stages of the typical equity bull market.

Any illustration of your concerns?

Our thoughts immediately go to our causal factors, like monetary policy, profit growth, pent-up demand and so on. Since we've discussed those extensively before, we'll instead share a couple of examples that do not exactly lead one to jump up and down with excitement.

Goldman Sachs recently published a study that reveals that, since 2010, the only source of net-positive flows into stocks came from corporate buybacks. That includes the repatriation of some of those profits held abroad that the administration was hoping would instead go into new capital investment. It wasn't meant to be. This means that all other investors combined had a net near-zero investment in stocks – including pensions, households, mutual funds, insurers and foreign investors.

Lastly, we're seeing many leveraged-up, private companies come to market to perhaps unwarranted enthusiasm. Around 80% of new IPOs have net losses, yet many have been very well received by investors, at least on the first day.

So we don't buy in entirely to the recent strength. While we continue to participate in stock price gains and incur material risk – say, around two-thirds of normal – we're keeping some chips ready for when expected returns from stocks are nearer or higher than those of lower-risk alternatives. The year is yet young.

Fixed Income Portfolios

The Fed: A Dramatic U-Turn But Still Data-Dependent

Executive Summary

In the closing quarters of 2018, the healthy global economic picture started to waver. Deleveraging and the trade war caused weakness in China, the strong dollar triggered turmoil in other EM countries, the European economy suddenly deteriorated, and even the U.S. economy began to show some signs of trouble. In response, the Fed suddenly shifted to a "dovish" stance by halting its interest rate increases and announcing an end to the planned reduction of its balance sheet (QT) later this year. Some investors feel that the Fed's U-turn was influenced by political pressure from the White House. While it is a concerning narrative, we believe the Fed is still "data-dependent", and that it feels current rates are near an appropriate "neutral" level.

As the Federal Reserve changed its view, we heard talk of the "neutral" rate. What's that?

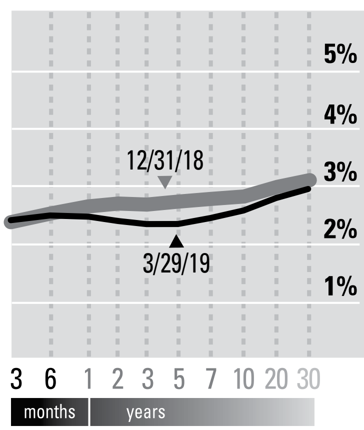
The "neutral" rate of interest (NRI) is the "goldilocks" policy rate that the Fed thinks is neither too high (resulting in a slowing economy) nor too low (pushing inflation out of control). In recent years, the Fed's estimate of NRI has been decreasing. At the current Fed fund range of 2.25~2.5%, the policy rate is thought to now be near the lower end of its NRI estimate. In light of last year's mounting global macroeconomic risks, we can understand why the Fed would hit the "pause" button on raising rates.

So there is no guarantee the Fed is done hiking rates then?

Correct. As we mentioned, the pause was a response to global weakness rather than the policy rate being above (or at the high end of) the Fed's NRI estimate. Should the U.S. and world economies start to reheat again and re-trigger inflation concerns, the Fed could very well change its tune. We believe the world economy is not heading into imminent recession; hence the market expectation that the Fed might cut rates later in the year may not come true. For instance, the continuing hike in oil prices may lead to higher inflation, pressuring rates upwards. Also, if trade war rhetoric subsides, or China's stimulus efforts were to come to fruition, and/or Brexit were to avoid the cliff's edge, the world economy could start to stabilize. In our view, the strong rally of bond markets since the beginning of this year is not likely to repeat in the next few quarters.

Treasury Yield Curve

Yield to maturity of current bills, notes and bonds.



I gather Hamilton Capital still likes short-duration investments?

Yes. Duration risk is still a significant concern as we focus on protecting capital, particularly so as the flattening of the yield curve bolsters our preference to invest in short bonds, reducing the incentive to invest in longer-term bonds, as short-term bonds pay roughly the same with materially less risk.

Additionally, credit quality also weighs heavily on our investment selection. This is especially true in the arena of corporate debt. In recent years, non-financial corporate debt has ballooned to record levels as a share of U.S. GDP, above the peaks of both 2001 (dotcom bubble) and 2008 (financial crisis). In a recent speech, former Fed Chair Janet Yellen also issued caution regarding the "high levels of corporate leverage" and the potential for "lots of bankruptcies." Though we don't feel that a rush to the exits is warranted, we do feel it appropriate to carefully calibrate our fixed-income risk.

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:

May 29
Lunch, Scioto Country Club

July 18
Lunch, Scioto Country Club

August 28
Lunch, Scioto Country Club

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

In Other Words

"The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them."

— Peter Lynch,
Legendary Mutual Fund Manager

"Defense (is) still the best offense in the bond market."

— PIMCO Investment Committee

Economic Outlook (Continued)

Meanwhile China was working to slow down (even reverse) its previous sharp increase in debt. This meant taking several "tightening" steps that were slowing its growth. And China is plenty large enough to impact global demand.

So far we see the cause and effect. What happened as the year reached the fourth quarter?

With China increasingly tightening, we observed a moderation in its economic pace and slowing demand for other countries' exports. Meanwhile, trade conflicts between the U.S. and China (and other counterparties) were also impacting growth. Commodity prices, especially oil, suddenly fell sharply in the fourth quarter. That drove inflation from over 2% down to a run rate of near 1.1% – suddenly well below the Fed's target – and threatened earnings in some sectors of the economy.

So the Fed, faced with a new environment, changed its bias as well. Rather than stubbornly sticking to its previous plan to raise rates several more times this year, it decided to hit the "pause" button. And this moderation in central bank policy wasn't isolated to the U.S. The Chinese and European central banks also took a more supportive position, keeping or driving rates in emerging nations and Europe back to low levels, which tends to support growth. Eventually.

That makes the logic behind the Fed's policy pretty clear. How about growth? Can you close the loop from fast to slowing to…what now?

In this rapidly changing and yo-yoing script, we're now in yet another act.

Fed voting members have now shifted to "on hold." They haven't actually changed interest rates for several months. They feel that, for now, rates are exactly where they should be and they're reserving judgment on next steps. Although they haven't touched "administered rates" (the short-term rates the Fed uses to implement policy), investors, on the other hand, have changed longer-term rates – buying bonds and driving yields lower. This has resulted in sharply lower mortgage rates, which are boosting lending (which was previously ailing) and helping affordability. This could bump up growth in housing somewhat relative to what it would have been otherwise.

Besides the Fed, what other factors are you viewing as particularly relevant?

One is China's public policy, which has continued to evolve. Whereas, say, six or nine months ago they were primarily focused on halting growth in debt throughout their economy, they now have shifted their bias. They have gradually increased the rheostat toward sustaining growth and employment, while devoting some but lesser energy to reducing leverage. A more balanced and nuanced approach.

We understand that because the economic reality is complicated, so is the explanation. But in simple terms, what does it all add up to?

Simply put, the U.S. is still "suffering" from the weakening impact of temporary factors that accelerated demand last year. Manufacturing has slowed, and so has the U.S. consumer. At the same time, that's partially offset by lower interest rates, which should help housing. Finally, China is placing greater emphasis on stabilizing growth.

None of these factors is overwhelmingly strong. Not yet. But we're also closely monitoring the price of commodities – oil especially. Though demand growth remains tepid, voluntary reductions in supply from OPEC and Russia, and problems in Venezuela, Libya and Iran (linked to U.S. sanctions), have led to crude price increases of nearly 25% in just a few months. This could help earnings briefly, but may also cause a surprise with inflation.

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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.