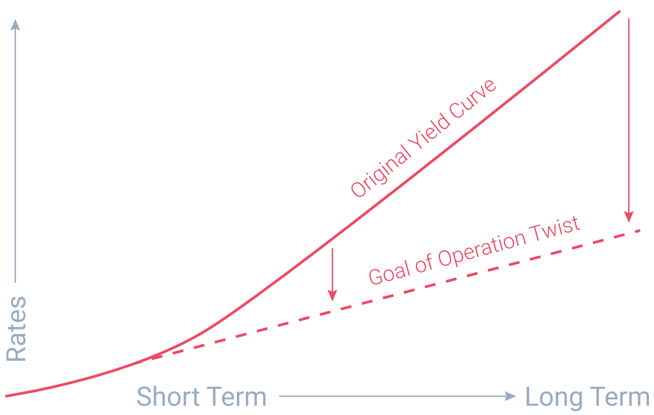
Good News, Bad News, and Some Twists Along the Way

In September of 2011, the Federal Reserve, still fighting the effects of the financial crisis, wanted to stimulate the economy. In order to encourage economic expansion, the Fed usually lowers short term rates (i.e. the discount rate), but by then short term rates had already hit the zero-bound interest rate. Constrained by short-term rates already at zero, the Fed instead focused on lowering the long-term rate by implementing a policy known as Operation Twist.

Operation Twist was the Fed's effort to lower long-term interest rates by buying long-dated bonds. With short-term rates pegged at zero, the Fed believed it could 'twist' the yield curve in the desired direction by buying enough long term bonds to impact their price. (Bond prices fluctuate through supply and demand. Because price moves inversely to yield, lower yields can be implemented through bond purchases.)

Fed's Desired Effect on the Yield Curve



Few market observers realized that Operation Twist was a reboot of a nearly sixty-year old Federal Reserve policy initiative. (Hence why it wasn't called Operation Twist II.) Fewer still realize the original policy's claim to fame: It was the first (and so far only) time a monetary policy action was named after a dance craze.

The original policy is still considered a benchmark to more recent Federal Reserve initiatives. In fact, in order to write the history of the Fed's large-scale asset purchase program (also known as "quantitative easing"), the precedent setting 1961 Operation Twist would be the first chapter.

Policy actions come and return, sometimes without even changing their name. Market cycles too come and return. As this cycle ages, economic data remains robust. But good news is now accompanied by a reminder that recessions are a natural part of the market cycle and that this bull market too shall pass.

With rates rising, equities at high multiples, and global markets starting to recede, it is not too soon for investors to position for the inevitable, unpredictable cycle shift.

KEY MARKET UPDATES

- **The US Economy: Still Strong After All These Years.** Economic growth continues at a healthy rate, tax cut capital spending is up, inflation seems contained, and employment prospects are plentiful.
- **The US Equity Market Remains Strong While Global Markets Stumble.** The US bull market is the second longest on record, though H1 gains lacked breadth. Volatility remains elevated. Worldwide stock market capitalization tumbled in H1.
- **Fixed Income Credit Markets Were Off to a Choppy Start.** Fixed income spreads remain tight. US bonds are relatively high yielding. Both investment grade (IG) and high yield bonds (HY) had H1 losses. The rising tide of higher rates lifted the floating rate loan market to positive performance.
- **Central Banks Move Toward Normalization and Prepare for the Next Recession.** The Fed continues to raise rates as expected and slowly reduce its balance sheet. The ECB works towards normalization, but is not expected to raise rates until 2019. The yield curve is now close to inverting, hinting at future economic slowdown.
- **Geopolitical Strain and Trade Tensions Create Additional Uncertainty.** Political turmoil in Europe and trade disputes were prevalent in financial market headlines, but the markets mostly shrugged off the news. So far, the risks appear hypothetical.

THE US ECONOMY: STILL STRONG AFTER ALL THESE YEARS

GDP continues to grow at a healthy rate, with 2.9% growth forecasted for 2018. Consensus expectations are for GDP to be slightly lower in 2019 and decline to 1.8% in 2020.

Steady economic momentum from December's tax cuts continues, although that impetus will dissipate as tax cut-driven spending is fully pulled forward. Record deficits make a further fiscal boost unlikely in the short-term.

Booming Job Market Continues — Companies Seek Quitters, Movers and Teenagers

A continued economic silver spot is the robust job market. Spurred on by economic growth, the jobless rate recently hit a 17-year low, while July jobless claims hit their lowest level since 1969.

One result is that there are more "quitters" than ever. Confidence in finding a new job is so high that Americans are quitting jobs they don't like without having other employment lined up. The "voluntarily unemployed" currently account for a larger percentage of the Total Jobless than at any other time in the past 17 years.

Shortages of workers have forced states to implement creative solutions. In a modern version of the Homestead Act, states are offering a variety of incentives to attract employees. Vermont went from offering perks ranging from free ski passes to year's supply of cheese *(seriously!)* to cash — $10,000 awaits workers willing to relocate. Besides cash, states have started offering student loan assistance and housing just for moving in.

Furthermore, companies are more frequently looking outside their usual age range when hiring. With a lack of available adults, teenagers are now being sought to ease the tight labor market.

Teen employment used to be common. It declined from 50% in the 1980s to roughly 25% in 2010. That trend is now reversing. Driving the decline was an increased emphasis on higher education, which required more enriching activities to add to applications than typical teen jobs.

A recent article in the Wall Street Journal noted that teen employment of 16 through 19 year olds has increased for the first time in nearly thirty years. Moreover, the amount of teens working in health services and in computer/data processing has doubled over the last twenty years.

Real Wages Remain Flat

Employees are in demand. Yet there is a dark lining to the silver cloud—there has not been a material increase in real wages in over ten years. Wages may increase, but workers are no better off if that increase doesn't outpace inflation.

The contradiction between a tight job market and unchanged wages has no single cause. Productivity isn't growing. Technology has increased worker fungibility. Expensive workers make automation seem more attractive. These trends, combined with off-shoring, act as a systemic governor on real wage growth.

Inflation: No Cause for Concern Yet

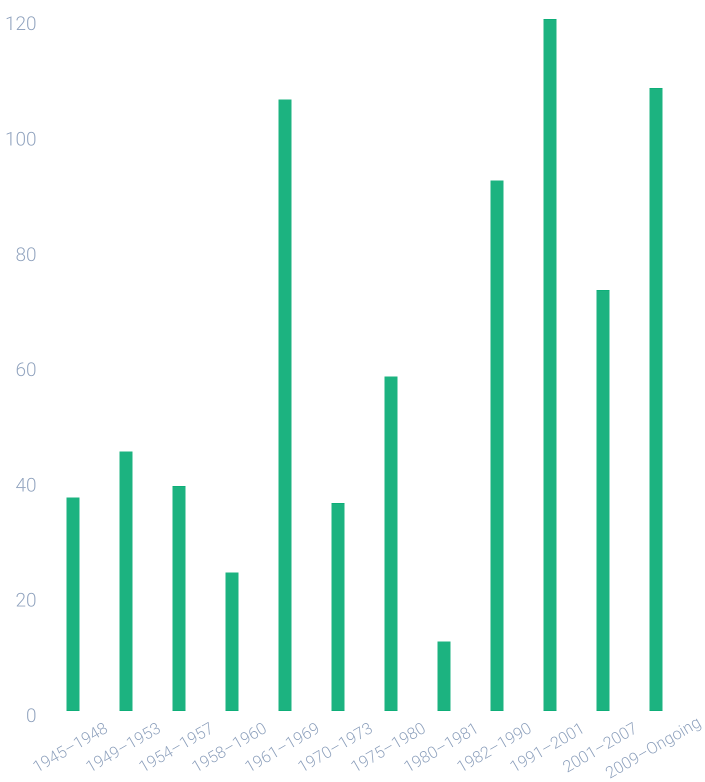
Signs of inflation have made frequent appearances, with increased prices unable to gain traction. Price increases remain a watered-down version of the real thing, like an inflation-flavored LaCroix.

Core PCE, the Fed's preferred measure of inflation, hit 2% year-over-year (YoY) in May. This was the first time the 2% target has been reached in six years and was an increase of 0.2% from April. However, this level of inflation is not expected to impact the Fed's planned rate increases.

THE US EQUITY MARKET REMAINS STRONG WHILE GLOBAL MARKETS STUMBLE

Now nearly a decade after emerging from the 2008 financial crisis, we are now in what may be the tail-end of the second longest bull market in post-WWII history.

U.S. Periods of Economic Expansion by Months of Duration



Data Source: List of Economic Expansions in the United States, Wikipedia, July 2018

Since the start of the bull market in March of 2009 the S&P 500 has gained 240%. That increase is a hard act to follow, but through H1 the S&P 500 has continued to show impressive earnings and revenue growth.

With growing earnings and relatively stable prices, valuation ratios have backed off from their 15-year highs from earlier this year. The continuation of this trend would result in an ideal soft landing for the equity market. If earnings rise as stock prices stabilize, ratios will gradually normalize to longer term averages.

Equity Market Up, But Lacks Breadth

Stock market increases are strongest when they are broadest. In H1 most of the S&P 500's gains were concentrated in just five technology stocks, according to recent bank research. The so-called **FAANG** stocks **(Facebook, Apple, Amazon, Netflix,** and **Google)** accounted for 3.4% of the S&P 500's 2.7% return. Without the **FAANG** stocks, the S&P's returns would have been negative, at -0.7%. However, following the end of the quarter, technology stocks experienced material declines, with Facebook experiencing the largest one-day loss in market capitalization of any company in US history.

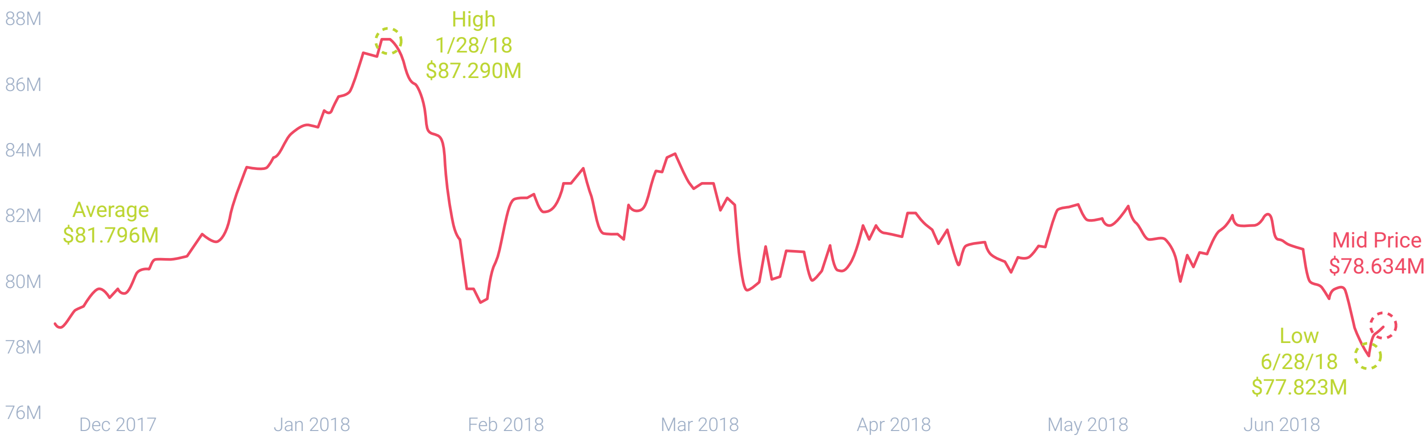
Volatility Remains Elevated

Volatility remained high in Q2. Since its record spike in February, the VIX has been in line with pre-crisis historical averages. The low volatility regime from the past few years has now transitioned into a higher volatility state. Through H1 2018, the VIX has averaged 16.5, a 40% increase over the same period last year.

Global Equity Markets Suffered in H1

Outside the US, worldwide equity markets may have already crested. The biggest drop of H1 2018 was not *Scorpion,* it was the world stock market capitalization, which has declined $10 trillion dollars from its January peak — losing the equivalent of the combined GDPs of Japan, Germany, and the UK.

World Exchange Market Cap (USD)



Data Source: Bloomberg H1 2018

FIXED INCOME CREDIT MARKETS WERE OFF TO A CHOPPY START

The credit markets have seen two unique occurrences the first half of the year.

The first is that investors can earn more by holding US debt than the debt of any other G10 country — an unusual case of the world's least risky asset earning outsized returns. Investors earn 2.9% by holding US 10-year bonds, while the German 10-year bond, for example, yields just 0.4%. This favorable spread differential exists throughout Europe.

The second unique credit markets occurrence was Investment Grade's (IG) under performance against High Yield. IG turned in a second consecutive quarter of losses for the first time since 2008 due to a combination of rising rates and foreign investors withdrawing from the market.

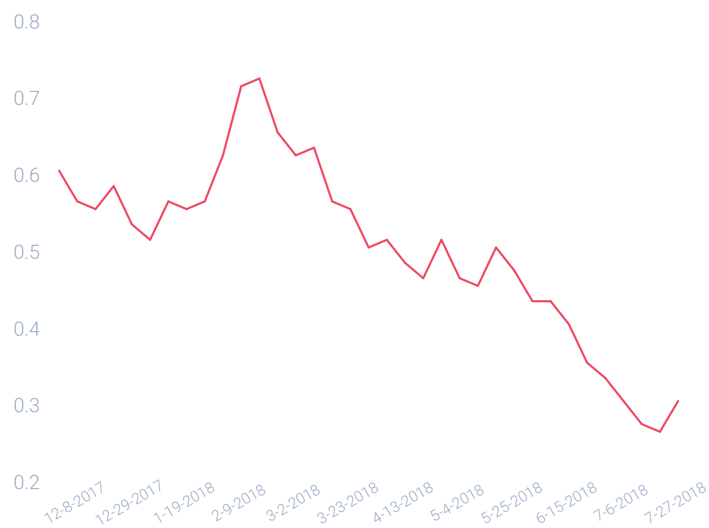
High Yield values have kept up better not only due to their shorter duration, but also because they are typically issued by companies with less international exposure, providing insulation from tariffs. Floating rate securities have outperformed IG and High Yield through H1.

CENTRAL BANKS MOVE TOWARD NORMALIZATION AND PREPARE FOR THE NEXT RECESSION

The Federal Reserve is expected to raise rates twice more this year and the ECB will stand pat until 2019. Central banks are no longer focused on stimulating the economy; instead, they are trying to reload for the next recession. But that could come before the Fed is ready.

In an effort to raise rates, the Fed is now close to inverting the yield curve (when short-rates are higher than long-term rates), which typically signals an imminent recession. The spread between 10- and 2-year Treasuries has narrowed over the last year from .92% to under .25% — its tightest spread in eleven years. The Fed wants to raise rates to insure against inflation, but not so high as to stifle growth — this is the knife edge of the neutral rate.

10-Year Minus 2-Year Treasury Spread



Data Source: Federal Reserve Bank of St. Louis

The Fed has already begun messaging that, perhaps, the 2-10 year spread isn't as important as everyone thinks. In June, staff economists presented a paper showing that a more reliable indicator of an imminent recession is the spread between three-month and eighteen-month Treasuries. And by that measure the US is not yet close to a recession.

GEOPOLITICAL STRAIN AND TRADE TENSIONS CREATE ADDITIONAL UNCERTAINTY

"Most of the time when markets move, no one has any idea why. A man who can tell a good story can make a good living as a broker. It was the job of people like me to make up reasons, to spin a plausible yarn. And it's amazing what people will believe. Heavy selling out of the Middle East was an old standby."

– Liar's Poker, Michael Lewis

Mr. Lewis would no doubt appreciate the attribution of otherwise inexplicable market moves to the modern standby of "geopolitical uncertainty". It might be true and it can't be falsified. But there is real market risk from the tariff tit-for-tats that have dominated financial headlines. Further, political turmoil in Spain and Italy show that the clashes between populism and globalism are still far from resolved. Populism and protectionism seem to go hand in hand and 2018 has seen an increase in both.

A Tariff for Tariff Makes the Worlds GDP Decline

Trade issues have dominated Q2 financial news. During H1, as the US proposed tariffs, trading partners responded with hard rhetoric and retaliatory sanctions. At the height of the dispute the fight had encompassed Canada, China, the EU, Japan, Mexico, and Russia.

Fortunately for the economy, trade compromises are being reached with most US trading partners. The direct damage seems contained, although the rapid expansion of tariffs to encompass thousands of items showed how quickly a tariff skirmish could escalate into a trade war.

FINAL THOUGHTS

Markets have their own crazes, cycles, and sequels; with the past and future rhyming and repeating; the stages are inevitable; the timing unpredictable. First recovery, and then expansion — when that fails, leverage, default, downturn, write-offs, and recession at last. Financial market history, with all its volumes vast, has only one page.*

Inevitability is not certainty. Timing market turns is still more alchemy than science. As the market maintains strength an investor can, without emotionally clouded judgment induced by losses, address difficult scenarios that, for now, remain hypothetical. What happens when GDP declines? Am I sufficiently diversified? How will my holdings react to higher interest rates? Do my holdings provide insulation from asset correlation and increased volatility?

The best time to dig a well is before you're thirsty; the best time to prepare for a downturn is before we are in one. When the market twists, will you be ready?

*Not exactly what Byron said, but what he meant.