EAST COAST
ASSET MANAGEMENT

Q3 2018 Investment Review

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“A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines.”

Ralph Waldo Emerson: *Essays: First Series, Self-Reliance* (1841)

Sleepy summertime US interest rate markets were snapped to life this quarter as the entire yield curve – from shorter-term money market rates to 30-year long-term government bonds - rose in yield. The impetus for this was not so much expectations for higher inflation in the near-term but rather the accumulation of incremental increases by the Federal Reserve of the fed funds rate. On September 27th, that rate was lifted to a range between 2% and 2.25% - the third change this year. In his prepared remarks announcing the move, Fed Chairman Jay Powell said; “Our economy is strong. Growth is running at a healthy clip, unemployment is low, the number of people working is steadily rising, and wages are up."

Powell’s comments summarize several key factors that have contributed to buoyant US stock prices. The S&P 500 closed the quarter having steadily increased to a +7.7% total return; there were only three down weeks for the period. The world’s developed markets also kept a positive bias with the MSCI All Country World Index advancing +4.3% and the MSCI EAFE rising +1.4%.

Benchmark Index Returns

	S&P 500	MSCI All Country World	MSCI Emerging Markets	MSCI EAFE	Bloomberg-Barclays Aggregate Bond	Gold $/Troy Oz.	Crude Oil $/bbl.
Q3 2018	**7.7%**	**4.3%**	**-1.1%**	**1.4%**	**0.0%**	**-4.8%**	**-1.2%**
Q2 2018	3.4%	0.5%	-8.0%	-1.2%	-0.2%	-5.4%	14.2%
Q1 2018	-0.8%	-1.0%	1.4%	-1.5%	-1.5%	1.3%	7.5%
Q4 2017	6.6%	5.7%	7.4%	4.2%	0.4%	1.9%	16.9%
1 Year	**17.9%**	**9.8%**	**-0.8%**	**2.7%**	**-1.2%**	**-7.0%**	**41.8%**

With mid to longer-term interest rates on the rise, the benchmark Bloomberg-Barclays bond index ended the quarter exactly where it began and posted a 0% total return (which implies a negative price result because of the income that naturally accrues from the underlying securities). Stock market volatility dropped and inflation appeared to be of no serious concern, two possible reasons why gold declined for the quarter by -4.8%. West Texas Intermediate oil fell -1.2%, arresting the three previous quarterly increases that led to a +41.8% rise since this time last year. The US dollar index (which is more than 57% weighted to the euro) rose slightly (+0.5%).

There have now been eight fed funds rate increases of 0.25% since December of 2015, so the Fed is seen by investors to be in a tightening mode – with an end point still to be determined. The widely followed 10-year US Treasury yield was 2.85% at the end of June and finished September at 3.05%. It was 2.33% this time last year. The link between the rate controlled by the Fed and the 10-year treasury is not direct, but we believe that the investment community has been correctly seeing the past increases as necessary moves to get the interest rate spectrum back to one that is normal from a historical perspective. Our observation is that a rate for ten-year bonds in the range of 3% to 3.5% is still very low, historically.

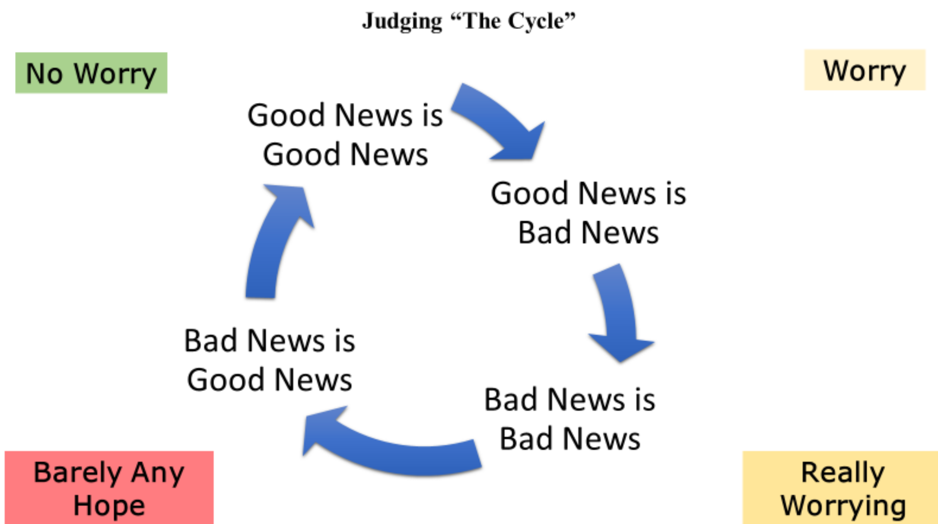
Because longer-term bonds typically offer more yield than shorter-term bonds (thus the yield curve is positively sloped), it makes sense that the rest of the yield curve would push somewhat higher as the fed funds rate rises. The key element of this analysis for investors, though, is how high those longer-term rates will eventually go. Mortgage rates, other borrowing rates, and even various insurance liabilities are tied to those further out points on the curve, so businesses of all kinds are sensitive to their fluctuations. We believe calculating the level at which these rates would eventually represent serious headwinds for overall US economic activity is not a mathematical exercise that can be solved with precision. We see the whole economy as too complex a system for that task, but for individuals and specific companies this study is beginning to take place. A critical component of the analysis is how much income the company, or family, or country will generate and how much that amount will grow in the future. If income to support principal and interest payments is durable, sustainable, and growing, the anxiety around expected interest rate increases can be managed. Revenue growth is important and when it comes to the economy as a whole, the most important underlying factor for growth is employment.

We have written before that most market dislocations occur, from our understanding of history, when surprises or otherwise unexpected changes occur to fundamental investment factors. Unexpected breakouts in inflation (commodity shocks), spikes in interest rates, sudden deteriorations in revenues, profit margins, or operating earnings – these are the traditional feedstock for stock market turbulence. At times, these surprises have led to persistent declines and formed the basis for bear markets. The point is that in these instances collective investor behavior was forced to shift from one point of view to another – one of optimism to that of pessimism. Investors that have been unable or unwilling to incorporate variant opinions into their analysis are particularly vulnerable to these dislocations. We do not believe that the current level of interest rates poses a near-term threat to either the economy or most corporations, but we acknowledge that interest rates as a fundamental investment factor are critical to monitor and evaluate.

There have been many investors speculating about how long the current growth phase of the economic cycle will last and then attempting to connect that cycle to the stock market cycle as a way to anticipate a market downturn. We see that all things in nature bend toward cyclicality and since the investment world is heavily influenced by human behavior, cyclicality is present in the markets. The markets don't conform to the drumbeat of a calendar, however; fall doesn't follow summer in the financial world with the same precision that it does in nature. It is worth noting that Australia is now into its *twenty-seventh* year of unbroken economic growth. Investors' perceptions of data tend to herd – meaning that the same

data can be interpreted differently by various analysts - but in total a consensus opinion ultimately prevails. Identifying the turning points in that consensus, in our opinion, is truly an art rather than a science. It was the second century Greek philosopher Epictetus who said: **"It isn't events themselves that disturb people, but only their judgments about them." (*The Enchiridion*, *Chapter 5*).**

As we consider cycles, both economic and stock market, we find a helpful construct is to compare financial news (data) and how it is perceived by investors and expressed in asset prices (collective judgment). Consider that when the truck is skidding into the ditch, it is a time when **'bad news is bad news'** for asset prices. The bad news can be about high unemployment, company bankruptcies, inflation surprises, horrible GDP results, etc. These items of bad news are taken badly by the markets and asset prices go down. That represents the downward-to-bottom arc of the "cycle."



It is just past this point, when the economic signals are demonstrably weak and stock prices are falling that the three traditional macroeconomic levers begin to be pulled for stimulus; monetary policy (the Federal Reserve begins to cut interest rates), fiscal policy (the government enacts spending programs and/or tax cuts for stimulus), and regulatory policy (the government rolls back restrictive policies or passes new laws designed to stimulate business). At this phase, bad economic news changes and is perceived to be good – in that as long as the news is bad, more stimulus will be applied. Here, **'bad news is good news.'** Asset prices begin a slow rise (or at least a stabilization) as investors sense there is support in the air instead of headwinds.

This represents the upward turning arc of the cycle and is a hopeful phase, but not one of broad support. Skepticism is still the prevailing attitude. After a while in this mode, confidence begins to take hold and news starts to have a positive tone. Now, **'good news is good news.'** Asset prices start to solidly respond to the positive news resulting from stimulative actions and the arc reaches the apex. Investors are filled with self-confidence and enthusiasm for investments is strong.

Finally, the Federal Reserve moves to its historic party pooper role and increases interest rates in order to stem inflationary impulses and slow economic growth. Now, **'good news is bad news'** because as the economy continues heating, market participants sense the macroeconomic wave will come crashing down to slow things; from monetary, to fiscal, to regulatory. This stage is past the peak of the cycle and on the downward slope toward bad news…and the cycle completes.

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As we enter this last quarter of 2018, we remind ourselves that trying to apply only one process or one form of analysis to an ever-evolving, natural phenomenon like the financial markets is unlikely to bring durable, sustainably satisfying results. We prefer to emphasize the wisdom in multidisciplinary thinking – applying what we believe are the best qualities of decision-making structures from several fields of study and applying them with patience to the task of prudent investment allocation. In this way, we believe our judgment is enhanced, based on solid foundations and not rigid like the repetitive calls from market participants trying to attract attention with daily divinations. We don't believe we have the probabilities on our side when we are asked to evaluate exactly where we are in the investment cycle, or even what the markets will do before year-end. However, we believe that the probabilities are high that we are able to identify the most important qualities that make up durable and sustainable securities for your portfolio. We continue to find such opportunities in the global stock markets, but we continue to find fewer and fewer in the fixed income world.

Global economic reports, US mid-term elections, and news about the holiday shopping season will soon dominate investors' attention and we are prepared with patience, open minds, and a flexible approach to determining quality and value. We remain hopeful for the months and year ahead, supported by the weight of the evidence.

We very much appreciate your continued support and hope you are looking forward to the holiday season.

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