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ASSET MANAGEMENT

Q4 2018 Investment Review

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"The problem with conjecture is the impossibility of having certainty with action and inaction."
Historian Niall Ferguson credit to Henry Kissinger's *Diplomacy* (1994)

Having reached a high for the year of +11.2% at the end of the third quarter (on September 20th), the S&P 500 slid a nerve-racking -19.8% to a trough on Christmas Eve. After staging a post-Christmas rally, the decline for the fourth quarter was -13.5%. For the first time since 2008, the S&P 500 index registered a negative annual total return; falling -4.4% for 2018. The S&P 500 had quite a bit of company in this adverse price environment. The Russell 2000 index, a widely followed measure of small company stocks, dropped even more; -20.2% for the quarter and -11.0% for the year. International markets fared poorly as well, especially on an annual basis. The MSCI EAFE index sank -12.5% for the quarter and -13.8% for 2018 and the MSCI Emerging Markets index lost -7.5% for the quarter and -14.6% for the year.

True to their reputation as havens in a storm, gold and US government bonds gained during these thirteen weeks. Gold rose by +7.3%, the broad-based Bloomberg Barclays Aggregate Bond index increased +1.6%, and the Bloomberg Barclays index for US government bonds advanced +2.6%. For the full year, these assets recorded an uninspiring -2.1%, 0.0%, and +0.9%, respectively. The 10-year US Treasury bond began the year offering a 2.4% yield and ended at 2.7%. Crude oil (West Texas Intermediate) fell a whopping -38.0% for the quarter and -24.8% for the year (ending at $45.41 per barrel) and the US dollar gained +1.1% for the quarter and +4.4% for 2018.

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.
Q4 2018	**-13.5%**	**-12.8%**	**-7.5%**	**-12.5%**	**1.6%**	**7.3%**	**-38.0%**
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%
1 Year	**-4.4%**	**-9.4%**	**-14.6%**	**-13.8%**	**0.0%**	**-2.1%**	**-24.8%**

Leading the list of concerns that stoked the global sell-off in stocks appeared to be: trade tensions between the US and China, the Federal Reserve's determination to increase short-term interest rates, the uncertainty surrounding Brexit, an inversion in the yield curve of US treasury rates between the two-year and five-year notes, and, starting December 22nd, a partial government shutdown.

Each of these issues tie back to the stock market via the heightened probability for a US recession and ensuing bear market. Trade tensions and threatened future tariffs have contributed to an economic softening in China. A weak Chinese economy hurts US and European exporters and may diminish US economic prospects. The Federal Reserve's history of tightening cycles (we are in the 15th such cycle since World War II) looms large in the study of recessions. In the eleven recessions since 1945, the Fed's tightening process has contributed to nine. Though not the only reason for the current erosion of European economic growth, Brexit is certainly a major factor. Like Chinese weakness, European weakness can diminish US growth. Yield curve inversions have typically, but not always, preceded recessions. Finally, a prolonged government shutdown is very likely to damage US consumer confidence and the economy is heavily reliant on the consumer's willingness to spend money. A meaningful diminution of consumer spending would be a serious threat to the economy.

We have been careful observers of Fed policy and their recent tightening actions because of the central role their strategy plays in the determination of short and intermediate term interest rates. Ultimately, as we have written in the past, this is because interest rates act on asset values like the force of gravity acts on the earth; higher rates mean more downward pressure on values. After considerable debate in the financial press, and emotional offerings of opinion from bankers, investment managers, and even from President Trump, the Fed elected to raise the benchmark fed funds rate to a range between 2.25% and 2.5% on December 19th, the ninth increase of 0.25% in this cycle. In his prepared remarks following the hike, Chairman Powell used words like "strong," "robust," and "healthy" to describe the US economy and noted subdued inflation and an unemployment rate that is likely to continue moving downward. The Fed's strategy has been to steadily increase rates in a measured, incremental way and to begin withdrawing from the Quantitative Easing ("QE") that has been the primary tool of alleviating interest rate pressure in these years after the Great Recession. At least a part of the decline in stock prices this quarter was due to the fear that rising rates will damage the growth prospects for stocks in the near future. The payoff of the Fed's policy was not immediately positive for investors.

Wikipedia says of conjecture: "in mathematics, a conjecture is a conclusion or proposition based on incomplete information, for which no proof has been found." A theorem, on the other hand, is a conjecture (proposition) that has been proven to be true. The experts at the Fed may believe that raising interest rates will help maintain a steady course toward price stability and full employment within our economy, but it cannot be proven absolutely at the outset. In this way, the Fed is operating in what Kissinger characterized as an impossible bind. To do nothing may be ok, to raise rates may be ok. We will only know for certain, much later, when each policy implementation can be observed and analyzed. This means that the policy maker, like a diplomat or an investor, cannot know *with certainty* which available strategy will prove to be correct. Certainty is an idyllic mental condition that very rarely exists.

Solving a problem (e.g. maximizing profits or protecting principal value) using a mathematical process seeks a "correct" answer. The field of game theory in mathematics came about, in part, to find provably optimal decisions for a participant (or multiple participants) in a contest. Higher levels of

game theory address ideal strategies for multiplayer games where uncertainty is present. Well, uncertainty is present in the financial markets and the number of participants – all with varying, often conflicting motivations – is effectively uncountable. We do not profess to be experts in game theory, or even to devote ourselves to its use in decision making, but we do consider our process to be one that highlights probabilistic thinking. The strategy in question (buying, selling, or holding) and the payoffs expected (Internal Rate of Returns for a base case and outlier scenarios) are regularly deliberated in our investment process. This debate allows us the opportunity to test our hypotheses and easily work new data into our assessments.

Perhaps the most important factor in the investment decision-making process is time. If time is limited, deliberating over an optimal strategy can be a whole lot more complicated (and error-prone) than an analytical process that uses longer time frames. With investments, some participants are very concerned with time (the end of the calendar year, for example) and others are less concerned, instead preferring to play the "long game." Add to this the estimate that during volatile days as much as 80% of stock trades are directed by machines, or what are known as algorithmic traders ("algos"), and what you have is a brew of activity. Buying and selling is then based on news that often has not been fully analyzed. Our suspicion is that the fourth quarter generally, and December in particular, witnessed time-delineated traders making decisions based on limited information in markets that didn't have enough depth to possibly balance the selling with buying.

"Do the right thing. It will gratify some people and astonish the rest."
Mark Twain

Kissinger described conjecture as a tragic aspect of policy-making, often requiring action based on a calculation that cannot be proved true at the outset. Uncertainty about the path the Federal Reserve would take at their December meeting and then on into 2019 was a critical component of many decision-makers during the fourth quarter. We suspect that some wrong decisions were made during those weeks by some investors where the unfortunate outcome may have been the permanent loss of capital. Our preference is to attempt to resolve complexity and simplify issues that are uncertain so that a proper assessment can be made. In this way we believe that we may harness the aspect of time to arrive at the right decision. Time for us is not an alibi for inaction, it is the basis upon which we believe we are doing the right thing – choosing the correct strategy. The proof of our patience, however, can only be known in the fullness of time.

Beginning in 1950 and ending in 2018, the S&P 500 gained 66% of the 276 quarters and 72% of the 69 years. Using probabilistic thinking, we believe that entering into a contest where there is a satisfactory outcome 72% of the time is a good choice. This statistic weighs heavily in the favor of investors who keep time on their side. While the inevitable price declines in the stock market can be emotionally agonizing, we are focused on the fundamental nature of the investment environment to make our decisions. So far, the weeks since Christmas have been a period of welcomed recovery, even though concerns remain squarely in the spotlight.

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With the prospects for continued annualized earnings growth (albeit at rates that are lower than 2018), moderate interest rates held that way by subdued inflationary expectations, and earnings multiples for stocks lowered by the price declines in this past quarter, the year ahead appears to us to have many of the positive fundamental qualities that favor investors. Thorny geopolitical risks, the pressures on municipal and federal budgets posed by historically high debt loads, and the economic calendar that reminds us that we have entered the tenth year of expansion keep us guarded, but optimistic. In our opinion, long-term opportunities in the fixed income markets continue to be difficult to uncover, while setting our sights on the short- to near-term securities has been more appealing. Finding what we believe to be attractive values in equity investments – those that we deem to be of high quality - has gotten easier as we enter 2019.

All of us at East Coast wish you and your families good health and happiness in this New Year and we very much appreciate your trust.

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