

Investment Commentary March 31, 2019

The More Things Change . . .

As I reviewed some of my investment commentaries from several years ago I was struck by some eerie similarities to today's markets, particularly back in 2013 while Ben Bernanke was still Fed Chairman. As I am sure you know "Helicopter" Ben Bernanke was the originator of the Quantitative Easing policies of the Fed in response to the financial crisis of 2007-2008. Bernanke's objective was to flood the market with liquidity, driving interest rates to zero, in an effort to boost the stock market. The theory was that wealth created by higher stock prices would encourage spending and spur economic growth. When the economy reached a self-sustaining growth rate the process could be reversed and everything would be fine.

By 2013 Bernanke and the Fed were five plus years into the process. The stock market was moving higher, well above the financial panic lows, and economic growth had improved. I wrote at the time that "Ben Bernanke signaled the intent of the Federal Reserve to begin to 'taper' the Fed's purchase of \$85 billion per month of US Treasury and mortgage backed securities. It was a move that economists knew had to begin sometime. The Fed had already dramatically expanded its balance sheet, accumulated a significant portion of outstanding securities, and faced the possibility of shrinking supply due to a decline in originations." The initial reaction to Ben Bernanke's announcement was positive as investors believed the stronger economy could withstand the reduction in liquidity flows. The initial reaction did not last long, however, and declines in the stock and bond markets forced Bernanke to quickly reassure the markets that the accommodative policies of the Fed would remain in place. Over the next two years the Fed balance sheet would increase from \$2.9 trillion to \$4.5 trillion, a 55% increase.

Fast forward to today and note the similarities. When Jerome Powell became Fed Chairman in February 2018 the Fed balance sheet was \$4.4 trillion. The stock market was enjoying a 9-year bull market and the economy was reacting favorably to tax reform and reduced regulatory burden. Under Powell, the Fed gradually increased interest rates and began to reduce its balance sheet. The Fed signaled that the process would continue despite some slowing in economic growth. Stocks continued to move higher until the final three months of the year, when investor concern about this restrictive Fed policy in the midst of slowing global growth

and continuing trade wars triggered a sharp reversal. In those final months, stocks declined almost 20% and yields collapsed, with a sharp selloff in the final weeks of the year.

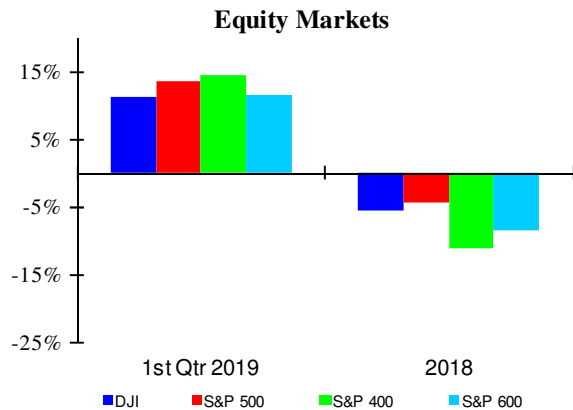
In a move similar to Bernanke's in 2013, Powell quickly reversed course. At their next meeting in January Powell announced that the Fed would be "patient" on future interest rate hikes. Powell also indicated that the Fed was finished raising interest rates this year and may be done with their monetary policy tightening campaign. Reaction in the markets was swift as both stocks and bonds rallied, pushing stocks close to their previous highs and pushing yields well below previous levels. The rebound was led by interest rate sensitive financial stocks and deeply cyclical stocks that were battered during the previous quarter.

The great policy experiment of Quantitative Easing can only be considered a success if the Fed is able to reduce its balance sheet to pre-crisis levels. As Ben Bernanke learned in 2013, and as Jerome Powell was reminded in 2018, the Fed needs to be very careful in any attempt to reverse the extensive monetary stimulus that has been supporting the markets. Similarly, investors need to learn that this over-reliance on Fed support adds another level of market risk which could be triggered by the slightest Fed policy error.

As investment managers we realize that we should not "fight the Fed", but at the same time recognize that we need to mitigate the risk of policy reversals. We cannot predict events beyond our control, but can only focus on the investment discipline that has guided us successfully through difficult markets in the past. We believe that company fundamentals matter and that an investment strategy built on that belief has the best opportunity for success over the long term. We will continue our search for companies that demonstrate the potential to grow revenue and earnings, have strong free cash flow, solid balance sheets, and invest in those companies whose shares are priced attractively relative to those fundamentals. We believe that this guiding principle remains valid regardless of how much things seem to be changing this time.

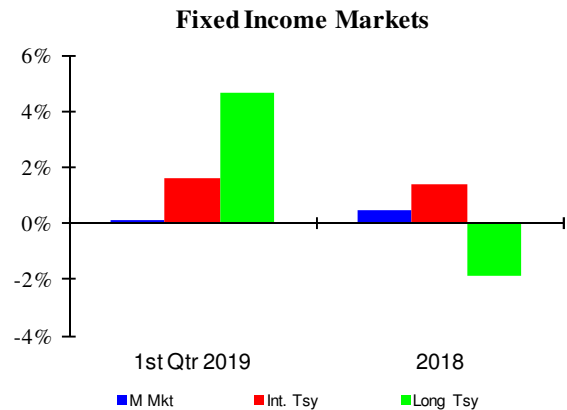
Sincerely,
Daniel A. Morris

Market Summary March 31, 2019



As 2019 began equity market investors surveyed the wreckage wrought by a sharp selloff in risk assets and a flight to quality to bonds during the month of December. Financial markets sent a very clear message to Federal Reserve policy makers that their intended path of continued gradual tightening, in the face of a deteriorating economic environment in Europe and Asia, risked making a difficult situation worse. The Fed got the message, and at their January meeting abruptly reversed course by removing guidance for further rate increases, and accelerating the end of their balance sheet shrinkage. Reassured by the apparent emergence of the “Powell Put”, equity investors drove market averages by quarter’s end close to their September 2018 levels.

The initial bounce from the bottom in January was led by oversold cyclical and small cap issues. As the rally persisted, leadership shifted back to mega cap technology names. Most indexes posted double digit returns with growth-oriented names handily outperforming value stocks.



Fixed income markets exited 2018 with parts of the yield curve slightly inverted, i.e. longer maturities in some cases had lower yields than shorter-dated paper. In effect, bond investors were betting that the Fed was unlikely to keep raising interest rates, and indeed was more likely to cut rates as the 2019 progressed. In very short order the Federal Reserve proved the bond market at least partly correct, by issuing new guidance in January that the Federal Funds Rate was likely to remain at current levels for the foreseeable future as policymakers evaluated incoming economic data. For much of the quarter interest rates traded in a narrow range as investors parsed each economic release for clues.

However, in the middle of March the European Central Bank, alarmed by a continued slide in economic data on the Continent, announced plans to resume their own version of Quantitative Easing. Markets reacted by sending yields even lower worldwide, indeed back into negative territory in Europe. By quarter’s end longer dated U.S. Treasury paper had significantly outperformed shorter-term instruments.