Morris Capital Advisors, LLC

Investment Commentary
June 30, 2019

The Fed "Franchise"

I must admit that it has been a long time since I went out to see a movie at a theater. I guess that is not surprising since I am clearly no longer in Hollywood's target demographic. The movie studios may not be getting much of my entertainment dollars, but they seem to be doing fine at the box office. The results are driven by a succession of action adventures based on superhero characters from our youth, or new characters that are derivations of those superheroes. Hollywood now refers to the films as "franchises" based on multiple installments of sequels or prequels, and they are immensely profitable until the storylines no longer entice movie goers.

The Fed has been acting as a market franchise for some time, and it has been immensely profitable for many in the financial industry. Since the "great recession" of 2008-9 the Fed's script has been the same; flood the markets with liquidity, push interest rates as low as possible, keep a market friendly public posture, and encourage other central banks to do the same. Banks have been major beneficiaries as low borrowing rates and interest on excess reserves at the Fed contributed to renewed profitability and provided an opportunity to rebuild balance sheets. Corporate financial executives saw historically low interest rates as an opportunity to tap the debt markets to add low cost debt to their balance sheets, often using the proceeds to buy back stock to improve earnings per share in the absence of more attractive growth projects. Stock market investors benefitted from the tremendous liquidity that flowed from the Fed through the banks that lifted stocks across the board, with the share price of many companies driven by price momentum rather than fundamentals. Among the only losers in this are fixed income investors who experienced a decline in yields and found limited alternatives to reinvest as their securities matured.

But the Fed "franchise" is at risk if policy errors cause investors to lose confidence, or if the Fed begins to push the limits of its policy resources. Over the past several years Fed policy moves have triggered a crisis of confidence among investors. In 2013 Ben Bernanke signaled his intent to "taper" the purchase of US Treasury and mortgage-backed securities. The initial reaction in the markets was positive because stocks were well above their panic lows and the economy had rebounded somewhat. 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. Similarly, Jerome Powell was forced to reverse course when his policy moves created a crisis of confidence during the 4th quarter of last year. Once again the stock market and the economy seemed strong enough to support a "normalized" Fed policy stance, but the unfavorable market reaction prompted Powell to reverse course. Six months later the Fed is considering interest rate cuts in addition to suspended balance sheet reductions.

The risk of policy error is greater because central banks around the world have instituted the same policies. Abe in Japan has pursued an aggressive liquidity program for years. In the Eurozone Mario Draghi has combined liberal interest rate policies with aggressive security purchases and outspoken public posturing to support the markets and consumer confidence. As his term comes to an end it will be critical for his replacement to continue in his footsteps.

A far greater risk than the policy errors described above, and one that is not as readily apparent, is the declining effectiveness of these extraordinary policy moves. As the financial markets and economy become more dependent on Fed support, the effectiveness of those moves diminishes, a gradual and insidious process. When the next crisis arises the Fed may not be able to push interest rates to artificially low levels, and may be unable to provide additional liquidity just when it is most needed. When that happens highly levered companies will be squeezed unmercifully, as well as investors who are overly reliant on strategies based on easy money and price momentum.

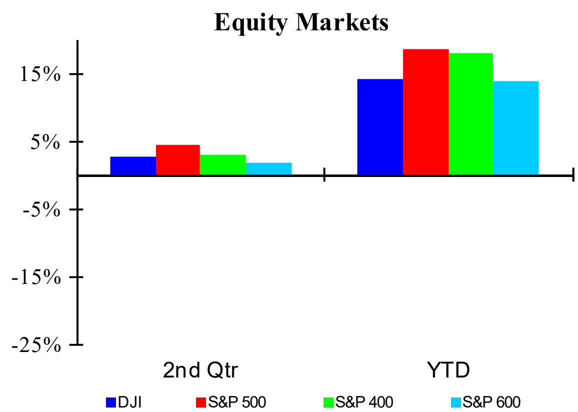
The Fed and central banks around the world have managed to avoid a major market meltdown up to this point. They have quickly reversed policy moves when the markets reacted unfavorably, and have not needed to address anything like the financial crisis of 2008. As those unpleasant memories fade, and as the markets push continually higher, investment strategies reliant on the Fed franchise are increasingly at risk. We believe that our focus on companies with strong fundamental valuations, with solid balance sheets, reasonable debt levels, and the ability to remain profitable in difficult times will be rewarded. Easy returns in momentum markets are fun to watch, but it can all change quickly when the unexpected occurs. We have watched that scene before and know that a sound investment strategy provides the best ending.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

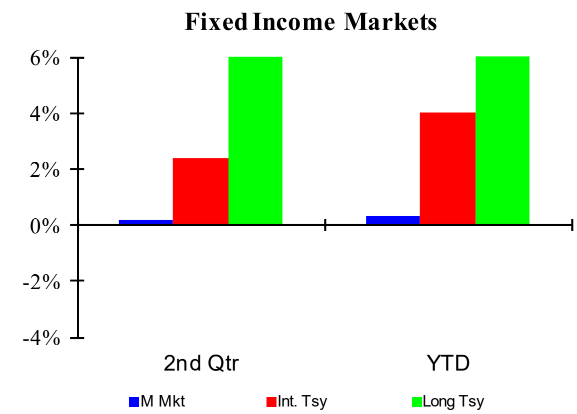
Market Summary
June 30, 2019



Stock markets traded in a fairly narrow range during April 2019, as earnings reports were fairly uneventful. Markets began to sell off in May, however, as economic reports both in the US and abroad painted a fairly uniform picture of continued deterioration in business activity. Word of collapse of the trade negotiations between the US and China, not to mention the threatened imposition of punitive tariffs on Mexico, added fuel to the fire, and by month's end equity markets were under significant pressure.

Fixed income investors came to the rescue, by driving bond prices up and yields lower, and delivering a message to the Federal Reserve that conditions warranted a near-term cut to the federal funds rate. June began with various Fed officials stating their opinion that rates should indeed be reduced, and by the time the official FOMC meeting was held, expectations for such a cut were validated. Equity markets responded with a sharp rally, re-attaining the highs achieved in early April.

For the quarter, most market indices recorded low single digit returns. Value stocks, especially interest-rate sensitive names, did marginally better than growth-oriented securities.



The U.S. Treasury yield curve began 2019's second quarter mildly inverted (short rates higher than long rates), which most observers consider to be a sign that investors were betting on a decline in Federal Reserve policy rates. As the quarter progressed the adverse flow of economic reports, combined with rising concern about the implications of a renewed trade war with China and other trading partners, served to emboldened fixed income investors. Traders increasingly bet on a sooner, and sharper, decline in the Federal Funds rate.

Accordingly, yields on Treasury paper across the maturity spectrum declined significantly throughout the quarter, although by quarter's end parts of the yield curve resumed a more normal upward slope as short rates fell further than long rates as the Fed made clear its policy intentions. As a result, longer-dated maturities substantially outperformed shorter paper, and indeed longer term Treasuries performed better than most equity market indices.