Investment Commentary
December 31, 2018

Don't Bite on the Double Move

Those of us in the Philly area are, once again, enjoying the improbable run of the Eagles to the playoffs. After a mediocre season they managed to sneak in on the last day despite numerous injuries on both the offense and defense. The impact of these injuries is most pronounced on defense where most of the defensive secondary positions are former backup players. In these critical playoff games many commentators are concerned about the tendency of these replacement players to "bite on the double move" on pass plays. This happens when a defensive player over-reacts early in the play and gives up a long pass behind him, often at a critical point in the game.

Investors should be wary of the risk of "double moves" in the markets, as well. We have hit a critical juncture where a confluence of events could easily contribute to classic investing mistakes. After a ten year bull market run fueled by massive amounts of liquidity injections by the Fed, artificially low interest rates, and accelerating economic growth, we are hitting an inflection point. The risk is magnified by the actions of central bankers around the globe that pursued similar policies at the urging of former Fed chairman Ben Bernanke.

Recently, the Fed initiated policy moves to begin to reverse the stimulus measures that have been in place for so long. The Fed started to increase short term rates very gradually in December 2015, and accelerated the pace over the past two years in an effort to push rates to more "normal" levels. The Fed also began to reduce liquidity injections by slowing the purchase of Treasury and mortgage securities, and by September of this year the Fed was reducing its balance sheet, allowing $50B of securities to mature each month without replacing them. These balance sheet reductions had the effect of draining liquidity from the system for the first time in almost ten years, and it is interesting to note that the recent market decline began at just about the time that the Fed balance sheet reductions began in earnest.

The recent market action highlights a risk that has concerned many economists since the inception of the quantitative easing experiment. If the massive liquidity injections by the Fed were intended to raise asset prices and stimulate economic growth, then the draining of that same liquidity should have the opposite effect. This effect could potentially be exacerbated since markets tend to react much more quickly, and forcefully, on the downside.

In a sense, both the Fed and investors are at risk of "biting on the double move". The Fed had been moving cautiously, but seems to be accelerating its activity at a time that the markets and economy seem to be showing signs of vulnerability. It runs the risk of tightening too aggressively and then needing to delay further action or even reverse their moves. This could send confusing signals to the financial markets that have become entirely too reliant on support from the Fed. Investors run the risk of "biting on the double move" if they allow themselves to over-react to every move by the Fed. The investment markets are often driven by emotion and at times of uncertainty the impact is magnified. Investors could be tempted to cover every move and could easily find themselves out of position in the event of a reversal.

The stimulus measures that we have enjoyed for so long made it seem all too easy. The virtuous cycle of central bank balance sheet expansion and liquidity injections lifted the markets and swelled investor accounts. Investors became enamored with the returns and underestimated the importance of risk management, relying instead on the Fed backstop. As the Fed continues the process of unwinding monetary stimulus, and as central banks around the globe begin to unwind their stimulus efforts, we will see higher volatility in the markets. The Fed will remain cautious to reduce the potential for missteps, but the process will be long resulting in an extended period of higher volatility.

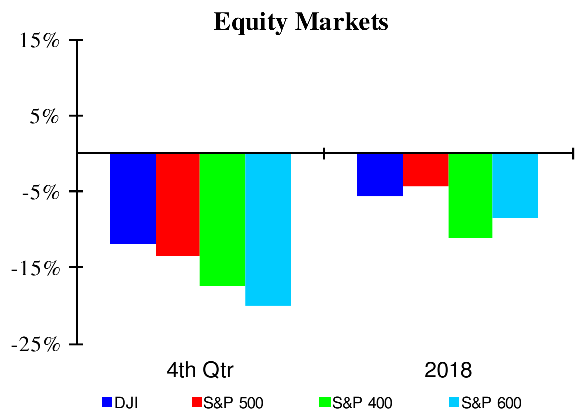
We continue to believe that the best play in volatile markets is to avoid overreacting to emotional shifts and focus instead on investing in companies with attractive fundamentals and sound business strategies. A pullback such as the one that we have experienced can create a buying opportunity for patient investors, so we respect the discipline of our valuation model and constantly look for ways to improve the return potential of our portfolios. We continue to believe that the best way to generate attractive returns while managing risk will be to focus on long term opportunities while resisting the urge to cover every short term move.

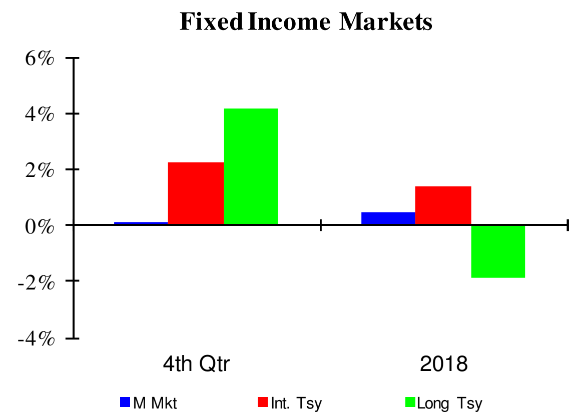
Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
September 30, 2018





Equity markets succumbed to substantial selling pressure throughout the quarter, culminating in year-end panic selling that drove market indices to levels last seen in September 2017. Investors could no longer ignore evidence of mounting weakness in Asian and European economies and US real estate-related businesses, especially after market leaders such as Amazon, Apple and Facebook announced disappointing earnings. Moreover, new Fed Chair Powell contributed to market unease by communicating intentions to stay the course on the program to gradually raise interest rates while reducing the size of the Fed's bond portfolio, seemingly oblivious to market concerns over the health of the economic cycle. Rising interest rates early in the quarter soon gave way to sharp declines and brief periods of an inverted yield curve in shorter maturities, which if sustained would be seen by many investors as a reliable predictor of recessions.

Most indices posted sharp double digit negative returns, with growth stocks doing worse than value stocks and small cap stocks underperforming large cap issues. Stocks closed the year with losses, more than erasing the year's prior gains.

Interest rates continued to climb in the first part of the quarter, with the 10-year US treasury bond trading above the critical 3% level through Thanksgiving. In December, however, yields across the intermediate and long-dated maturity spectrum declined rapidly, reflecting a number of factors: signs of increasingly weak European economies, fears of an impending un-negotiated or "hard" Brexit, clear growth deceleration in China attributed at least in part to the trade war with the Trump administration, and asset allocation moves out of declining equities and into appreciating bonds. These developments were magnified by commentary from Fed leadership that the central bank would continue to raise interest rates, a commitment that was increasingly viewed as unlikely given the rapid change in market sentiment. By quarter's end the shorter end of the treasury yield curve was slightly inverted, meaning intermediate maturity bonds had slightly lower yields than Treasury Bills maturing in less than one year. Market participants were expressing their views that the Fed was unlikely to raise rates further, and instead began to build bets that a cut in the Fed Funds rate was possible.

Declining yields across the maturity spectrum led to widespread gains, with longer-date paper outperforming shorter maturities.