Morris Capital Advisors, LLC

Investment Commentary
December 31, 2019

Repo Man

Repo Man was a 1985 science fiction black comedy that became a cult classic. The main character was Otto Maddox, a punk rocker in LA who lost his job, lost his girlfriend to his best friend, and found that his hippy parents had squandered the money that they set aside for his education. While wandering the streets he is offered the opportunity to work repossessing cars, which he initially refuses. He changes his mind, and Otto, the once reluctant repo man, learns of a Chevy Malibu with a high repo bounty. The car is apparently possessed by aliens, but Otto and a mechanic from the repo shop finally grab the car, and when they do it suddenly flies them over the LA skyline and into space.

Early on, Fed Chairman Jerome Powell seemed to be a reluctant repo man, and some of his critics probably hoped that he would get launched into space, as well. Remember that early last year Powell set Fed policy on a course to normalize interest rates and reduce the Fed's balance sheet as the economy showed signs of improvement. That policy raised concerns among critics who lobbied for additional stimulus, but the markets seemed to take it in stride. Things changed later in the year amid signs of economic uncertainty, compounded by Powell's reluctance to slow the balance sheet runoff. Late in the year the markets reacted negatively, driving large-cap stocks down 15% and small-cap stocks down over 20%. As the markets hit bottom on December 26, Powell clearly made the decision to terminate the balance sheet runoff and lower rates. When the change was announced early in 2019 the markets reacted immediately, beginning a rebound that pushed the stock markets up and interest rates down.

As the year progressed, however, investors began to focus once again on trade war tensions and signs of slowing economic growth, tripping up the equity markets and triggering a further decline in interest rates. At the same time the spread between short term and long term rates compressed, and briefly turned negative when the 10 year yield fell below the 2 year yield. This "inverted yield curve", which often precedes a recession added to investor concerns. The markets stabilized and then began to move higher again when Fed chairman Powell announced that the Fed would "act as appropriate to sustain the expansion", signaling the reemergence of the Fed market backstop and fueling investor expectations of future rate cuts.

Simmering in the background, however, were concerns about reduced banking liquidity due to the reduction of excess reserves at the Fed. Banks increasingly relied on these reserves to strengthen capital ratios, so declining reserves translated immediately into reduced liquidity as bank repurchase agreement activity evaporated. Liquidity shortages had occurred earlier in the year but became acute in mid-September when overnight rates on "repos" spiked to almost 10%. The Fed responded by pumping liquidity into the banking system through massive repo offerings and outright purchase of recently issued Treasury bills. This liquidity shortage, much of it out of the view of many investors, reached critical proportions as the Fed was forced to repeatedly increase the repo offering size. By year end the Fed had pumped more than $300 billion into the banking system, reversing much of the balance sheet reduction from the previous year.

It is clear that the once reluctant "Repo Man" Jerome Powell has been reinvigorated in his support for the markets. There is nothing like a near-bear market and a liquidity crisis to focus ones attention. The Fed went to great lengths over year-end to avert the liquidity crisis and hopefully gathered intelligence allowing them to anticipate similar problems in the future. It seems apparent, as well, that Fed has a higher sensitivity to risks in the markets and will continue to use the tools at its disposal to avoid market disruptions.

Around the same time that the banking system experienced its liquidity issues the stock market experienced an observable shift away from growth and momentum stocks to shares with more conservative valuation metrics. This shift could mark the reversal of a trend that has dominated market activity since 2009. Our investment approach has always started with a search for companies that have strong earnings, the capability to grow, and a solid balance sheet to support that growth. Our objective is to invest in companies whose share price is attractive based on those fundamentals. It has been our guiding principal for almost three decades and could benefit from both the market shift to valuations and the support of Jerome "Repo Man" Powell.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

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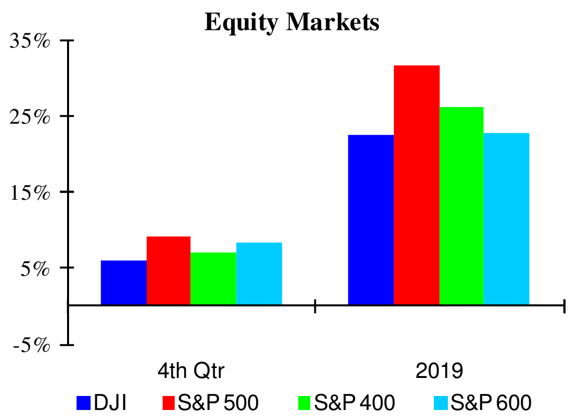
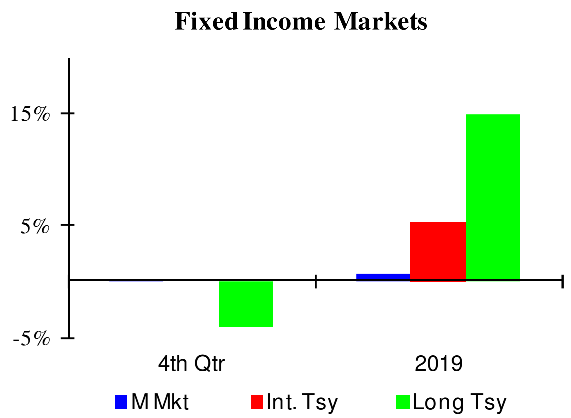
Market Summary
December 31, 2019





Stock markets ended the third quarter of 2019 consumed with worry that the global slowdown in manufacturing, and an apparently inattentive Federal Reserve, might cause recessionary conditions to take hold in the U.S. By the fourth quarter, those worries were seemingly dispelled, and equity indices staged strong rallies across all market sectors.

As always, Fed action took center stage. Monetary authorities made sure to provide plenty of liquidity in the market for overnight repurchase agreements; removing any risk the technical issues that affect this market might cause the fed to lose control of money market interest rates. The effect of these actions was to sharply increase the size of the Fed's balance sheet. Investors interpreted these moves as a return to the policy of quantitative easing that has dominated markets since the financial crisis of 2008-09.

Now that the Fed has joined the ranks of other central banks in returning to an easy stance in monetary policy, investors displayed confidence that economic activity worldwide is in the process of bottoming. As a result most indexes soared past their prior peak levels of September 2018, and delivered high single digit returns. Large cap stocks outperformed small cap shares, and growth sectors sharply outperformed value-oriented industries.

Trading in fixed income markets during 2019's fourth quarter was dominated by an abrupt change in the Federal Reserve's policy stance. In reaction to apparent liquidity shortages in the market of overnight repurchase agreements, the Fed provided nearly unlimited bank reserves by resuming large purchases of short-dated U.S. Treasury paper. As a consequence, the decline in the Fed's balance sheet, which had been underway through most of 2018, was almost completely reversed by quarter's end.

At the same time, closely watched indicators of economic activity, which had been declining for most of the 2019, showed signs of bottoming. The successful conclusion of trade negations between the U.S. and China removed another risk factor markets had been pricing in. Various commodity prices rallied, and the price of gold surpassed $1,400 per ounce for the first time since 2013.

As a consequence, yields on long-dated Treasury paper advanced steadily throughout the quarter, and restored a modestly positive slope to the yield curve. Short maturity treasuries barely generated a zero total return, while longer-term bond prices suffered losses.