Will the Real Market Please Stand Up

January 11, 2019

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Strategic Income Outlook
January 2019

The markets have not been kind to investors lately. There were precious few bright spots in the recent quarter, and it seems there was nowhere to hide, except cash. Our instincts, however, tell us that cash is not a long-term solution. After almost 10 years of positive returns in equity markets, the decline from recent peaks came very close to bear market territory before reversing course, with most major domestic markets ending the year down between low and mid-single digits – not a major catastrophe, but not a great finish to the year either. Declines have been far worse in some emerging markets, like China, which has been selling off for most of the year and is decidedly in a bear market. This should be no surprise as they are much more dependent on trade.

The optimists, including some in the economic profession, would say the glass is half full, citing very low unemployment, accelerating wage growth, steady retail sales, slowing inflation, dubious yield curve signaling, healthy corporate profits and positive small business sentiment. The pessimists, which include most financial writers and some economists, would say that the glass is half empty, citing the possible deleterious effects of a prolonged trade war, political disfunction, slowing economic growth, a possible "BBB" bubble, a sagging leveraged loan market and lower oil prices. Pragmatists, like us, would say neither full nor empty matters, as the glass can be refilled, citing fiscal stimulus here, in China, Italy and most recently in France.

It seems the world has switched from synchronized growth at the start of the year to a slower growth regime, and the concurrent flight from risk that comes from deteriorating sentiment has resulted in record outflows from equities and credit funds and massive inflows to cash-like funds. Our biggest challenge as investors is determining which path will be correct; will negative changes in sentiment spill over into the real economy, or can we stabilize at a slightly lower level of economic growth and improve from here once the economic outlook appears more steady?

Clearly some of the "negatives" cited by investors are in fact positive for the health of consumers, particularly declining energy prices and lower inflation. Although weakness in the energy sector accounted for a preponderance of the negative returns among non-investment grade bonds in 2018, lower oil prices benefit almost everyone except the producers of energy, as we have written about in previous letters. It is very important to understand why oil prices are weak, and today most agree that it is not due to a lack of demand, but rather an excess of supply. The Organization of the Petroleum Exporting Countries (OPEC), especially Saudi Arabia, and Russia acknowledge this and have recently announced production cuts. The U.S., however, continues to forge ahead with increased production and will only respond with cuts when either funding is cut to producers, as it was a few years ago, or prices decline to where it is uneconomical to drill. We are not there yet, but most commodity-related imbalances do correct themselves over time, and then we would expect investors who now view weak oil prices as a precursor to an economic slowdown may change their minds.

The trade war with China, and its uncertain impact on future global growth, has been routinely blamed for much of the market's decline, but we feel a closer examination is warranted. If we look at the not-too-distant history, we may gain some insights into the current situation and possible outcomes. We remember a time when Japan was the dominant manufacturing economy. While U.S. companies were essentially excluded from doing business there, "Japan, Inc." maintained a stranglehold on popular goods we did not produce, like small fuel-efficient cars and personal electronics. They amassed huge trade surpluses, the Yen soared, and they snapped up trophy properties such as the Pebble Beach golf course, the Empire State Building and a lot of other real estate in Hawaii and California. They also became one of the largest buyers of U.S. Treasury bonds, helping to fund our trade deficit, a position they retain to this day. Sound familiar?

Japan was also a huge importer of oil as they had very little natural supply. As irony would have it, the OPEC embargo and subsequent spike in the price of oil allowed them to create a beachhead abroad by exporting small fuel-efficient cars to the world, which started their rise to manufacturing dominance. It was the spike in oil prices during the Gulf War in 1990, and the ensuing recession, that sowed the seeds of their decline. History will cite many other reasons as well, but for this essay, suffice it to say that the combination of a U.S. recession, Japan's hubristic failure to innovate, misguided fiscal policies favoring the hoarding of cash by corporations over investing, a crippling demographic bubble and a very restrictive immigration policy allowed South Korea to step in and capture large chunks of their share in global trade.

Korea's crown rested on an uneasy head as China mobilized its vast human and capital resources and began its rise as the dominant manufacturing power in the region. China deliberately undertook the biggest economic transformation and modernization of a nation the world has ever seen. This was done with massive infrastructure spending and the targeting of industries they wanted to dominate. The latter was somewhat symbiotic, as the massive buildout would have been impossible relying solely on imported steel, cement, aluminum, shipping, etc. They needed to develop these industries quickly and on an enormous scale. Today, Chinese steel and aluminum production dwarfs that of the rest of the world. Steel and aluminum anti-dumping tariffs have predated the current trade tiff for good reason: as their infrastructure spending slowed, they needed to offload excess product to keep their plants running and their people employed. China realizes they have a problem with overcapacity, as well as very inefficient and highly polluting manufacturing plants.

China today is like the U.S. in the late 1960s following our massive post World War II infrastructure buildout: a heavily polluted, overbuilt industrial complex. Thankfully, China, as we did, recognizes that this is untenable and must be reversed, and they are doing so. They have started closing inefficient plants as the oversupply they created cannot to be sold abroad indefinitely at a loss. While it is painful to close plants and see people lose their jobs, both here and in China, this is how imbalances correct.

The allure of China's vast market opportunity attracted many foreign companies and China allowed foreign firms to do business there but with strings attached. Foreign companies have had to run a gauntlet of mandatory partnerships and technology-sharing agreements to do business in China. Given the size and potentially lucrative market opportunity, foreign companies have mostly gone along. This is one of the main sticking points in the trade "negotiations" today, and we hope that it can be resolved. While we are of the view that they have likely appropriated all our key technology already, now that China is in the midst of a major slowdown perhaps the gilding is off the lily for these companies and they may pull back from China. We have been seeing a reduction in foreign direct investment to China, so it may already be happening.

Of course, it's not quite that simplistic, but the point is that manufacturing dynasties rise and fall, and balance is usually restored until the next disruptor arrives with even cheaper and better made goods. We are possibly facing one of those rebalancing points today. No matter how the trade conflict ends, as we have seen in the past, when goods from one region become less competitive, another region ascends to the throne of manufacturing powerhouse. Stay tuned.

The flattening and some recent inversion of the yield curve has been the subject of much debate lately. For the record, the only part of the yield curve that was still inverted as of December 31st was the very front end. Jim Reid and Craig Nicol at Deutsche Bank point out that [inversions at] different points on the yield curve have had differing predictive success regarding the forecasting of a recession. Their conclusion seems to be that the probability of recession is low for 2019. This is no longer the consensus view in the markets. Beyond 2019, however is anyone's guess. This *is* a consensus view!

As we have pointed out previously, the Federal Reserve's (the Fed's) own longer term predictive track record is abysmal, so they are not a useful guide. We have had only three recessions in the past 30 years, but we have had many more false predictions of impending recessions. Prakash Loungani, an economist from the International Monetary Fund, published a report in 2001 and an update following the Great Financial Crisis of 2008 that examined the accuracy of economic forecasts. Sadly, the prognosis was not good. Without dwelling on the details, a quote from the report sums it up quite nicely: "The record of failure to predict recessions is virtually unblemished." We'll leave it at that as we do not believe the Ouija boards have improved much since then. As Michael Goldstein of Empirical Research Partners points out, Paul Samuelson once said, "Wall Street has predicted nine of the last five recessions" and added that "when the market's multiple declined by an amount like that we've just seen, it recovered in the next year in 15 of 20 episodes." Let's hope the future is on the side of the majority here.

On December 19th the Fed unanimously voted to increase the target fed funds rate to a range of 2.25%-2.50% and said they expect to raise it two more times in 2019, which is fewer than they had previously guided. Given that the Fed's preferred gauge of inflation, the Personal Consumption Expenditures (PCE) deflator, is at 1.9% and the headline Consumer Price Index (CPI) is at 2.2%, real interest rates today are not restrictive. We feel that the most recent increase was the correct action and if the weak patch continues, the Fed can take a pause if necessary. For those who like to parse words from the Fed statements, they added "some" as a qualifier to "further rate increases." We do not try to over-analyze small changes to the commentary, but with inflation near their 2% target, we believe they will indeed become more data-dependent going forward.

Steve Blitz at TS Lombard noted that "the problem with data dependent monetary policy is that economic data often follow asset markets, thus making shifts in Fed policy late by definition." As we have said before, this is a long and proud tradition at the Fed and we expect it may be no different this time around. However, this recovery has been one of the most anemic and slow moving in memory and as such, may offer some clues as to the shape of the economy's future direction, despite the lag in Fed policy. When recessionary forces do eventually take hold, they could be very mild, slow moving and very shallow, mirroring the recovery. They may also be accompanied by low inflation, modest interest rates and a somewhat stronger dollar vs. our trading partners. Corporations may still be hard-pressed to find enough qualified employees in this scenario, which may keep the unemployment rate from rising much and wages would remain healthy. This, in turn, could be a self-re-enforcing factor in keeping the recession shallow. Unfortunately, in this type of environment, investors will be very jittery, wondering when the next shoe will drop. If interest rates do decrease meaningfully, there may also be a revival of the search for yield, which favors some sectors of the fixed income markets.

Turning to the bond market, one worry is that the BBB cohort of the investment grade universe has grown too big relative to the rest of the market, creating the potential for downgrades that could hurt the non-investment grade index. The size of the BBB Index is now $3.2 trillion, up from $2.1 trillion five years ago. We have taken a closer look and we feel it is unlikely that a rash of downgrades will suddenly wreak havoc on the non-investment grade market. First, concentration is very high. The 25 largest corporations in the BBB index (ICE BAML U.S. Corp. BBB Rated Bond Index) comprise ~32% of the index. This means that we can more easily observe which names are in trouble. Second, non-U.S. and Canadian issuers, which are not eligible for inclusion in the high yield index, comprise ~35%, of the BBB universe. Third, we could see some contraction in the BBB market as Moody's has put some of the larger bank issuers, like Citibank, on review for upgrade out of the Index, many of which were downgraded following the Great Financial Crisis and added to the BBB Index. Banks and insurance companies are ~16% of the BBB Index. Fourth, by the time a company's bonds do get downgraded, the price has usually already discounted most of the negative change in fundamentals, so the negative impact upon inclusion into the non-investment grade indices may be muted. And last, insurance company capital rules for non-investment grade holdings will mostly ease starting in 2019, and rules for most investment grade bonds will tighten, which means that at the margin, they may be less likely to automatically sell downgraded holdings and may even be a buyer on weakness. In sum, as in the past, we view any downgrades as potential opportunities to buy better quality companies at discount prices rather than a material negative for the non-investment grade market.

The leveraged loan market has also been in the news lately. The market has grown by 30% in the past two years to over $1 trillion, having recently surpassed the size of the non-investment grade bond market for the first time. Prices have been a bit soft recently as loan funds have seen large redemptions. As background, given that loans are floating rate investments, when rate normalization began, demand for the product jumped. Investors here and in low interest rate regions such as Japan, wanting exposure to rising interest rates, piled into the product over the past few years, fueling its growth. The question is whether weakness in this market correlates to a dimming outlook for future interest rate increases or worries about a spillover effect dampening traditional commercial and industrial (C&I) lending, which now represents about 20% of total bank credit. According to Wells Fargo, "there does not appear to be overwhelming evidence to support the notion that weakness in the leveraged loan market leads to significantly slower growth in C&I lending." They add that "growth in overall bank credit generally has had a low degree of correlation with prices of leveraged loans." Further, with rates in the 2.5% area and inflation in the 2% area, financial conditions are far from tight today. We agree with their assessment and believe this has more to do with investors' less hawkish view on interest rates.

Eventually, we will have a recession; that much is certain. When, how severe and how long it lasts are the questions that are on investors' minds today. If the yield curve is in fact forecasting a potential recession, the historic lag is a range of 8 months to 4 years following the first yield curve inversion. That is not very helpful in predicting when a recession shows up. Evercore ISI points out that since 2011, real Gross Domestic Product (GDP) growth has averaged 2.1% and S&P 500 Index (S&P 500) earnings growth has averaged 6.6%. A recent survey of economists (SIFMA, Dec 13, 2018 and Bloomberg, Dec 21, 2018) estimates real GDP growth in 2019 of 2.6%. Additionally, FactSet's latest analyst forecast for 2019 S&P 500 earnings growth, although reduced from 10.1%, is still 7.8%. Even if those estimates decline a bit further, barring exogenous factors, a slow growing, but still expanding economy, is not a recession. Given historical lags between the first sign of yield curve inversion and the start of a recession, we feel that late 2020 is the earliest we should start to get worried. Despite what seems like plenty of time, we believe it is not too early to take a bit more defensive posture now.

As such, we have been taking advantage of the flatter yield curve by increasing our holdings in commercial paper, short dated investment grade floating rate notes and some higher rated shorter-term bonds. We also reduced our positions in equity sensitive convertibles on strength earlier in the quarter. Given where short term rates may be heading now, and where the non-investment grade market has sold off to, we may favor leaning toward the latter. The yield spread between the two has widened considerably in the past quarter and we find that at these levels, high yield is becoming much more compelling. 2018 has been an eventful year and we wish the best for 2019.

As always, we thank you for your support and welcome your comments and questions.

Sincerely,

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It is not possible to invest directly in an index.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

PCE refers to personal consumption expenditures.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

ICE BAML ICE U.S. Corporate BBB Index is a subset of the ICE BAML U.S. Corporate Index including all securities rated BBB1 through BBB3, inclusive.

Credit Quality weights by rating are derived from the highest bond rating as determined by Standard & Poor's ("S&P"), Moody's or Fitch. Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as S&P, Moody's and Fitch. These firms evaluate a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. In limited situations when none of the three rating agencies have issued a formal rating, the Advisor will classify the security as nonrated.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.

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