July 5, 2018

Dear Clients and Friends:

Alan Greenspan once said, "I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I said." The Maestro was very good at obfuscation during his long tenure, even if his legacy as an economic steward has been tarnished by events subsequent to his retirement. The chairs that followed him decided that the goal of economic stability would be enhanced by ever-increasing levels of openness in communication, for as we all know, markets hate uncertainty. Of course, the value of openness is dependent on the quality of the information being communicated. A kind of "garbage in, garbage out" potential exists. Mr. Greenspan, rolling with current trends and striving to stay relevant at the age of 92, recently opined that the only part of the yield curve that interested him was the slope between 5 and 30 years. He indicated that the overall slope, which is very flat, is of no concern to him and should not be to the rest of us, because it is, in his opinion, flashing positive signs. Forgive us if we do not share in his sanguinity at the turn of the year.

In the continued search for ever-increasing openness and concomitant reduction in uncertainty, current Federal Reserve Chairman Jerome Powell will now hold a press conference after every meeting. I must admit I find his anodyne demeanor and pleasant delivery easier to take after the last two chairs, but as stated previously, it all comes down to the quality of the information being disseminated. We are being assured that the economy is robust and the future is bright, and we are being warned that the risk is economic overheating. As a result, the Federal Reserve's bias is to raise rates, and we should expect many more. The trap they fall into is believing in their unique ability to predict the future of something as complex as the global economy despite no supporting evidence. We believe economic history can be a much better guide, and while no two environments are identical, there are powerful, almost immutable, forces acting on the economy.

So let's go to recent history, or what seems recent, mid-year 2007. Then, like now, we found ourselves in an aging expansion in which the Fed had raised rates and was biased to raise them further. The yield curve was very flat. The favorite measure of Alan Greenspan was almost identical to today at 20 bps vs 25 bps currently. Economic growth was robust with GDP coming in at 3.1% for the second quarter 2007, which is very close to the estimate for the second quarter 2018. Stocks were on a bumpy ride to a modest mid-year return, and most measures of volatility had picked up. Federal Reserve rhetoric was focused on the positive, and it seemed the business cycle was finally conquered. Well, we now know that we were already well on our way to the inner circles of Dante's Hell. The signs then, like now, were hiding in plain sight.

Of course the yield curve matters. Of course the age of the expansion and the level of asset valuations matter. Of course trade wars, or the potential for them, matter. Do we know what will occur over the next 12-18 months? Of course not! What we do know is that valuations are stretched, our central bank is acting alone and zealously focused on rates, and our yield curve is flashing warning signs that are being ignored at the investor's peril. At the same time, the current expansion is just shy of the record in terms of length. If you line up the current environment and compare to similar moments in history, the strategy to follow is clear. It is the strategy we have been patiently following for well over a year. Protection remains inexpensive, so buy it. The cost of liquidity is low, so buy it. Risk remains expensive, so avoid it. Real rates in the United States are very cheap on a global basis, so avoid them at your peril. We see limited downside in this positioning relative to the potential gains and after all, that is investing 101. No PhD required.

Sincerely,

Mark M. Egan, CFA
Managing Director

Data obtained from Bloomberg Terminal, accessed 6/29/2018.