January 3, 2019

Dear Clients and Friends:

A popular television show, Game of Thrones, has the catchphrase "Winter is coming," but with the show about to begin its eighth season, fans are still waiting for the arrival of the frosty period and the terrors that accompany it. It has seemed nearly as long to us that we have waited for the effects of the Federal Reserve tightening program to manifest themselves, unleashing the terror of asset price destruction while creating entirely new fields of study for folks trying to discern what the Fed is doing, why they are doing it, and when they will stop. For reference, please see the periods of 1989-1990, 1998-2002, and most recently, of course, 2007-2009. In each of these instances, the Fed (through misguided policies lacking any basis in theory and certainly lacking subtlety) engineered asset price destruction only to reverse course and prop them up again. Please see the, at the time unheard of, 3% on Federal Funds in 1992, followed by 1% in 2003, and then, of course, 0% plus quantitative easing in 2009. Recall only three years have passed since the Fed first raised rates from the zero boundary, and only about one has passed since they began aggressively shrinking their balance sheet on a scale that has never been attempted at anywhere close to the current levels.

As we know, the Fed has a virtual army of PhDs, many in the pseudo-science of economics, pumping out thick tomes, assuring themselves they know exactly what they are doing. Rest assured they do not. They never really have and likely never really will. The current Chair of the Federal Reserve, Jerome Powell, said as much; he mentioned something about how if you are stumbling around in the dark, you should go slowly. That seems enlightened, but he then followed that sage advice with the assurance that the balance sheet adjustment, the likes of which have never been attempted before, is on auto-pilot. A cursory glance at history should provide all the guidance you need for what is to come, and yes, it likely involves pain.

Let's put aside the fancy academic stuff for just a bit and take a gander at what is happening. After a period of unprecedented monetary action on a global scale, the likes of which were never thought possible a decade ago and which have elevated asset prices across virtually all classes, our central bank has decided to reverse course, do so aggressively, and go it alone. The focus in the press seems to be on raising rates, which is more visible and understandable. While gradual, it has opened up a gap between the U.S. and the rest of the world to levels that are not justifiable on fundamentals. This has the effect of strengthening the dollar and depressing commodity prices. The other lever the Fed is pulling is the more relevant, and far less visible, draining of liquidity by $50 billion a month. Let us say again that this has never been done. But it is good to know it is on autopilot, per Mr. Powell. As a quick review, the Fed pumped massive amounts of liquidity into the system to raise asset prices, and it worked. They are now draining that same liquidity at a rapid pace, for what purpose no one knows or explains. Now I do not have a PhD, but I would think sucking up to $600 billion per year out of the system with a fiscal deficit approaching $1 trillion, a deficit that was essentially financed by the Fed for years, might be dicey. One might expect at least a partial reversal of the bubble in all things, and wouldn't you know, almost all asset classes experienced negative returns in 2018.

To those who profess surprise at the way the year ended, we encourage them to study Federal Reserve policy over the last 30+ years. It has been their policies that have driven asset prices to a large degree, and this shows no sign of ending soon. It has likely been their policies behind each economic disruption we have seen since its founding. The fact that this policy regime is more complex than any undertaken in history should at the very least make an investor wary. One might recall the old adage that when the Federal Reserve taps the brakes, someone goes through the windshield. As of now, they are standing on them.

Because we have been patiently waiting for the markets to turn, as they did in the latter half of 2018, we consider ourselves well prepared. We welcome the volatility we have seen, and while it may seem extreme to some, it is actually perfectly normal. Valuations in many areas of the fixed income markets have become at least fair, and we have reacted accordingly by slightly increasing our exposure to risk assets. They are likely to become cheaper than just "fair." This may be alarming, but valuation, along with a proper time horizon, has always been key to investing success. This cycle will be no different. There will likely come a time when compelling valuations dictate aggressively adding risk, even if it means short-term pain. We are, of course, prepared to take advantage of such opportunity on your behalf. It has been a long time coming, but winter may finally be arriving. Yet, unlike winter in Game of Thrones, it will likely be nasty, brutal, and short. Credit given to Thomas Hobbes.

Sincerely,

Mark M. Egan, CFA
Managing Director