PCA Perspectives

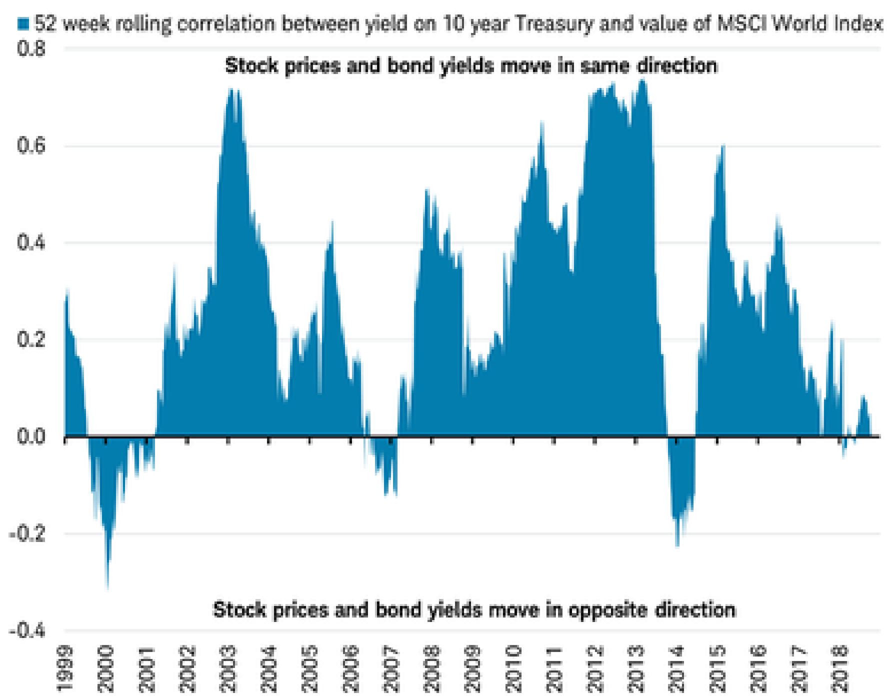
Permit Capital Advisors' Thoughts on the Investing Landscape

October 2018

"I can't change the direction of the wind, but I can adjust my sails to always reach my destination."
-- Jimmy Dean

The past week has seen markets roiled in the face of a confluence of factors, which could presumably bring a halt to a ten-year expansion that has been largely without volatility. These factors include signs of rising bond yields, fears of slowing growth, and a litany of geopolitical concerns. Perhaps most unsettling to market participants was the coincident sell-off of both stocks and bonds. As a general principle of risk management, asset allocation is dependent upon the notion that a diversified approach trades a measure of upside for the stability that comes with a balanced portfolio. For this to work, the relationship between bond yields (which move inversely to bond prices) and stock prices needs to remain positively correlated. Per Exhibit 1 below, that has generally proven to be the case over the past twenty years, as we expect during deflationary or disinflationary periods.

Exhibit 1: Correlations Signal Warning



Source: Advisor Perspectives, "Always Be Prepared" by Liz Ann Sonders, Jeffrey Kleintop, and Brad Sorensen of Charles Schwab, October 12, 2018

Once disinflation gives way to higher current and expected inflation, the correlation tends to become negative. In each of the three occasions where this occurred previously (as shown in Exhibit 1), global equity declines soon followed. This is not a regime change that occurs suddenly, or in a vacuum. Indeed it is related to the rising bond yields referenced earlier that helped spook markets last week. In the first week of October, on the heels of Federal Reserve Chairman Jerome Powell heaping praise on the American economy and noting that interest rates are a "long way from neutral", the 10-year Treasury yield rose to 3.23%, its highest level in more than seven years. While this can be a healthy byproduct of the Fed's normalization process, it runs the risk of contributing to an eventual recession, which is the only surefire development to create meaningful impairment to capital markets.

While it is rare for economic downturns to be caused by a single factor, Exhibit 2 points out that, historically, tight monetary policy is likely to be a leading culprit. Exacerbating the anxiety investors are currently experiencing, Exhibit 3 illustrates four previous occasions since the mid-1980s when real interest rates increased by two percentage points, and three of them ended in a recession. With that cloud looming, and the effects of tax cuts and other fiscal thrusts likely fading, the U.S. growth picture starts to look murky at best.

Exhibit 2: Factors Leading to 45 Recessions in G7 Economies Since 1960

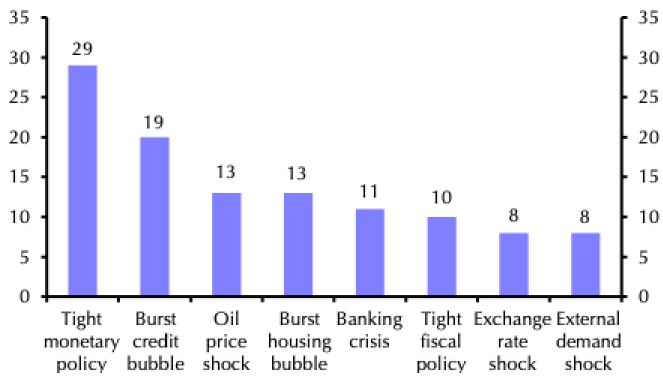
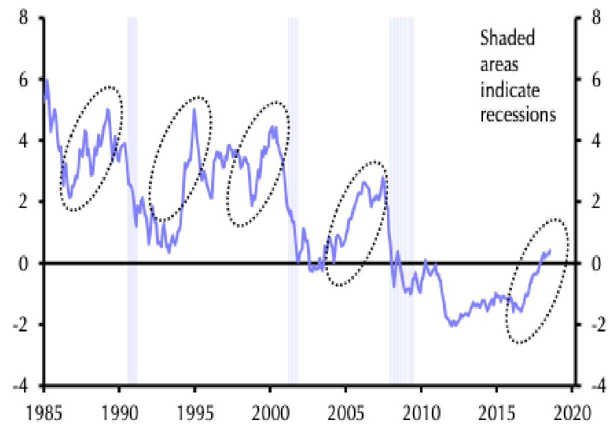


Exhibit 3: 2-Year U.S. Treasury Real Yields (%)

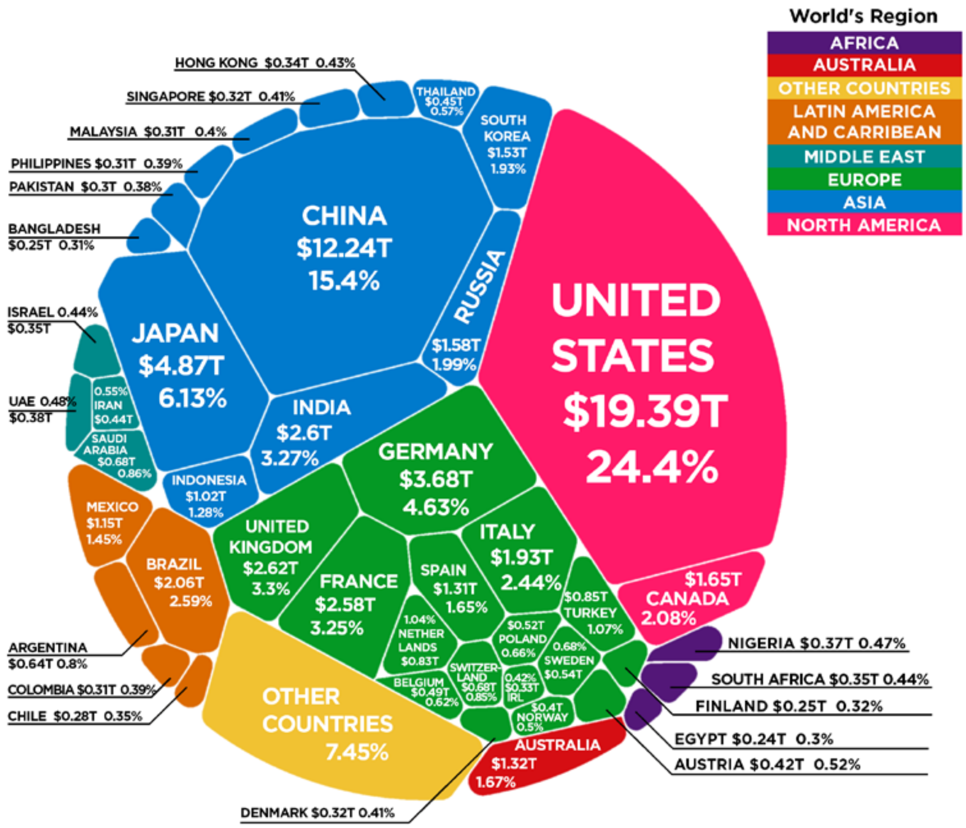


Source for both charts: Capital Economics, "What Will Cause the Next Global Downturn" by Neil Shearing, October 15, 2018

While recently posted growth numbers in the U.S. have been very strong, the International Monetary Fund recently cut its forecast for global growth, in part blaming trade tensions and stress in emerging markets. Even the U.S. growth profile appears tenuous in the face of monetary stimulus that is likely to be removed. While we are pleased with a 3% real GDP figure in 2018, there is reason to believe we're going to be on a glide path to lower growth, as our economy has rallied on the back of recent fiscal spending. That's set to expire in the coming years based upon legislative spending caps that were a part of the most recent budget process. In 2019, the real GDP growth figure is projected to dip to 2.8% and move to 1.8% for 2020-2022.[i] This uncertain environment around slowing growth may be tough to navigate for businesses and ultimately result in a hit to earnings.

Outside the U.S. growth concerns understandably center around China, though there are other problem areas as well. Italy is now questioning reform that would hamper the ability of the International Monetary Fund (IMF) or European Central Bank (ECB) to provide assistance to Italy's massive debt market should it get into trouble. Moreover, both Turkey and Argentina are facing deep recessions as a result of previous financial excesses. Still, China, and more specifically its relationship to the U.S. on the global stage, sits at the epicenter of concerns about global growth and geopolitical risks more broadly. It is made clear in Exhibit 4 below, which at a glance depicts contributions to the world economy by country and region, that China currently has the second largest GDP at $12.2 trillion, or 15.4% of global GDP. What is not shown is that it is expected to contribute 35.2% of global real GDP growth during 2017-2019.[ii]

Exhibit 4: Gross Domestic Product (GDP) by Country in 2017

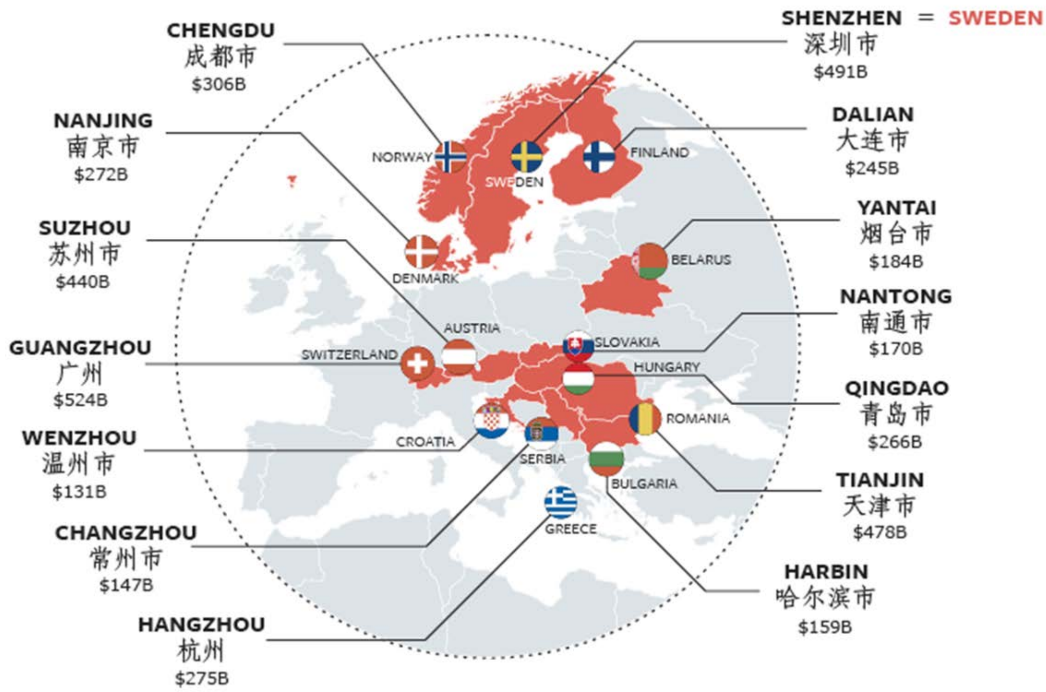


Source: HowMuch.net, "Visualize the Entire Global Economy in One Chart"

While this growth is paramount to equity and prosperity in China, where since 1990 over 800 million people have been lifted out of poverty and 10% arable land is insufficient to feed its 1.3 billion people, it is also critical to the economic foundation for the rest of the world. With the Trump administration's imposition of 10% tariffs on $200 billion of Chinese products, countered by Beijing retaliating with 5-10% levies on $60 billion of U.S. goods, a trade squabble is underway. If this becomes a full-scale trade war, as some are calling for, the hit to global equities would be significant. JP Morgan estimates that 25% levies on all Chinese imports to the U.S. would trim earnings for the S&P 500 index by $8 per share from analysts' original projection of $179 for 2019. Ironically, the onset of the trade dispute seems to have been a boon for U.S. growth in the short term, as businesses have been rushing to stock shelves before tariffs increase.

Two other dynamics worth monitoring in China involve the health and direction of its current growth profile. New data released in China suggests businesses are having a tough time lately, as evidenced by the alternate PMI Business Conditions Index produced by Cheung Kong University in association with the China Federation of Logistics and purchasing. That slowing, and China's growing troubles with the U.S., may explain China's recent shift in direction more heavily towards European engagement. In 2016, Chinese investments in Europe soared to nearly $40 billion, almost double the previous year's total.[iii] While overall Chinese foreign direct investment fell in 2017, its share spent in Europe continued to increase.

Exhibit 5: The GDP of Chinese Cities Compared with European Countries



Source: Visual Capitalist, "The 8 Major Forces Shaping the Future of the Global Economy" by Jeff Desjardins, October 4, 2018; Permit Capital Advisors, LLC

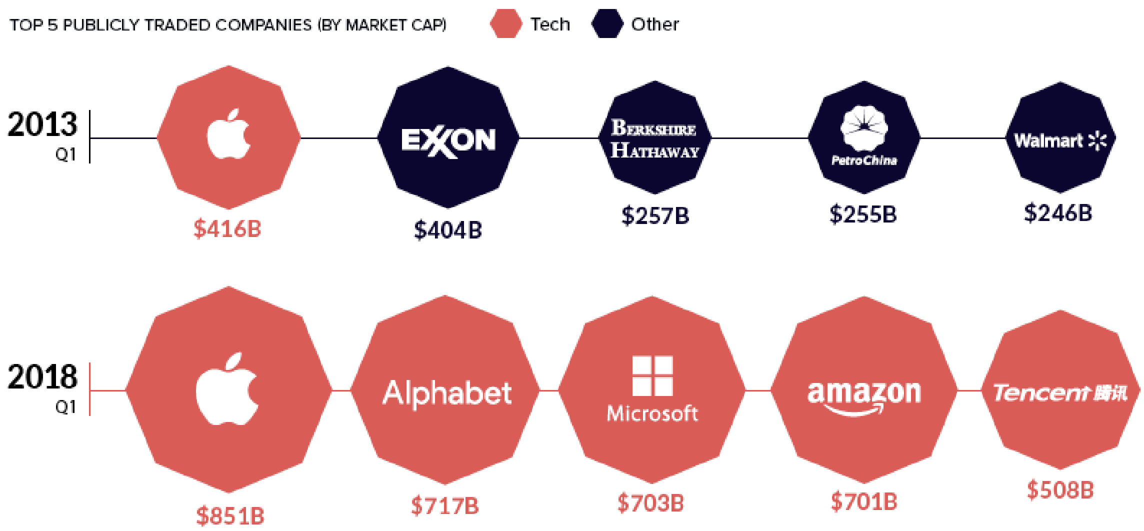
The huge influx of money has prompted leaders in Berlin, Brussels, and elsewhere to worry about the power and influence China was gaining in the process, especially in the EU's smaller countries. This would seem to be warranted given the comparative economic footprints visualized in Exhibit 5 above. Elsewhere includes the U.S. The terms on which the emerging undemocratic superpower invests in the outside world are of interest to all countries—particularly if other things, such as foreign policy, may be affected. Americans, increasingly consumed by fears that China poses a commercial threat, should be mindful of competition for the loyalties of its oldest ally.

In addition to rising interest rates in the U.S. potentially leading to a recession, slowing global growth, and China's deteriorating relationship with the U.S., one other geopolitical and economic factor to monitor is the price of oil, a price increase of which can be a tailwind for certain emerging market economies but a headwind for many consumers here in the U.S. Oil prices recently hit a 2018 high of $86 a barrel for Brent crude. This comes at a time that sanctions on Iran are just beginning and sanctions on Saudi Arabia, for the suspected killing of Washington Post contributor Jamal Khashoggi, may be around the corner.

While we are vigilant about these concerns, we are also mindful of the role that asset allocation plays in a successful long-term investment framework. This exercise of setting appropriate strategic targets and rebalancing accordingly leads us to examine two parts of a diversified portfolio that have lagged of late and now represent a smaller component of most portfolios: international equities and value equities. For reasons previously explained, along with a strong U.S. dollar that has wreaked havoc on emerging markets, equity markets outside the U.S. have struggled on a relative basis since the end of the Great Recession and on an absolute basis over the past twelve months. Over the latter period (trailing twelve months ending 10/5/18), the S&P 500 index gained +15.25%, while the MSCI All Country World ex-U.S. index declined by -1.09%, and the MSCI Emerging Markets index fell -6.79%. A combination of cheaper valuations and more accommodative monetary policy (while the U.S. is now nearly three years, eight rate hikes, and $200 billion into the normalization of Fed policy, the ECB and the BOJ continue to keep rates at or near zero) make us bullish on the relative fortunes of non-U.S. equities over the next cycle.

With respect to value equities, as compared to their growth counterparts, the underperformance has been just as significant. Dating back to the beginning of this expansion and accelerating over the last five years, growth has been dominating value. The result of this dominance can be clearly seen in a look at the top five publicly traded companies by market cap, as shown in Exhibit 6 below. This appears to be a byproduct of both exceptional technological developments along with favorable monetary conditions, and it has split investors into two camps: those who believe that value investing is anachronistic and those who are trying to identify a point at which reversion to the mean will ensue. We fall largely into the latter category.

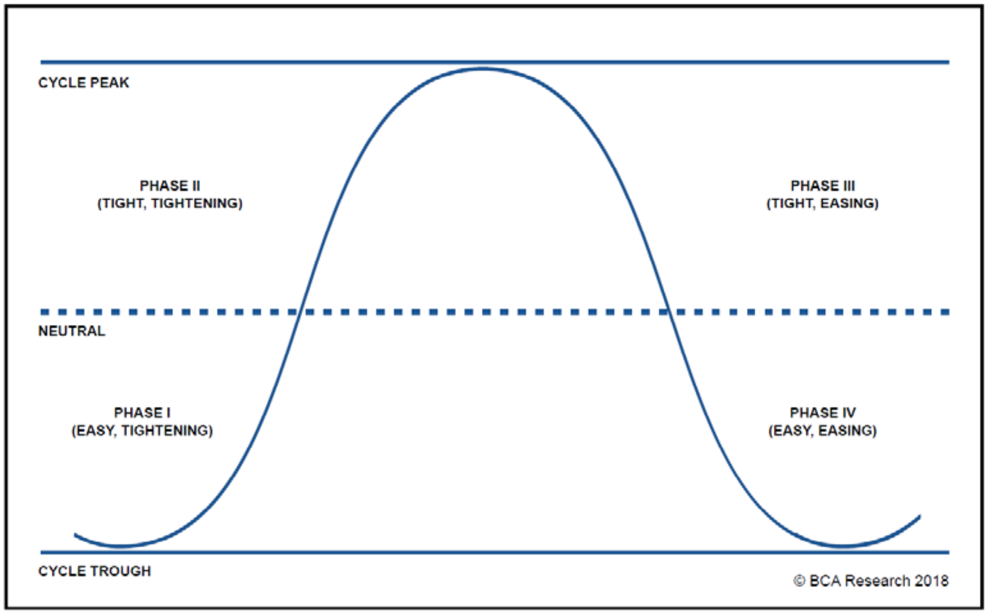
Exhibit 6: Top 5 Publicly Traded Companies by Market Capitalization



Source: Visual Capitalist, "The 8 Major Forces Shaping the Future of the Global Economy" by Jeff Desjardins, October 4, 2018

Less clear is the notion of what is the most opportune point to shift between growth and value styles, as well as how to implement the pivot in a portfolio context. Relative style performance has not corresponded reliably to business cycle, inflation, interest rates, or broad market direction. However, monetary policy stance has been a fairly reliable predictor of this dynamic.[iv] Historically, tight monetary policy has been most conducive to value outperformance. In that context, value's decade long relative slump is not a surprise given the ultra-accommodative tide that has lifted all boats. This may continue for some time, as we are still firmly ensconced in Phase I of the policy rate cycle, as shown in Exhibit 7.

Exhibit 7: The Fed Funds Rate Cycle



Source: BCA Research, October 2018

However, the clock for a pivot seems to be ticking, as the expansion is in its later stages and building inflationary pressures will continue to influence Fed action. Value investing is by its nature a contrarian exercise that plays off negative overreaction or neglect, and we believe this time will be no different. We are looking at various strategies to position portfolios to benefit from this eventuality.

Although the spike in volatility can be unsettling, especially after an unusually tranquil couple of years, it is to be expected as a normal component of market action. While we continue to focus on rebalancing within equity allocations, those of you who speak with us regularly know we are also spending significant time evaluating unique fixed income strategies that take advantage of idiosyncratic credits to offer attractive yields with limited duration risk. As always, we recommend a disciplined approach to managing a well-diversified portfolio while remaining opportunistic, both in public and private markets. Please feel free to call us with any thoughts or questions.

[i] Citi, Catherine Mann, Global Economic Strategic Challenges – 10.9.18

[ii] Visual Capitalist, The 8 Major Forces Shaping the Future of the Global Economy – 10.4.18

[iii] The Economist, China’s designs on Europe – 10.6.18

[iv] Bank Credit Analyst, Is It Time To Buy Value Stocks – 9.28.18