August 2019

Avoiding Cognitive Entrenchment

It has been said that the four most dangerous words in investing are *This Time Is Different*. The title of the post-Great Recession book written by Carmen Reinhart and Kenneth Rogoff is also a familiar refrain uttered by investors, most of whom went on to have their proverbial heads handed to them, who thought that decades of empirical data and experiences were no longer relevant to their chosen strategy. But what if it eventually is different, at least partially, and reliance upon history was the exact wrong approach to take? This is in part the subtext of another book, written this year by David Epstein, called *Range: Why Generalists Triumph in a Specialized World*. In it, Epstein explains how specialists in various endeavors rely upon mastery of outcomes tied to a narrow set of circumstances that they're able to eventually control via pattern recognition.

This ability is inherently dependent upon the notion that the domain is what psychologist Robin Hogarth termed a "kind" learning environment, in which patterns repeat and feedback is generally accurate and rapid. On the other hand, Hogarth termed "wicked" those learning environments where the rules of the game are often unclear or incomplete, where there may not be repetitive patterns, and where the feedback is often inaccurate, delayed, or both. In the most devilishly wicked environments, experience may reinforce the exact wrong reactions.

When rules are altered slightly, it makes experts who rely on a traditional decision-making framework appear as if they have traded flexibility for narrow skill. According to a study recounted in the book, when experienced accountants were asked to use a new tax law for deductions that replaced a previous one, they fared worse in the exercise than did novices. Erik Dane, a Rice University professor who studies organizational behavior, calls this phenomenon "cognitive entrenchment". In the investment world, examples of cognitive entrenchment would include anticipating recession to result from an inverted yield curve, expecting an increase in interest rates to follow a long period of extremely low rates, and assuming global leaders would do everything in their power to avoid a trade war that would surely be mutually destructive.

As we look around today, does it feel like we're operating within a "kind" learning environment or a "wicked" one? In a world in which 30% of the bonds in the Bloomberg Barclays Global Aggregate Bond Index pay interest to the borrower rather than the lender[i], do traditional measurements of interest rate and credit risk hold form? In a world in which the Federal Reserve raises rates in December amidst a full-blown equity market collapse, and then reverses course and cuts rates with full employment figures and the stock market close to a record high, does traditional analysis of monetary policy still hold? With the term premia that generally shape a yield curve seemingly distorted because pension funds and insurance companies have been forced to buy long-term assets with extremely low yields in order to avoid locking in negative ones, does an inverted yield curve tell us much about future economic growth? And in a world in which the last two global economic slowdowns were reversed on the backs of massive Chinese stimuli, will Chinese leaders follow the same playbook to keep global trade on track given the fact that they are primary beneficiary of this activity, or will they stay on the sidelines, miffed at being branded bad global citizens over their trade and currency policies?

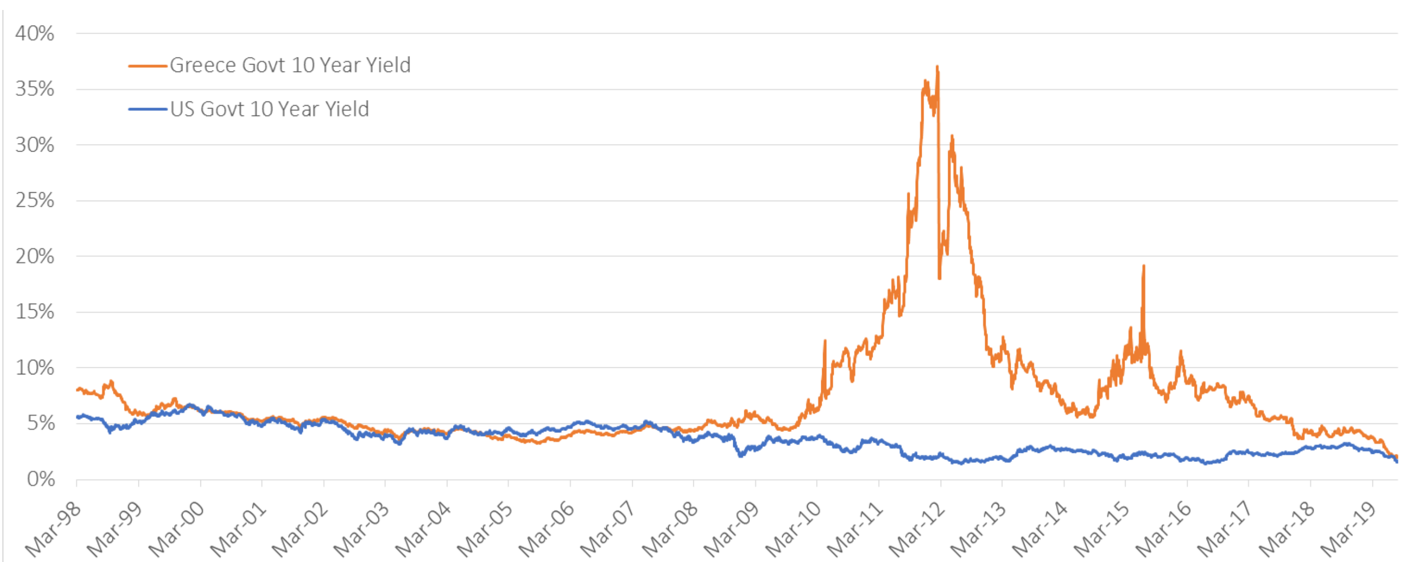
These are the questions investors are faced with as they weigh dovish central bank policies which may extend the long economic expansion, against a backdrop of rising geopolitical tensions and distorted measurements of risk. The answer may lie somewhere in between relying on historical precedent and believing that it's a whole new world out there, somewhere in between "kind" and "wicked", but the reality is we won't know until we have the benefit of hindsight. What we at PCA do believe strongly, is that the proper approach involves building and then relying upon a resilient portfolio that should withstand the volatility that inevitably accompanies any long-term investment approach.

Of Low Rates and Inverted Yield Curves

It is easy to come to the conclusion that the yield on the U.S. 10-Year Treasury is too low with it hovering in the 1.5% range. But it is harder to think of that yield figure as too low when it is compared to the yield on the Greek 10-Year bond, which recently traded at an even lower yield than its U.S. counterpart. Yes, this is the same Greece that has been in default on its external financing for nearly 50% of its time as an independent country, and in fact even managed to default before it became an independent country.[ii]

This is not a dynamic limited to Greece. Rather, in most of the euro area and indeed in other developed countries around the globe, short-term rates can't fall much further from current levels. This most likely means that the only way for central banks to ease financial conditions is to signal that rates will stay lower for longer and to buy up longer-term bonds through large-scale asset purchase programs. This naturally leads to lower bond yields and flatter yield curves. Falling bond yields in Europe and around the world have, in turn, dragged down U.S. yields.

Borrowing Costs in Greece Relative to the U.S.



Sources: Bloomberg; Permit Capital Advisors, LLC

This is not to say that more traditional factors are not at play in this low yield regime as well. Historically, prospects for growth have been a significant driver of bond yields, and we are facing a scenario in which weaker growth overseas and trade frictions could continue to cut into demand for U.S. manufactured goods, likely leading to lower rates. In fact, of all relevant economic data, the ISM Manufacturing Index has the highest correlation with 10-Year Treasury rates.[iii]

Manufacturing Has the Highest Correlation with 10-Year U.S. Treasury Rates

Economic Variables	Correlation with 10yr Treasuries
ISM Manufacturing index	**72%**
Durable Goods (%, YoY)	**43%**
Empire State Manufactruring index	**43%**
Retail Sales (%, YoY)	**40%**
ISM Non-Manufacturing index	**37%**
CPI (%, YoY)	**32%**
Conference Board Consumer Confidence	**13%**
Nonfarm Payrolls (000s)	**-5%**

Sources: Bloomberg; Piper Jaffrey, "Economic Brief," August 12, 2019

Technical factors also point in favor of low yields staying low. There is still a substantial speculative net-short position on the U.S. 10-Year, meaning the market is nowhere near the extreme net-long position that would normally augur a big sell-off in bonds. While this analysis does not mean we are rushing to add duration, or interest rate sensitivity, to our clients' portfolios, it does make us comfortable holding a portion of our fixed income in longer-dated securities. Even Treasuries, or other sovereign bonds, which do not offer much in the way of yield-generated return, do offer a level of protection against a deflationary scenario that makes them a reasonable arrow to maintain in the quiver of the aforementioned resilient portfolio.

Much has also been made of late in the financial press about the inversion of the yield curve, most recently at the heavily watched 2-year/10-year point. This is an understandable point of consternation, as the historical prescience of an inverted yield curve as a harbinger for a recession has been well documented. But, given the factors that have brought down yields on the long-end of the curve, including heavy buying by foreign investors flocking into the U.S. bond market as yields turn increasingly negative in Europe and Japan, it is fair to ask if this inversion is more likely to be signal or noise. Even if form holds, the timing of the future downturn can be hard to predict, as recessions presaged by yield curve inversions can take up to three years to manifest.[iv]

With regard to inverted yield curves and low-if-not-negative yield regimes, it is important to think of not only cause but also effect. For example, banks, which depend on the positive spread created by their ability to borrow at short rates and lend at long rates, are vulnerable. What we have seen thus far in various parts of the world is that banks have been hurt by a reduction in net interest income and, up to this point, they have been unable or unwilling to pass this diminishing spread on to their retail customers. With reduced income from their security holdings and a potential loss in income from reduced credit creation, the balance sheets of banks could be poised to weaken. As we have seen across the eurozone, Scandinavia, and Japan, banks in countries that adopted an extremely low or negative interest rate policy have been brought to their knees, and without a healthy financial sector, it has proven extremely challenging for these economies to grow.

Value Versus Value

Of course, difficult circumstances do not necessarily mean there aren't opportunities to carefully mine. In Europe, it may be that there is relative value because sentiment has become too bearish. Earnings expectations in Europe appear to have fully priced in the risks of slow growth, and the European risk premia (the expected excess returns for equities relative to government bonds) are similar to those of riskier emerging markets. Meanwhile, European stocks currently trade at an approximate 20% valuation discount to those in the U.S., near the widest level since 2010.[v]

If indeed we are in a "low and getting lower" rate environment, then there are potential lessons for U.S. investors from markets in the euro area, Japan, and Switzerland, where over the past decade this has become the new normal. One such lesson has been the value placed on alternative sources of yield, including core commercial real estate, where in the U.S., property yields have not declined to the same extent as government bond yields over the past year.

Other sources of value appear to be private credit strategies that step into a void created by a pullback in bank-related risk taking, especially credit strategies tied to the consumer. Particularly consumers in the U.S., who have lower debt burdens on average than businesses. Indeed, consumer confidence remains high even as economic growth is slowing.

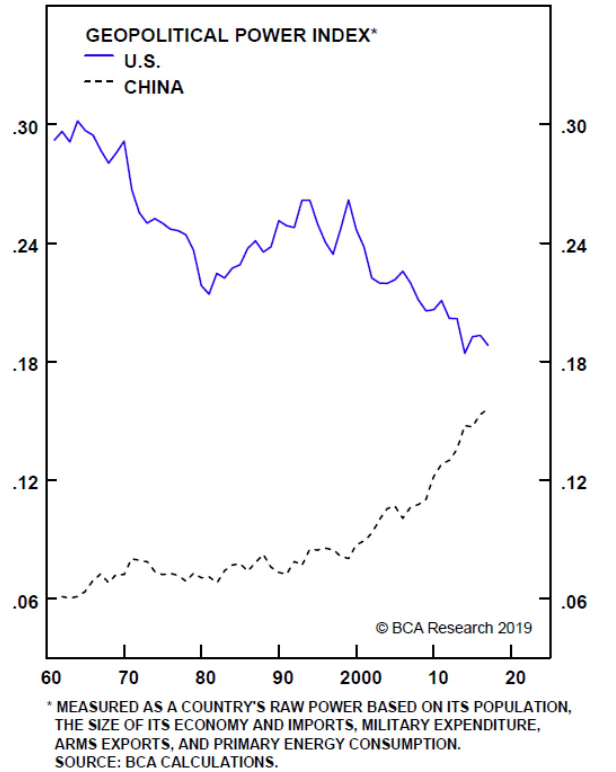
Ironically, one area that might be premature to call value is value equities. Despite the fact that valuations relative to growth equities are cheap as a byproduct of, on average, two percentage points per year of underperformance over the past 12 years, if interest rates stay at paltry levels it may not bode well for the value style of equity investing. Low interest rates tend to encourage risk-taking amongst market participants, and that tends to translate into a favoring of growthier sectors, including technology.

The Trade Skirmish

While much of the oxygen in discussions about geopolitical, economic, and market developments of late has been sucked up by proclamations about the impact that the current trade-related negotiations between the U.S. and China will have on those countries and the rest of the world, the dirty truth might be that the dustup is only marginally about trade. It should perhaps more broadly be seen as a battle for predominance in a now multipolar world of competing powers and spheres of influence. Perhaps these tensions should be seen as not only inevitable but perhaps here to stay, for years, if not decades.

It is likely wrong to think of the outcome of the trade war as binary. It is more realistic to think that neither a comprehensive solution nor a full-blown war is likely. As far as likely damages, initially they are likely to come in the form of indirect impacts, such as a hit to business confidence and investment rather than a meaningful direct effect on trade flows. These indirect effects can be hard to measure, and further, they can extend beyond the countries which are imposing the tariffs on one another.

The Era of Unipolarity Is Over

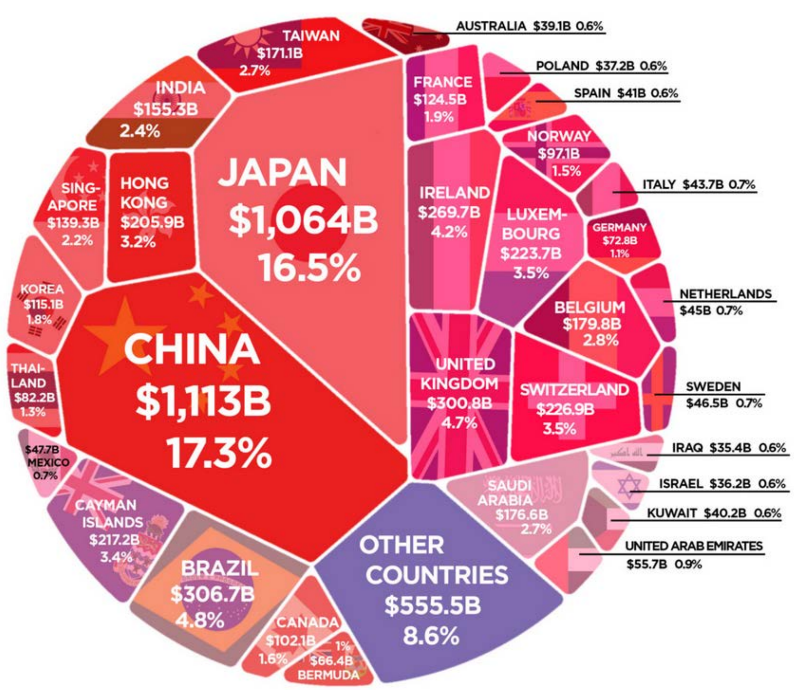


Source: BCA Research, "Global Investment Strategy," May 16, 2019

One indirect effect that would not be hard to measure would be a decision by China to "weaponize" its large holdings of U.S. Treasury securities by applying selling pressure as a form of retaliation for actions by the U.S. that it considers to be unfair. With over $1.1 billion worth of Treasuries in its coffers, China is the largest non-domestic holder of what might be our country's most strategic asset.

Further complicating U.S.-China relations is the situation that has been unfolding over the past ten weeks in Hong Kong, where huge anti-government protests and strikes have shut down key systems and transportation hubs. While the absolute number of protesters has fallen from an estimated 2 million who marched in the streets on June 16 to roughly 350,000 strikers currently, the tactics of the masses have become increasingly violent. As the protest methods have changed, so have the objectives. What began as opposition to a bill which would have allowed for the extradition of suspects in Hong Kong to mainland China, has evolved into a revolt against the local government and, for some, against Chinese rule itself.

Countries That Own the Most U.S. Debt



Major foreign holders of treasury securities holdings at the end of April 2019
Sources: Visual Capitalist, "Which Countries Own the Most U.S. Debt?", July 2, 2019; HowMuch.net; U.S. Department of the Treasury

China is no longer as directly dependent on Hong Kong for its economic welfare as it was at one time, when foreign firms operating from the territory and the access to international markets via the Hong Kong port were critical. At the time of the handover in 1997, the territory's economy was equivalent to nearly 20% of China's. Today the figure is 3%, and the port is no longer a necessary step in shipping goods from the mainland.[vi] The fear is that this lack of dependence will empower the Chinese government to be more aggressive in its handling of the protesters, and that bloodshed would pull other powers, including the U.S., into the fray. Indeed, Hong Kong has already become a factor in the escalating cold war between China and the U.S. China is enraged by the high-level reception given in recent weeks to leading members of Hong Kong's pro-democracy camp during visits to Washington, and their meetings with senior officials and members of Congress have been cited by China as evidence that the U.S. is a "black hand" behind the unrest.

Build to Last

As stated, we believe that careful analysis and thought should be applied before reflexively assuming that we are hurtling towards an imminent U.S. recession, a sudden spike in interest rates, or an all-out global trade war. But, that does not mean that we are sending out the all-clear signal either. We already know we are in a world in which German industry is in recession, Asian exports are contracting, the U.S. ISM Manufacturing Index is close to a three-year low, and the possibility of a "no deal" Brexit seems more likely. None of these are expected to promote sound sleep for investors responsible for making portfolio allocation decisions. But success in investing, achieved by way of successfully satisfying ones' financial goals, is generally attained by virtue of actions taken, or not taken, in response to the unknown. For now, we believe that what that means may differ from what some market observers declare. What does promote sound sleep in our mind is the comfort associated with a resilient portfolio, built upon a diversified set of investments with a mix of uncorrelated strategies, designed to narrow the range of outcomes in an increasingly outcome-uncertain world.

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[i] JP Morgan, "Flows & Liquidity: Negative Rates Are Neither Necessary nor Unavoidable," August 16, 2019
[ii] The Leuthold Group, "When a Cut is Not Enough," August 2019
[iii] Piper Jaffray, "Declining Exports to Drive Rates Lower," August 12, 2019
[iv] Capital Economics, "Yield Curve Inversions Are Blind in One Eye", August 15, 2019
[v] iShares by BlackRock, "Investment Directions," Autumn 2019
[vi] The Economist, "Seeing Red," August 10-16, 2019