BEACON POINTE

“THE APPRENTICE” – DISSONANCE OUT OF DC

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Beacon Pointe
Investment Commentary
Asset Allocation & Portfolio Strategy

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- **Turnover in the Trump cabinet. The government shut down. The President has privately discussed firing the Federal Reserve Chairman. The Treasury Secretary attempts to calm markets by convening the “capital markets group” to discuss market volatility.**
- **US equities are flirting with bear market territory.**
- **Risk aversion - and political risk - is rising. Many investors are asking: Is it time to sell?**
- **Our view: if we do not enter a recession in the coming quarters, we think that the current market environment may present an opportunity to add to risk positions.**

The market was expecting a “holiday rally”, and we are not getting it. The tug of war in the markets continues between the current, good economic news and concerns related to future economic growth. The incoming economic data remain solid with above-trend GDP numbers, low unemployment and high consumer confidence. In aggregate the data has been good for a very long time - we are nearing one of the longest cycles on record.

It is not unusual to see increasing volatility at this late-stage in the cycle. Investors have become skittish, reacting more powerfully to negative news, and market moves are exaggerated by poor year-end liquidity conditions and program trading. The yield curve - a good indicator of recession probabilities - has flattened as the probability of a recession in 2019 has increased. The main issue investors face is the possibility that volatile markets become a self-fulfilling prophecy as declining stock prices tighten financial conditions, lowering the growth outlook further in 2019. We see an economic slowdown in 2019. We do not anticipate a recession.

The proximate cause of the recent market sell-off can be traced to turmoil emanating from the White House. The sell-off last Friday was caused at least in part by the resignation of well-respected Defense Secretary General James Mattis. Treasury Secretary Mnuchin attempted to calm markets by calling the CEOs of the six largest US banks to inquire about credit and liquidity conditions. His efforts backfired, and markets moved decisively lower on Monday as market participants questioned why he needed to make that call – does the Treasury Department know something we don’t? We should not expect the Treasury Secretary to take this kind of action absent a major impairment in banking and credit, and our view is that credit markets are currently functioning well.

News reports over the weekend suggest that President Trump has privately discussed firing Federal Reserve Chairman Jerome Powell, a move without precedent. Although appointed by Trump, it is not clear he can easily remove him. The markets would react very poorly if Trump tells Powell “You’re FIRED”. We believe that cooler heads in the Administration will prevail and Powell will remain at the Fed, although he could conceivably resign in frustration as did Defense Secretary Mattis last week. A statement from the White

House supporting Powell would be helpful. We expect this. We don't expect the tweets to stop, and therefore the uncertainty surrounding Fed independence will remain.

What to do? Ignore the current news flow and focus on the current, strong economic fundamentals? Or change course and reduce risk? Some drivers of the sell-off are temporary and will fade, others are not. Year-end liquidity constraints will fade. On the other hand, we are in a new, less accommodative monetary policy regime as global central banks normalize their balance sheets, while the Fed commits to raising rates. We believe balance sheet adjustment will continue, removing the positive tailwind of global QE.

However, the Fed's commitment to raise policy rates is not a foregone conclusion. It is unclear how long they can stay on the sidelines - equity markets desperately seek the relief that would result from a dose of soothing Fed rhetoric. The recent decline has provided cover for such dovish remarks. The Fed's summary of economic projections released just last Wednesday will soon prove overly optimistic should the market sell-off persist, dampening growth via negative wealth effects and subdued business confidence. The Fed can use tighter financial conditions to put forth a "real economy" argument and positively jawbone markets. We expect this to occur if markets do not right themselves on their own.

Unfortunately, the Trump administration, by directly attacking the Fed's rate hikes, is not making it easy for Chairman Powell or any other Fed representative to sound dovish. The Fed cannot afford to appear like it is caving to political pressure - the loss of perceived independence would make the central bank's job that much harder in the future. But current market conditions may force their hand. And while the Fed has steadfastly refused to admit just how much monetary policy is affected by equity price movements, the academic literature tells a compelling story - that equity market moves do affect monetary policy [1]. We expect the Fed is (almost) done raising rates for now; if the stock market does not rebound the next move is more likely to be a rate cut. Our outlook for Fed rate hikes has always been less than the "dot plot" implied and the market is now coming around to that view, and, we believe, so is the Fed. We expect relief in the form of dovish Fed-speak, and more should "talk" not prove effective. We further expect that the political dissonance from Washington will persist and intensify as Democrats take control of Congress, offsetting any positive catalyst provided by central bankers.

It is important to recall that equity markets have always been volatile, and the current sell-off, while painful, comes after an unusually long bull market run. Furthermore, lower equity prices today do imply higher equity returns in the future. Our view of the macro environment suggests that, barring an earnings recession, the stock market currently trades at valuations that have historically been viewed as on the "cheap" end of the "rich-fair-cheap" scale. Other asset classes including emerging market equities and bonds have also seen a shift in their relative attractiveness in the current sell-off. Our views of the major markets are summarized below.

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[1] "The Economics of the Fed Put", Anna Cieslak and Annette Vissing-Jorgensen.
A quote from the paper: "Negative stock returns realized between FOMC meetings are a more powerful predictor of subsequent federal funds target rate changes than almost all macroeconomic news releases." Although not explicit, it is interesting how much the Fed actually focuses on stock market movements.
http://faculty.haas.berkeley.edu/vissing/cieslak_vissingjorgensen.pdf

We like US stocks at 14x earnings for the long-term, but the ride will be bumpy. US bonds are no longer "dead money" with yields that provide income and a recession hedge. International developed stocks are not preferred given the political uncertainty in Europe. Emerging market stocks are preferred over international stocks on valuation. Emerging market debt is preferred over developed market government debt.

It is times like this that require a clear-eyed look at fundamentals and valuations, and to determine whether there has been a thesis violation relating to any of the major investment themes that have guided our thinking to date. In effect we are asking, "does the recent market volatility violate any of our longer-term beliefs about asset class returns, or violate any longer term investment themes that would precipitate a material asset allocation shift?". Our answer is "No". We think the market will right itself, and that Fed will come to the rescue if needed. What would cause us to re-think investment in risk assets? Increasing political risk in the US or a clear recession signal - indicative of a Fed policy mistake - would cause us to increase cash levels and reduce risk assets further than that already imposed by the market decline. Acting unemotionally requires discipline and a commitment to rebalance when opportunities arise.

Volatile markets provide opportunities as prices fluctuate. We at Beacon Pointe, and the investment managers we work with, are consistently analyzing the macro environment and valuations and remain on the lookout for such opportunities.

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