Market Reset

It is About Time, Because it Has Been a Long Time

Transitioning "Lower for Longer" to Balanced Investing

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John D. Coombs
Member of The Poindexter Group of Oppenheimer & Co. Inc.
Senior Director – Investments
Senior Portfolio Manager,
OMEGA Group

Just about 34 years ago, I got into this business. At that time the investment agenda between client and portfolio manager (especially when that PM was a rookie) was actually quite simple.

The 10 year FDIC backed CD's were yielding over 13%, fixed rate.

At the time, while stocks as an investment still did exist, and had been showing signs of coming out of their long, multi-year hibernation (since the bear market bottom of 1973-1974, which was one of the worst on record), how did you compete with a fully government backed 10 year fixed rate CD of over 13%?

Simple answer...

...You did not!

Unlike the financial markets of these last 8-10 years, back then "savers" did not need to pretend to be "investors"; today's "lower for longer" interest rate levels unfortunately have not afforded that same luxury to the most current version of "savers".

The toughest part of the whole investment experience at that time was getting those savers who had witnessed the Federal Reserve under Paul Volcker dramatically and repeatedly raise rates to commit their money to 10 year Treasuries. I remember responses such as "I am afraid rates are only going to go higher", "what about inflation and locking my money up for so long?", etc. (Funny how "savers" worry about time as a risk, yet "investors" worry about price).

In other words, at a time when the conditions in the financial markets had quite emphatically changed, most of which had long term positive implications, many investors still resisted resetting themselves and their expectations. They were guilty of trying to move forward by watching in the rear view mirror.

But, enough folks listened to what I had to say and my career began. Now, 34 years later, I am here to tell you, in my opinion, that as the financial markets and investor behavior/participation were resetting themselves back "then", the very same mechanics of change and "reset" may very well be at work today. And, if that is indeed the case, accordingly, astute and especially prudent investors must heed the simple fact those times are changing and so must their investment methods and performance expectations; being reintroduced to the time tried concepts of balance, diversification, and valuation while eschewing momentum. Keep in mind, that diversification does not guarantee a profit nor protect against a loss.

Actually, it is not as simple as I have just outlined.

The resetting process is really about things as we have known them first actually having changed, followed then by the acknowledgment from investors and market observers that things have indeed changed. (This gap between actuality and acknowledgement may often be a time of great volatility and even violent market behavior)

And then there is that "thing", that entity, known as "the market".

Market Reset? Perhaps for our purposes, and in the interest of the readers of this letter, it is really more about investor reset. More specifically, we may need a change in mindset.

In my opinion, the financial markets tend to discount the future with a collective eye and "wisdom" of its many participants, attempting to assess present value to that which is perceived as the future, interspersed with bits of myopic distraction. Fighting against those inherent market qualities are the "savers", the "investors", even the "speculators", who in varying degrees tend to the seek the market comfort of "what was", instead of the "what will be". That is, until they are forced to change.

When markets begin to discount new and changing macro conditions, they often go through a metamorphosis of sorts. Until there is a trend established in those financial markets between the "give" and the "take", at the outset of such change, there tends to be a lot of doubt, I believe, conveyed in the form of time, price or both. (Recall what I said at the outset about my early clients being concerned toward 10 yr fixed rate, insured CD's at 13%!)

For the purposes of this piece, I call it a market "reset" and subsequently, an investor "reset".

Just about 9 years ago, the Federal Reserve, in response to the US financial system coming under great systemic distress, ushered in the era of "zero interest rate policy". (In actuality, when one considers inflation, what are called real interest rates, yield levels were actually negative, net after inflation). While such levels had been seen before (the early 1960's come to mind as having had very similar Fed policy), the sheer length of time which such monetary policy had been in force was unprecedented. What had been intended to both shock and stimulate the US economy into growth through its financial markets, for the better part of the last 9 years, appeared to have worked better on the latter than the former.

Since March 2009 the S&P 500 index rose from less than 1,000 to over 2,000 and bond yields on the 10 year Treasury bottomed at 1.35% in the summer of 2016. While past performance is no guarantee of future results, many asset categories saw major advances in prices. With no real global economy yet able (or willing) to compete for that overly abundant pool of liquidity, it had truly only one place to go.

Asset inflation.

Think about it.

I had to struggle as a rookie in this business getting clients and potential clients to invest their money in government backed, 10 year CDs at 13.25% (to be exact), but approximately one and a half years ago, the "collective investor" was willing to buy US 10 year Treasury debt at approximately on tenth of that 1984 10 year CD yield.

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My conclusion?

It was that today's investors, had become convinced, if for no other reason than length of time in existence, "lower for longer" interest rates were here to stay. How else could one explain and justify both the current equity market valuations and the willingness to buy such low bond yields in the debt markets in 2016? (That being said, the 10 year Treasury hit its all-time low yield mark in summer of 2016 of 1.35%. By the end of that year, those same 10 year Treasuries were yielding almost 2.70%. The change in Fed monetary policy toward less accommodation playing no small part....early signs that what had worked up until then as an investment agenda, perhaps was about to change?)

In November 2016, this country elected a new President who was viewed as favoring a "growth agenda". By summer 2017, both the US and global economies began to expand at rates not consistently seen since before the last recession; the term "synchronized global expansion" became popular around this time.

Keep in mind that this second half of 2017 was a pre-tax legislation time period, yet corporate earnings began to rise at a rate far in excess of that which had been expected. Through the combination of such earnings growth being generated by actual global growth acceleration, the prospect of higher interest rates and rising inflation appeared more than ready to challenge "lower for longer".

Change in the form of market and investor "reset" I believe will occur. In my opinion, three key and major possibilities are now confronting the financial markets and investor expectations: 1) "lower for longer" interest rates, now rising, are going to become less and less accommodative for higher equity prices; 2) the investment agenda of not just the last 8-9 years, but the last 34 years of cyclically falling interest rates is coming to, or indeed has come to, an end; and 3) equity only investors, facing higher volatility in their respective markets, might have to acquiesce to the concept of including debt and/or cash investments to temper such volatility in their portfolios. If any combination of the first two points actually becomes realized, then the long term implications on asset values could prove to be profound; the logic being simple….that which had been inflated by interest being so low, now stood to feel the forces on some level of deflation due to those interest rates now rising.

And what if "lower for longer" in time becomes "higher than expected" (as it pertain to interest rates)?

After this past January, which exceeded all or most expectations for market performance, the financial markets did indeed "reset" in February in the form of an equity market correction. The prospects for higher interest rates, in part due to growth, and in part due to an increase in inflation expectations, had risen. As Treasury yields on longer dated maturities moved (it was not long ago that the dominant talk about the Treasury Yield Curve was that it was flattening) closer and closer to the 3.00% mark, talk of their impact on equity prices grew.

I believe that we are now at a point in time, very similar to 1983-1984, when the financial markets have begun to change. Whether investors, "savers disguised" as such, or even as speculators allow their collective market calculus to morph or reset, we could very well be seeing such change already underway in the actual markets themselves. If for no other reason, look at how much more volatile January and February 2018 have been when compared to all of last year. Et tu, March?

The last 30 years or so, in my judgment, had been dominated not so much by rising equity prices as they had been by the major secular cycle in interest rates and the rate of inflation falling. What else could as fully explain these last 8-9 years of mediocre economic growth, even as S&P 500 index has risen so dramatically? Corporate profits on record net margins go a long way toward such an explanation. However, the common link between the fundamentally based rise in equity prices of the 80's, 90's and early 2000's compared with liquidity based rise in equity prices since March 2009 is that of falling interest rates.

In that most recent time period (March 2009 until the Present), those rates did remain lower for longer than anyone had anticipated. Now the investment agenda based on such a mindset is changing. The global economy is the newest guest to the party and it is competing in no small way for its share of that giant pool of liquidity, which the financial markets once had all to themselves. As Treasury yields and the prospects of inflation rise, perhaps what we may see in my opinion, is a more defensive, former momentum-driven, "equity-only" investor along with a collective market stance based on "higher than most expect" (interest rates). Such a "reset", should it unfold, would no longer allow, let alone reward the graceful, momentum-driven rise in stock prices, as many had gotten used to, simply due to expanding P/E ratios. But what would be allowed and increasingly sought after is the increasing justification and inclusion of bonds (especially shorter to intermediate maturities) and even cash into a well-balanced portfolio.

It is about time!

John D. Coombs
Senior Director – Investments
Senior Portfolio Manager,
OMEGA Group

Oppenheimer & Co. Inc.
30 Penhallow Street, Suite 100
Portsmouth, NH 03801
(603) 383-8054 Phone
(603) 436-7721 Fax
(800) 863-5434 Toll Free
john.coombs@opco.com
http://fa.opco.com/john.coombs