April 2019

INVESTMENT PERSPECTIVES

Connections

In the late 1970s, the BBC presented a 10-episode documentary, hosted by James Burke, which cleverly and creatively linked aspects of modern life to series' of seemingly unrelated historical events. The crux of the show contended that the development of a particular aspect of the modern world could not be viewed in isolation. Instead, the entire gestalt of the modern world stems from an intricate web of interconnected events. Each event comes about because an individual or group, acting for isolated reasons (e.g., profit, fear, curiosity, belief), impacts the course of history without any understanding of how their actions would interact with others to shape modernity. The interplay of the results of these isolated events is what drives history and innovation. Financial markets work in much the same way, with millions of actors behaving in ways unique to their own needs. Amazingly, these billions of independent decisions coalesce into market prices and economic trends. Asset prices and economic data are inextricably linked, as are the prices of different classes of assets (e.g. stocks, bonds, commodities). In our previous Investment Perspectives, we discussed the trauma of asset prices in the fourth quarter with a hint of its cause. With the benefit of time, we now have a thorough understanding of the cause and effect. In this paper, we will discuss the interconnectedness of economics and financial markets and how the same data is being interpreted in very different ways by various market participants. Although we've discussed it before, the growing importance of investor sentiment warrant further exploration. We will elaborate on the connection between the mood of the market, price volatility for stocks, bonds, commodities, and diminished market liquidity.

Because the stock and bond markets are sending such different signals about the future, we will explore these expectations; one critical expression of bond investor pessimism is the recent yield curve inversion[1], which contrasts with rising price-to-earnings multiples on stocks. As always, we will pull all these topics back to their relevance in our decision-making and portfolio construction process. Even though asset prices are virtually unchanged from levels seen in September 2018, much has happened over the past six months, with price behavior not seen in over 70 years.

- December 2018 was the worst month of December for equities since the Great Depression
  - Equity mutual funds experienced their most significant outflows of investor funds since 2009; this cash fled risk markets and went into money market and risk-free assets
- The first quarter of 2019 was the best quarter for equities since the 2008 financial crisis
  - Performance drivers included: robust employment data, the Federal Reserve's shift away from tightening, a weaker US dollar, and a recovery in oil prices
  - As is common after a sharp sell-off, the best-performing stocks were among the lower quality issues

The conditions of the fourth quarter 2018 set the stage for the unusual rally in the first quarter of this year. The recovery in stock prices reflects the Fed's change in policy, but also realization that it's not all doom and gloom for the US economy.

The Triple Threat

What caused the dramatic equity sell-off in the 4th quarter of 2018? What motivated the Fed's abrupt about-face in policy? A confluence of tightening financial conditions provoked reactions across multiple markets. A combination of three factors conspired to produce a market seizure. The US Treasury was issuing a tremendous amount of short-term debt, and the Fed was raising rates to make that debt more attractive. At the same time, the Fed was draining liquidity from the

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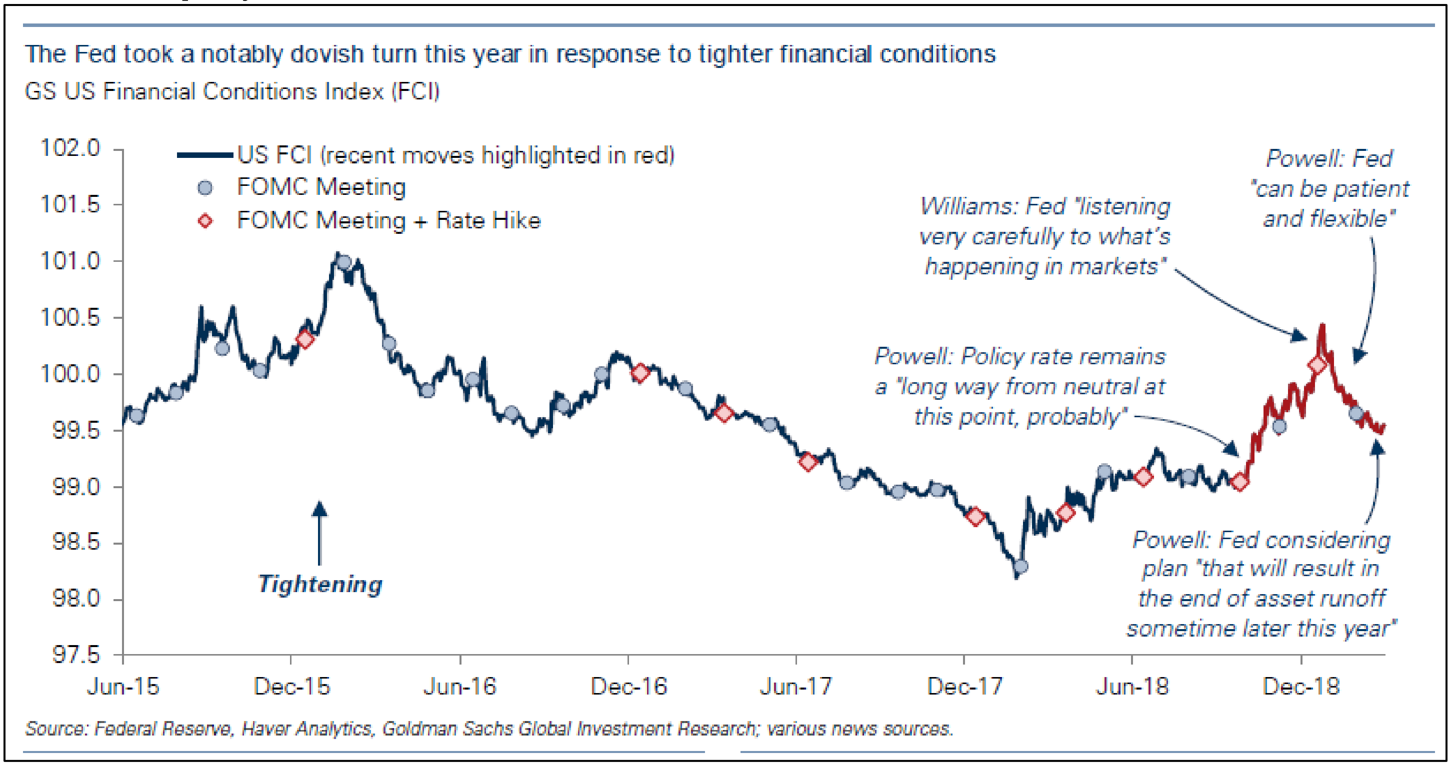
[1] Under normal economic conditions, the interest rates on longer term bonds are higher than the rates on shorter term bonds. The higher yields are compensation for higher risk. Inflation erodes the purchasing power of money, making currency held today worth more than it will be worth in the future. When investors think economic growth is slowing dramatically, and their inflation expectations decline, they aggressively purchase long-term bonds; in extreme cases, this can push the yields on longer-term bonds below shorter-term yields, a state called ***Yield Curve Inversion***.

financial system by reducing its balance sheet[2]. This was such a meaningful reduction of market liquidity that it provoked an exodus of money from nearly every risky asset. We think it caught investors off guard to see the US Treasury issuing so much debt this late in the economic cycle. This heavy issuance came at a time when the Fed and foreign buyers had stepped back from the market. The yields on all this new debt issuance rose to high levels in order to clear the market. This was a contributing factor to the US yield curve inversion—rising short-term rates coincided with declining long-term rates, as bond investors grew pessimistic over economic growth. One of the Fed's critical mandates is maintaining financial stability, and the three-part liquidity drain caused the financial system to freeze, disrupting stability and prompting the Fed to reverse course.

- The modern global economy is highly dependent upon liquidity
- This liquidity amounts to 40% of worldwide GDP



The bond market and the equity market are behaving in ways that send distinctly different messages; with equity markets near all-time highs while the yield curve is inverting, suggests some confusion. Investors all have access to the same data, so the difference can only be attributable to variations in sentiment. In our opinion, the role of investor sentiment has never been so impactful.

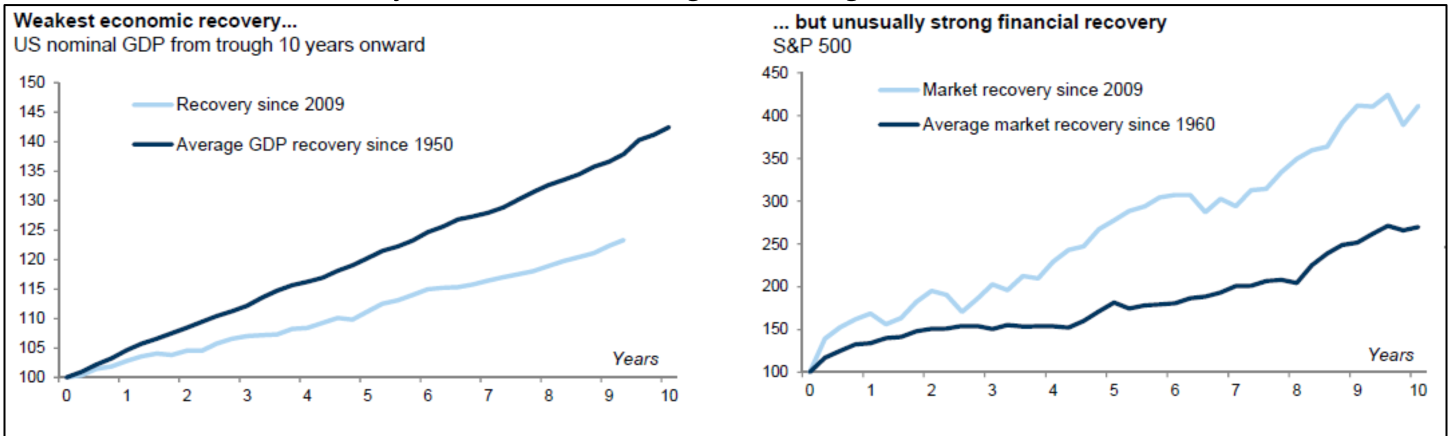
The Power of Sentiment

Why would disposable income be rising while consumer spending is declining? Despite ten years of stable economic growth and bull markets, why do companies continue to play it safe, buying back stock rather than taking risk? How much companies and individuals <u>can</u> spend depends on past success, but how much they <u>choose</u> to spend depends on their expectations of future success. When economies and markets are stable, investing feels predictable. Predictability brings a feeling of control. Perceptions of control bring a propensity to spend and to take risk. This is a self-reinforcing cycle as data and sentiment interact. When investors and consumers feel less confident, they tilt toward assets with a closer conversion to cash. Nervous consumers save more of their wages rather than spending while uncertain investors are more inclined to sell than buy. Declining prices bring fear, discouraging buyers and lowering market liquidity. Lower liquidity can mean disorderly prices, fueling higher volatility. This is why there's so much attention paid to volatility. Market prices don't always behave in an orderly fashion, as prices can decline sharply with changes in sentiment and diminished liquidity, even when fundamentals are unchanged. Economic data come in both "hard" and "soft" forms. Hard data are quantitative measures like GDP, inflation, wage growth, etc. Soft data are survey-based, measures of expectations such as

[2] During the post-GFC period, the US Federal Reserve purchased $4.5T of fixed income securities from the open market in its plan to raise liquidity and reduce interest rates. Beginning in October 2017, they allowed maturing bonds to run-off their balance sheet at a rate of $50bil per month; the actual maturing value of bonds average only $28bil per month in 2018.

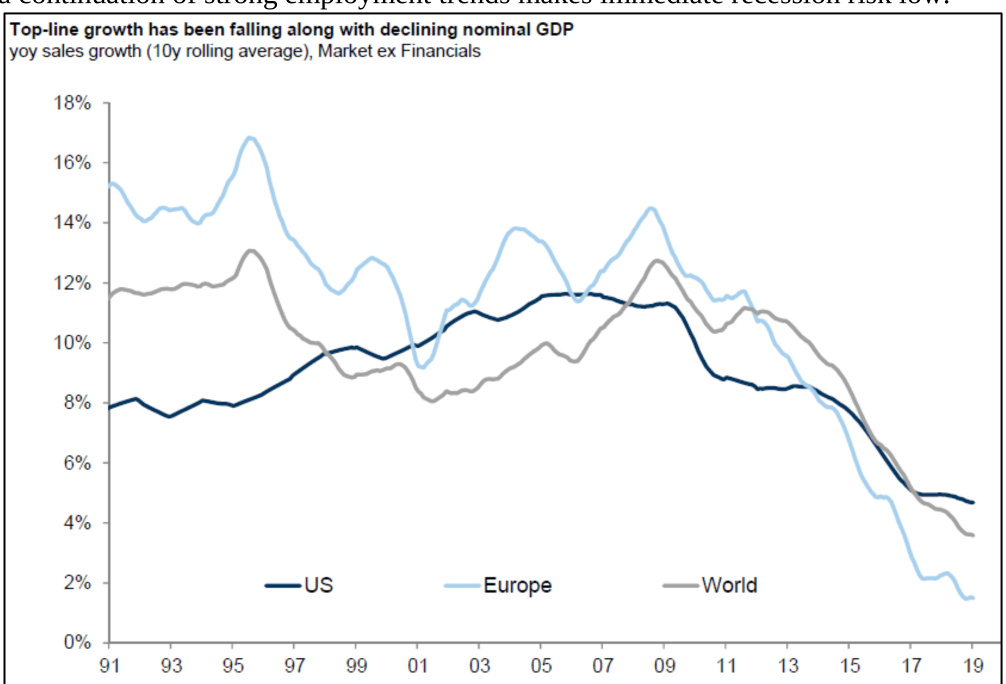
consumer confidence. At the same time that investors were embracing risk, there was a sharp departure between hard and soft economic data, with quantitative measures increasing only slowly while survey data exhibited growing optimism. Simultaneously, equity markets climbed to all-time highs in September 2018 on the back of growing investor enthusiasm--September 2018 was the least volatile month since 1964. However, as we've discussed before, sentiment can be fleeting, and within weeks volatility had spiked to 25%, its highest levels since 2011. Before the December sell-off, we had been in the longest rally for balanced portfolios[3] in 100 years.

Company Fundamentals: This has been an unusual recovery for stocks and for the economy, with stocks performing much better than the real economy. We attribute this divergence to rising investor sentiment.



Source: Haver Analytics, Datastream, Oscar Jorda, Moritz Schularick and Alan M. Taylor, Goldman Sachs Global Investment Research

Stock prices rise through a combination of earnings growth and price-to-earnings multiple expansion. Earnings per share (EPS) growth is a function of increasing sales and profit margin expansion. This cycle has generated EPS growth of 6% p.a., consistent with previous recoveries, but the sources of that growth were quite different; historically, these drivers are 70% sales growth and 30% margin expansion. During this recovery, that mix was upside down (40% sales growth and 60% margin expansion). With sub-par economic growth, companies did not have the benefit of strong sales growth, so they focused on cost reduction. Low interest rates, technology-driven efficiencies, and low wage growth pressure were the pillars under this margin expansion. Even though EPS growth is slowing, following the stimulus provided by corporate tax cuts, we think a continuation of strong employment trends makes immediate recession risk low.



Source: Worldscope, Datastream, Goldman Sachs Global Investment Research

[3] A typical balanced portfolio is 60% stocks and 40% bonds.

When growth in the economy is scarce, equity investors will crowd into those select stocks of companies able to grow sales at rates exceeding GDP growth. During an extended cycle like this, investors are paying ever-higher valuation multiples to gain exposure to growth. There is a very close connection between economic growth expectations, government bond yields, and equity style selection. The sustained period of low economic growth, leading to weak sales growth, has prompted investors to pay increasing multiples for growth stocks while shunning value stocks.

The valuation gap between MSCI Growth and Value is the highest in 13 years

Source: Barclays Research, Datastream, MSCI.

The value/growth trade is linked to the bond yield direction

Source: Barclays Research, Datastream, MSCI.

A Powerful Cocktail

Volume, volatility, and trading liquidity are interrelated. Sharp declines in stock prices coincide with rising volatility, and subsequently damaging liquidity. One of the side-effects of this long market cycle is a profound change in the types of investors who dominate the trading activity. Market studies show that the depth of markets has declined, leaving less shock absorption during downturns. Declining markets and media attention can heighten anxiety and result in mental errors. We are knowledgeable of the changing dynamics of market structure and attentive to opportunities that episodes of heightened volatility may bring. Through active oversight and constant vigilance of client portfolios, we are prepared to capitalize on future opportunities. Part of that preparation, tailored for this late stage of the market cycle, include the measures below:

- Evaluate whether price pressure has fundamental roots or is merely technical
- We've developed a comprehensive watchlist of stocks we would buy if prices declined sufficiently
- Maintain position sizes that are consistent with potential risks—leaving room to add if prices drop

How Does Market Sentiment Connect With Macroeconomic Factors?

We focus on the Fed because the past ten recessions were all preceded by tight monetary conditions. Over the past 40 years, there have been few significant declines in equity markets in the absence of recession.

- When markets detect a change in circumstance, prices decline five-times faster than they rise[4]; investors who believe change is afoot will, therefore, try to get ahead of any potential avalanche

Declining expectations of future economic growth bring lower estimates of inflation and lower long-term bond yields. When the Fed is raising short-term interest rates, and investors grow more bearish about future growth, the yield curve can invert. We care about this because past yield curve inversions have been potent indicators of pending recessions, and recessions are damaging to stock market returns.

[4] Interview with Rick Rieder, CIO, Blackrock Fixed Income; *Top of Mind (Issue 76): The Fed's Dovish Pivot*; Goldman Sachs & Co.

Conclusion

One outcome of extended bull markets is the prevailing idea that *Investing is Easy*. However, we know this is merely a symptom of investor sentiment that has grown overly confident. This is a perilous state for markets. It remains true that, under emotional duress, most investors revert to common behavioral biases. At this point in the market cycle, with sentiment high in equity markets, bond market signals pointing to a slowdown in economic growth, we are focused on companies of high quality, with sound cash flow visibility, and a solid track record of stable growth. Changes in market structure have damaged trading liquidity and market depth. With these considerations in mind, we are bracing for higher volatility in the future, and hope to use any sharp declines in markets to add new positions to client portfolios. We are cautiously optimistic that we will continue to find stocks worthy of entering the portfolio, while remaining prepared to capitalize on volatility.

- During the recent market selloff, while other investors were pulling money out of stocks in quantities not seen in 10 years, we were sharpening our pencils to buy stocks we had on our watchlist
- Many investors who sold stocks in December, likely missed the sharp rally in the first quarter of 2019; we used the weakness to add four new positions to client portfolios
- We maintain a long-term focus in the face of so much short-term noise
- With the Fed now on hold for some time, we are less worried about balance sheet risk and are focusing our stock selection on high-quality companies providing stable cash flow growth
- The US dollar should stop rising which would help our commodity-exposed companies

For a complete list of holdings, please see our most recent 13F filing on the following SEC website: http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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