CAPITAL ADVISORS

RESEARCH UPDATE
November 26, 2018

Key Points

- Financial markets have been wrestling with a host of potentially unnerving developments since the end of September, resulting in a meaningful pull-back for several asset markets, including stocks.
- These uncertainties include further deterioration in trade relations between the U.S. and China, a surprisingly sharp drop in the price of oil, continued weakness in international equity markets, and a change in stock market leadership away from the so called "FAANG" stocks (Facebook, Amazon.com, Apple, Netflix and Google).
- In addition to these developments, we suspect investors may have become increasingly anxious about the outlook for U.S. interest rates and monetary policy.
- We are tracking all of these issues (and more), but we wish to highlight interest rates in this report because there are two events in the near-term that could be market-moving in one direction or the other.
- Specifically, we suspect the next 5% to 10% move in global equities could be higher if the Federal Reserve signals a softening in its outlook for interest rate increases at one or both of these upcoming events, or lower if they signal the opposite.
- The first opportunity for such signaling from the Fed is this Wednesday, November 28th.
- Regardless of the near-term outcome, we have been positioning our investment strategies for a changing market landscape, and highlight a few specifics on page-five.

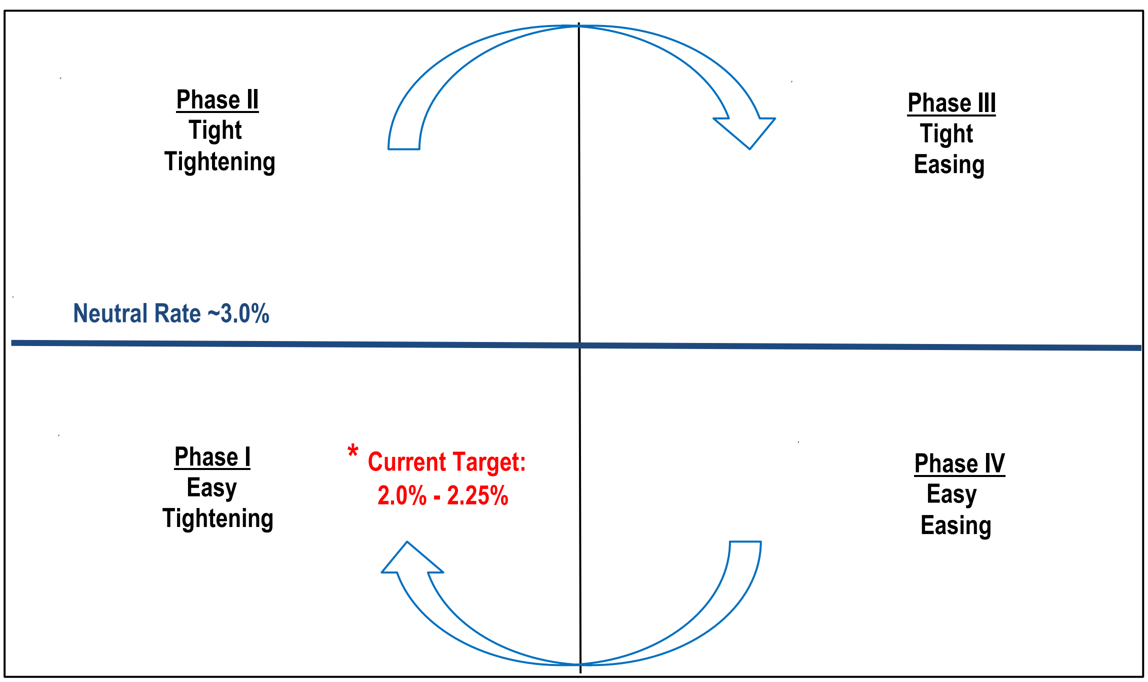
Contemplating the Next Move in the Stock Market

Investors should have two significant opportunities to refresh their outlook for interest rates and the economy over the next four weeks. The outcome of these potential investor "resets" might determine whether the next move in the stock market will be higher or lower.

The first event that might shape investor expectations occurs this Wednesday (Nov. 28th) when Federal Reserve Chairman, Jerome Powell is scheduled to address the Economic Club of New York. Investors are eager to see if Powell might soften his rhetoric about future interest rate hikes in light of numerous developments since his last public comments spooked the markets in early October.

The second potentially influential event is the December meeting of the Federal Open Market Committee (FOMC) on the 18th and 19th, when the committee is widely expected to raise the overnight lending rate by another quarter-point to a range of 2.25%-2.50%. The December meeting also includes a press conference, where Powell might deliver a more comprehensive update on the Fed's outlook, including its current view of the so called "neutral" Fed Funds rate. The neutral rate is an imprecise estimate of the interest rate target for overnight bank loans (i.e. "Fed Funds") that neither stimulates the economy, nor restricts it. The Fed currently believes the neutral rate is approximately 3.0%.[1]

Monetary Policy Cycle: Changes in the Fed Funds Target Rate



Source: The framework for this graphic was developed by BCA Research, November 2018 Monthly Outlook

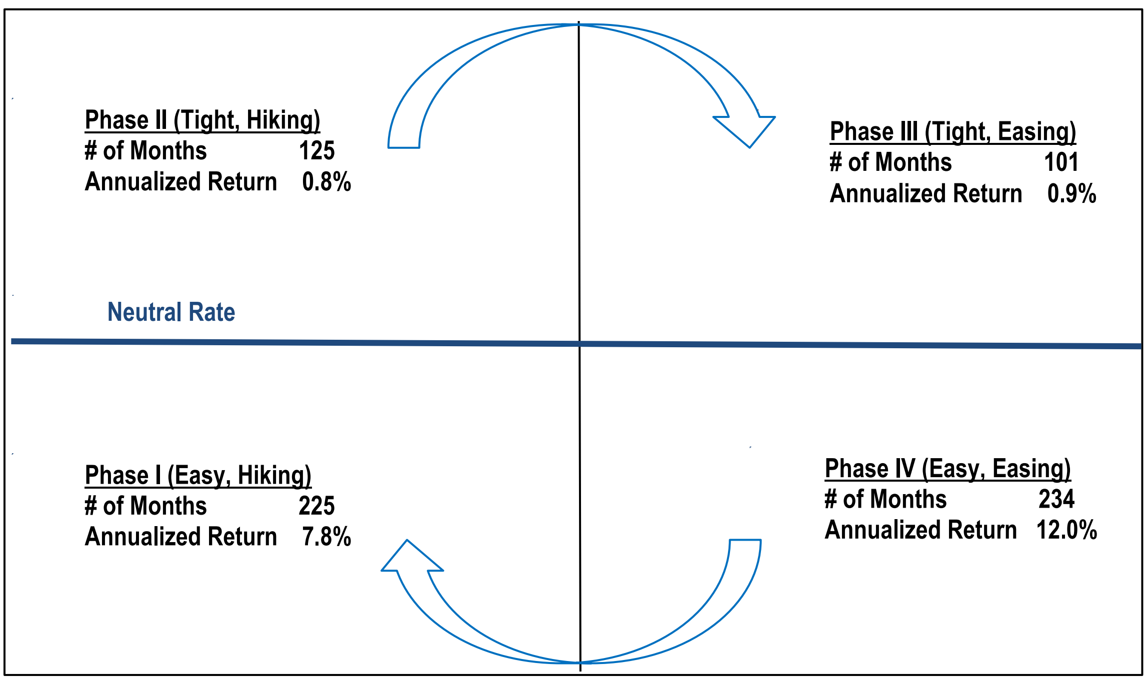
[1] Source: Minutes from the September meeting of the FOMC, including the "dot plot" of interest rate forecasts among the individual members of the committee.

Monetary Policy May Be Approaching an Important Juncture

We believe investors' expectations about the future path of monetary policy might determine whether the next 5% to 10% move in the stock market will be higher or lower. The graphics above and below provide a framework to explain why. These graphs are divided into four quadrants to reflect the four phases of a monetary policy cycle. When the FOMC sets the Fed Funds target below the neutral rate, monetary policy is considered to be "easy," meaning it is expected to stimulate the economy (Phases I and IV in the graphs). When the FOMC pushes the Fed Funds target above the neutral rate policy is said to be "tight," meaning it is intended to restrain the economy in an effort to tamp down inflation (Phases II and III). Within each policy stance – easy or tight – the committee might be pushing the Fed Funds target higher ("tightening"), or lower ("easing").

This framework is relevant to investors today because the stock market tends to perform significantly better when monetary policy is easy versus tight, regardless of whether the direction of incremental policy change is looser, or tighter. As the graphic below shows, ***stocks tend to do much better when the Fed Funds rate is below the neutral rate.***

Distribution of Stock Market Returns
S&P 500 Index Annualized Price Return
Aug. 1, 1961 to Aug. 31, 2018



Source: BCA Research **It is not possible to invest directly in the index**

There's Just One Problem…

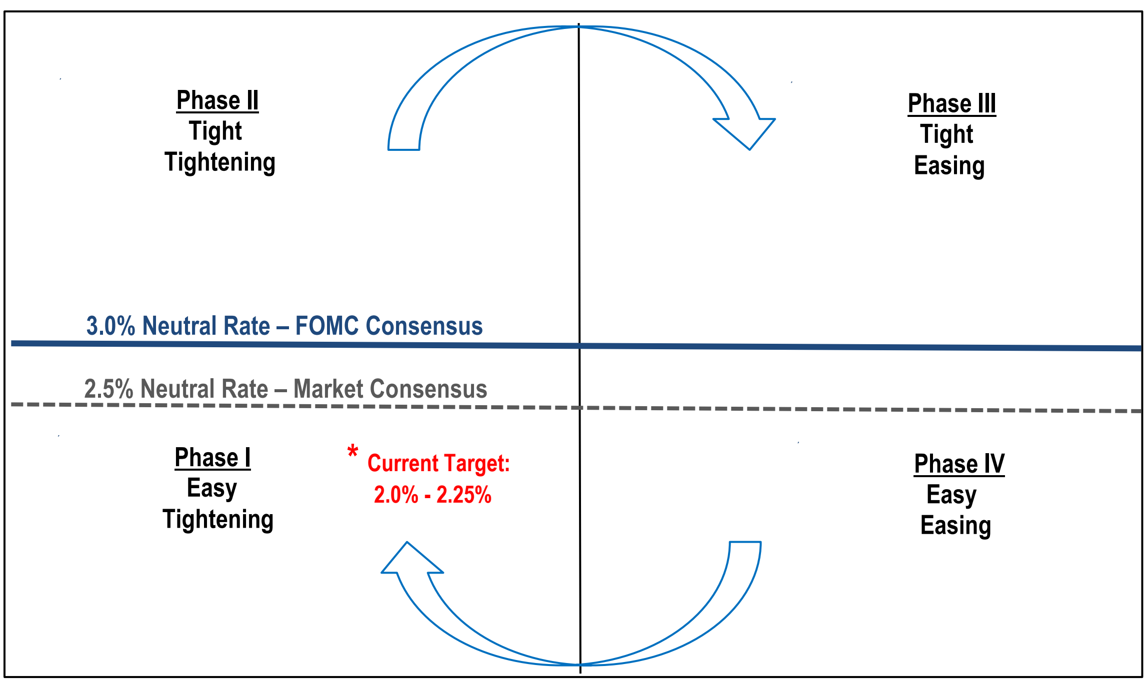
Unfortunately, defining the current stance of monetary policy is messy in the real world because the neutral rate is not static, and no one knows exactly where it is at any given time. This includes the members of the FOMC who are responsible for executing monetary policy in the first place. As such, monetary policy is a highly imprecise exercise of maneuvering short-term interest rates above and below a moving target that cannot be measured with precision.[2]

This is why central banks get monetary policy wrong from time to time, contributing to asset bubbles when they keep conditions too loose, and recessions when policy becomes too tight. Considering the less-than-perfect track record of central bankers throughout history, it is not surprising that financial markets have begun to agitate as the current tightening cycle in the U.S. approaches neutral.

Where Are We Now?

As stated above, the Fed currently believes the neutral Fed Funds rate is approximately 3.0%. Importantly, however, market participants disagree. Based upon recent prices in the Fed Funds futures market,[3] the consensus view of neutral among investors is closer to 2.5%. If the "market view" of neutral turns out to be more accurate than the Fed's target of 3.0%, U.S. monetary policy may only be one rate hike away from reaching neutral, and two hikes away from becoming "tight" for the first time in more than a decade. ***We suspect this pending milestone has been an important driver of the recent weakness in the stock market.***

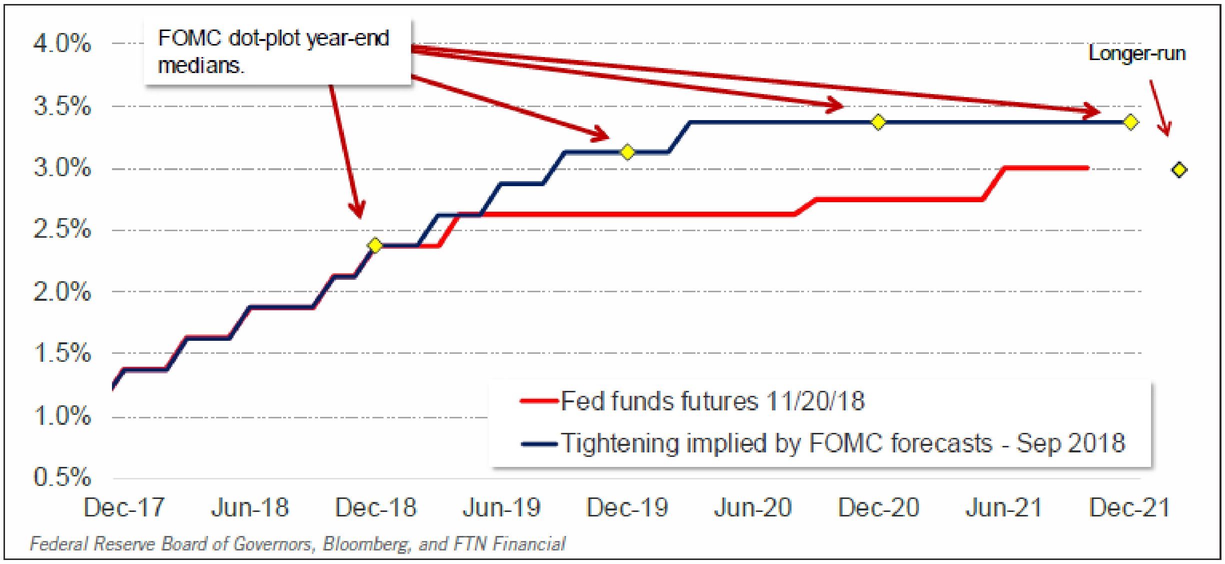
Aiming for a Moving Target
The Current Stance of Monetary Policy
Depends on the Level of "Neutral"



Source: BCA Research

[2] Central banks use other tools to implement monetary policy, including large-scale asset purchases and interest rate targets for bank reserves, but the relationship between overnight lending rates and the neutral rate is a primary indicator of the overall posture of monetary policy.
[3] Source: CME Group

Who Will Be Right About Rates?
The Fed (blue line) is Currently Above the Market Consensus (red)



What to Watch in the Near Term

All else being equal (which is never the case), we might expect some recovery in the stock market if investors perceive a softening in the Fed's outlook for interest rate increases, which could be expressed as soon as this Wednesday. The second opportunity for a favorable refresh will accompany the December policy meetings on the 18th and 19th, when the notorious "dot plot" of interest rate forecasts among all the FOMC members will be updated for the first time since September.

Of course, it is also possible for these events to trigger a negative reaction from the markets. If the Fed chooses to signal a steadfast commitment to its September "dot plot," as reflected in the blue line in the graph above, stocks might continue to struggle through year-end. This is because the blue line anticipates up to four more rate hikes *after* a presumed increase in mid-December. Such a path would take monetary policy well into restrictive territory based upon the Fed's own estimate of the neutral rate, while it would signal a likely policy *mistake* in the minds of those who believe the neutral rate is lower than 3.0%.

Investment Implications

We have been adjusting for a potential phase transition in monetary policy for some time now within our active investment strategies. Within the *Managed Equity Dividend* strategy this involves a shift toward companies with stronger balance sheets, and lower, but faster-growing dividend policies. Recent examples include **CenterPoint Energy (CNP: ~$28)**, **Intel (INTC: ~$47), Invesco (IVZ: ~$20); Leggett & Platt (LEG: ~$38), Lockheed Martin (LMT: ~$295)** and **Whirlpool (WHR: ~$121).**[4]

[4] Note: Stocks listed here were chosen for their fit with the objective being described: i.e. stronger balance sheets and the prospect for growth in the dividend. This list includes stocks that have performed well and poorly since purchase. Over the time period shown (trailing 3 months), the strategy also saw the purchase of **New Residential REIT (NRZ: ~$17),** which does not fit the description as closely due to a higher starting yield, and expectation for more limited growth.

The most noteworthy adjustment we have been making in the *Managed Equity Growth* strategy is to right-size its allocation to high-growth technology stocks. This effort began in the fourth quarter of 2017 with partial sales of **Amazon.com (AMZN: ~$1525), Coherent (COHR: ~$128)** and **Visa (V: ~$134)** among portfolios with particularly large commitments to these stocks (due to appreciation). We have continued this process in 2018 with partial sales of **Alphabet (GOOG: ~$1031), Apple (AAPL: ~$175),** and **CRISPR Therapeutics (CRSP: ~$37)**, and the complete sale of **Booking Holdings (BKNG: ~$1751), (the rest of) Coherent, Intellia Therapeutics (NTLA: ~$18)** and **Salesforce.com (CRM: ~$123).**[5]

Within our *Fixed Income* strategies we have been replacing maturities of individual corporate bonds with U.S. Treasuries among portfolios constructed with individual securities. We have also targeted a relatively short average duration for our fixed income strategies to reflect the Fed's tightening policy cycle and its likely influence on interest rates across the yield curve.

Among our tactical strategies we have been reasonably pleased with the defensive posture of the *Tactical Dynamic Allocation* strategy in 2018, particularly its timely exit from international equities and emerging markets earlier this year.

The relative strength discipline in the *Tactical Global* strategies has successfully emphasized better-performing domestic markets in 2018, even though these strategies have suffered from exposure to certain diversifying assets like natural resources, emerging markets and small-cap international.

Lastly, we made a modest adjustment to the *International Focus* strategy in October to shift more of its portfolio into developed international markets, while reducing the position in emerging markets.

Final Thoughts

We encourage all investors to keep the recent downturn in the stock market in proper perspective. Risk markets are inherently volatile. That's what makes them risk markets…you never know what they might do in the short-term.

Investors are rightfully concerned that the Fed might overdo it with interest rate hikes. Trade skirmishes threaten to disrupt global supply chains, and might dent the profit margins of companies that are directly affected. Regulatory risk is rising for platform technology companies, while the price of oil is tanking. Yet none of these concerns are hidden from plain view. These challenges are the reason stocks have dropped roughly 10% from their highs in the U.S., and substantially more throughout the rest of the world (the *MSCI Emerging Markets Index* is down approximately 22% since January 31, for example[6]).

Most importantly, however, for every issue that might get worse, things could also get better. More things can happen than will happen. This defines risk in a nutshell, but it is also the source of opportunity. There is a lot to like about the stock market right now, including healthy corporate profits, a reasonable price-to-earnings ratio (P/E), and an interest rate backdrop that remains very low by historical standards. Good news can happen too. Stocks should respond quite favorably if it does.

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[5] Note: The stock sales listed here do not represent all sales throughout the past year. These transactions were selected to reflect the investment objective being described: i.e. rightsizing the portfolio's exposure to the technology sector. Transactions shown include both favorable and unfavorable timing.

[6] Source: MSCI, Inc., Morningstar.com

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