AUGUSTINE
ASSET MANAGEMENT

April 2019

1551 Atlantic Boulevard, Suite 103 Jacksonville, FL 32207
Telephone: (904) 396-6944 Fax: (904) 396-7275
inquiries@augustineasset.com

Market Summary

Equities

MSCI AC World	508.55
Price / Earnings	17.6x
Dividend Yield	2.5%
S&P 500	2,834
Price / Earnings	19.3x
Dividend Yield	1.9%

US Treasury

2 Year Yield	2.3%
10 Year Yield	2.4%
30 Year Yield	2.8%

US Corporate Spreads

Investment Grade	1.2%
High Yield	4.5%

Equity Volatility

CBOE SPX Volatility	13.7

US Economic Figures

GDP Growth 4Q18	2.2%
Unemployment	3.8%
Inflation	2.0%
Fed Funds Rate (mid)	2.4%
3 Month LIBOR	2.6%

Commodities

Oil (Brent)	$68.39
Natural Gas	$2.66
Copper ($/lb.)	$2.94
Gold ($/oz.)	$1,292

Foreign Exchange

Euro	$/€	1.12
Japanese Yen	¥/$	111
Chinese Yuan	元/$	6.71

Market summary data as of:
March 31, 2019

Hair of the Dog

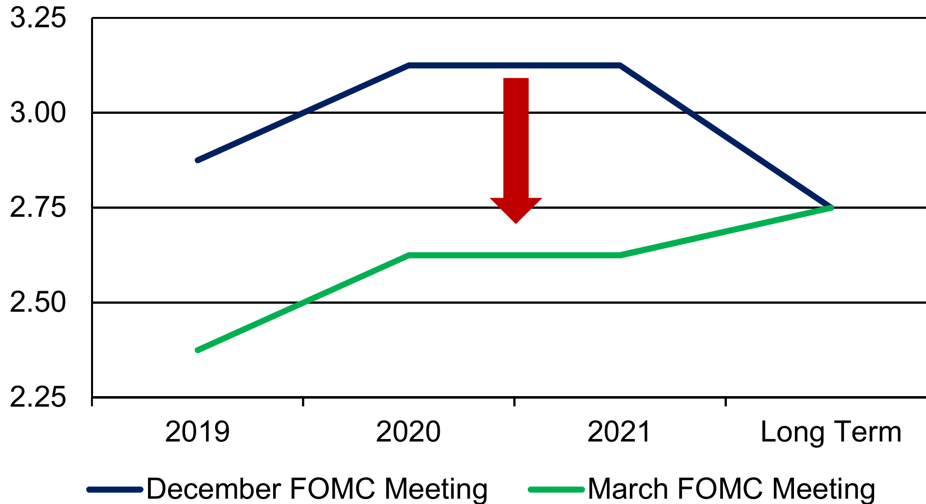
What a difference a few months make. Financial markets are rallying with global equities rising by 12.2%, US equities by 13.6%, and US bonds by 2.9% during the first quarter. The contrast to the market tone in the prior three months is striking. The sharp fall in the fourth quarter has been almost fully recovered in a V-shaped bounce in prices.

The powerful shift from despondency to elation is unusual, even considering the tendency for financial markets to be influenced by the ebb and flow of investor sentiment. So, why the bi-polar swings? We think it's primarily due to the shift in stance by the Federal Reserve and other central banks.

Readers may recall from our recent letters, *Taking the Punchbowl* (October 2018) and *Reversions* (January 2019), how the Fed's policies of raising the short-term interest rate and reducing the size of its balance sheet in a programmatic manner created a tightening of monetary conditions that financial markets found difficult to digest. Combined with aggressive trade rhetoric and very low year-end liquidity, the lessening of monetary support led to sharply lower market prices.

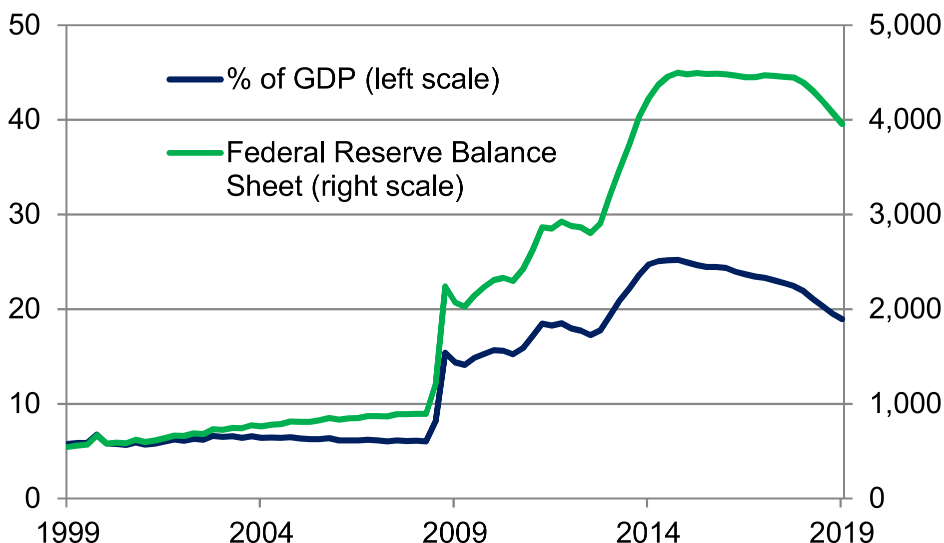
This year's market rebound began in earnest with a dramatic change in the Fed's policy stance. Early in the quarter, Fed Chairman Powell announced a shift toward “patience” regarding any further increases to rates. Toward the end of the quarter, the Fed made additional announcements to solidify its return to easy money.

Exhibit 1: “Median Dot” Year-End Forecast for Federal Funds %



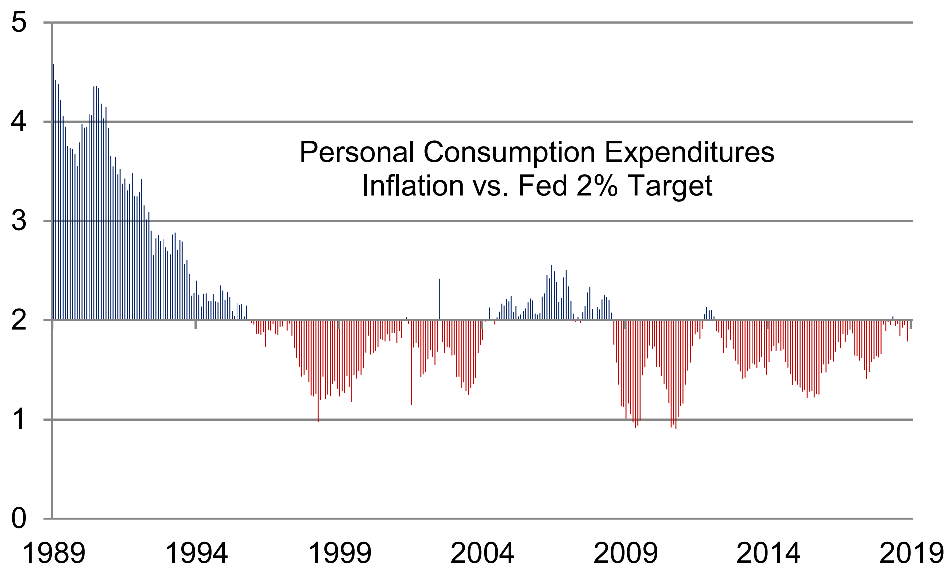
Rather than letting the size of its balance sheet gradually decline through maturities among its bond holdings, the Fed now plans to resume in September reinvestment with new bond purchases. By maintaining its balance sheet at $3.6 trillion and 17% of current GDP, compared with $0.9 trillion and 6% of GDP prior to quantitative easing, the Fed is making a key element of its hitherto temporary support for financial markets permanent.

Exhibit 2: US Federal Reserve Balance Sheet % of GDP & $ Billions
a.k.a. Hotel California



Furthermore, several Fed governors have begun to redefine the Fed's inflation target in terms of a moving average, supporting the notion that it should keep rates low even if inflation rises above its stated 2% target to the extent that past experience has been below that goal. With the Fed's preferred measure of inflation (Personal Consumption Expenditures) having spent most of the last 25 years below 2% (and on average a half percent below the more widely followed Consumer Price Index), policy makers appear to be stretching for latitude to permit a period of higher inflation that may be substantial in magnitude and time.

Exhibit 3: Some Like It Hot?
Fed Considering a "Catch Up" Period of Higher Inflation



The last six months in which tighter policies drove markets down and looser policies spurred a recovery highlight how increasingly sensitive markets have become to monetary support. And the volte-face in the Fed policy stance, along with a new round of subsidized loans from the European Central Bank, highlights how difficult, and perhaps politically impossible, it is for central banks to withdraw support. What has been described as unconventional actions taken during crisis conditions now appears as an intractable condition underpinning the financial markets.

Investors have certainly cheered the return of the proverbial punch bowl. The expectation of a central bank put option -- easing if the economy or markets weaken but no tightening if the economy or markets overheat -- has returned and with it a preference for risky investments. During the first quarter rally, stocks with weaker balance sheets, higher market risk, lower profit margins, and downgrades to earnings forecasts strongly outperformed those with the opposite, higher-quality characteristics. A similar pattern of risk-seeking behavior was evident in the bond market, with the US high-yield distressed debt index generating over 3x the return of the overall bond market.

Beyond the rise of the broad stock and bond market indices and the relative performance of lower-quality speculative securities, market volatility has fallen to levels well below historical norms, and financial speculators have placed a near-record volume of bets for further declines in volatility.

Exhibit 4: Stock Market Volatility Fell After the Fed Pivot…

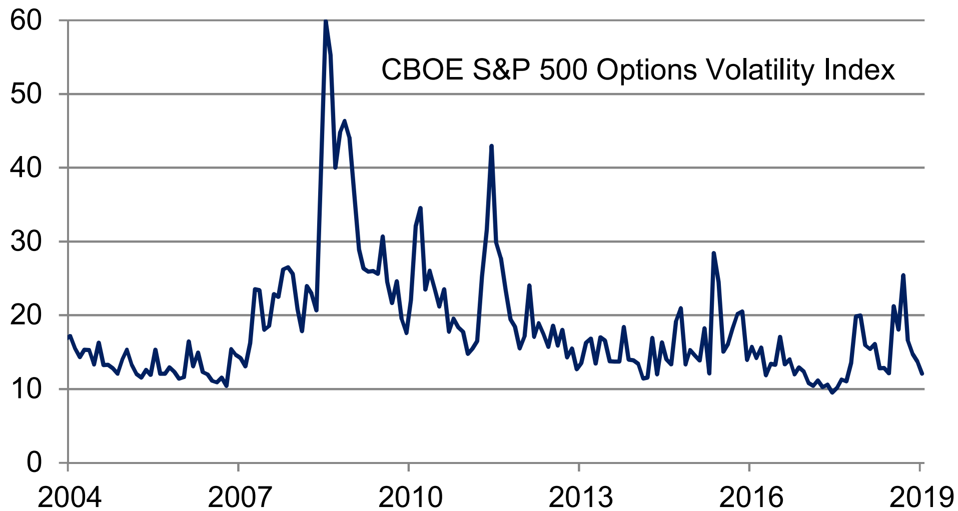
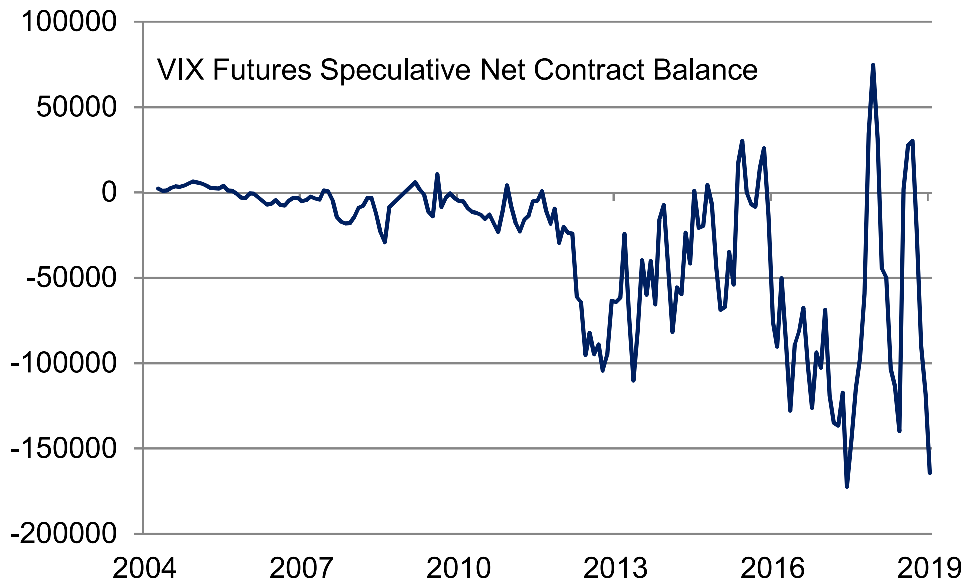


Exhibit 5: …and Speculators are Betting Heavily for Volatility to Fall Further



Renewed policy support has also helped markets move in an opposite direction to expectations for the economy, corporate earnings forecasts, and the cyclical signal implied by the yield curve. Economic surprise indices show that economic activity during the first quarter fell well short of expectations, and earnings forecasts have likewise fallen. Since the beginning of the year, consensus earnings estimates have fallen by 6% for both domestic and international companies. Yields, meanwhile, have fallen in concert with the weaker economic data to a point where the spread between long-term and short-term rates are implying a slow pace of growth in coming quarters.

Exhibit 6: Citigroup Economic Surprise Indices Have Largely Trended Negatively

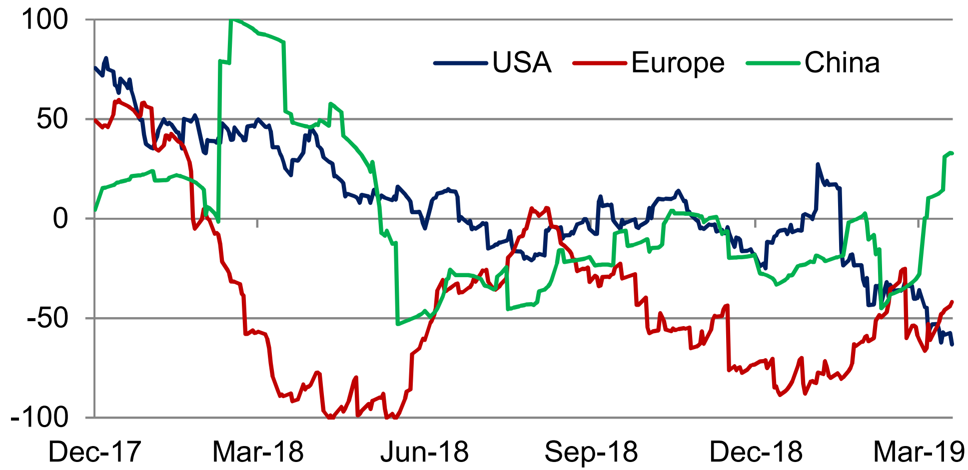


Exhibit 7: Global Consensus Earnings Estimates Have Declined

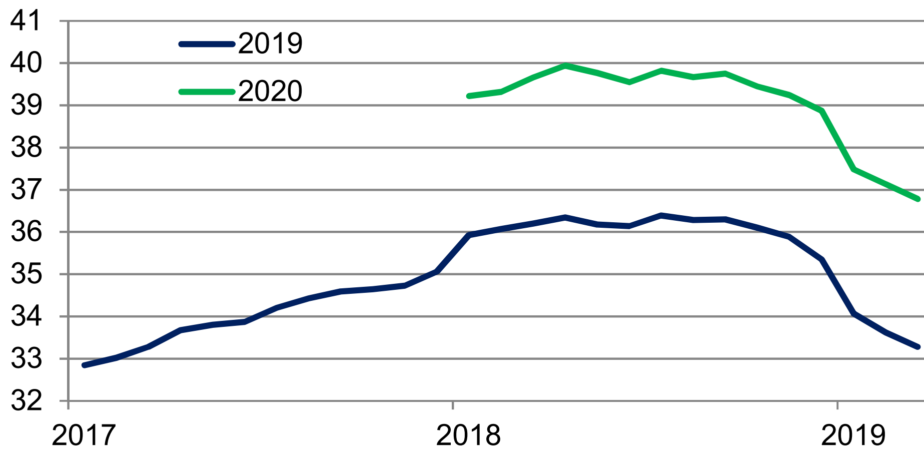
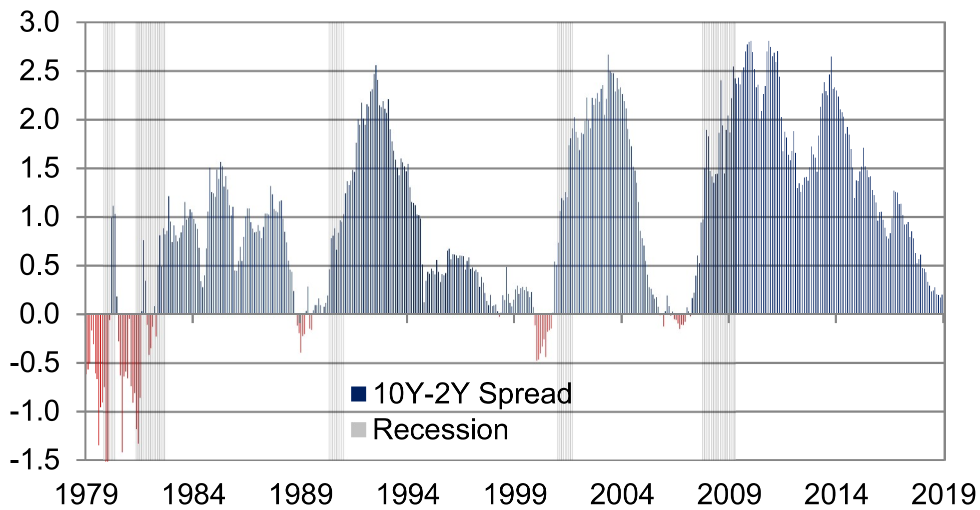
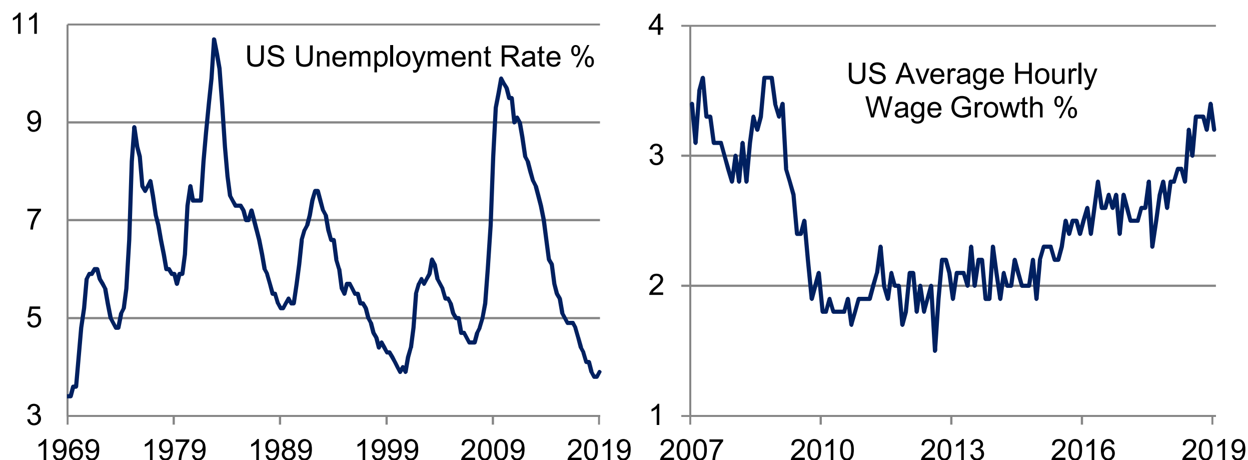


Exhibit 8: Flattened Yield Curve Points Toward Slow Growth (But Not Yet Toward Recession)



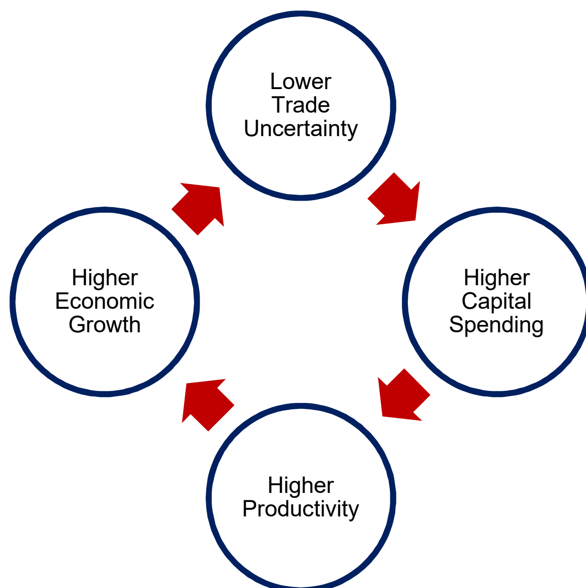
The deceleration of economic and corporate earnings momentum witnessed so far this year is consistent with the "slowing but still growing" outlook for 2019 we expressed in our prior letter. The myriad of indicators we monitor, including credit markets and industrial activity, collectively point toward a low probability of recession globally and domestically over the next several quarters. The consumer, whose spending drives over two-thirds of the economy in the US, appears particularly healthy with very low unemployment and an accelerating pace of wage growth.

Exhibit 9: Strong Consumer Fundamentals



Trade policy remains a wild-card to the outlook. Harsh rhetoric and new tariffs in 2018 hurt business optimism and capital spending. While it's hard to see an immediate resolution to trade discussions that covers all concerns around foreign government subsidies, market access, and intellectual property theft, any substantial progress could help release belayed corporate capital spending plans that were incentivized by the 2017 tax rate changes.

Exhibit 10: Upside to Growth if Trade Disputes are Resolved



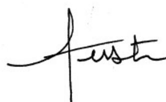
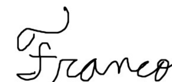
With our expectation for continued, albeit slower, growth, we continue to tilt client capital toward higher exposure to equities versus bonds relative to otherwise "normal" asset allocations. Historically high valuations for domestic and speculative stocks lead us to favor a globally diversified stance tilted toward value. If stock valuations relative to earnings and cash flow revert to historical averages, international would outperform domestic and value would outperform growth by 20%. Within bond portfolios, the low and flat yield curve, our non-recessionary outlook, and the potential for the Fed to allow higher inflation lead us to favor shorter maturity corporate bonds that pass the hurdles of our credit analysis.

The first quarter delivered a welcome recovery from the market turmoil at the end of 2018, and financial markets may continue to provide gains should the fundamentals catch up with the rally in prices. Central banks are again providing a lift to markets. That's a short-term benefit that must eventually be weighed against long-term objectives. A highly supportive stance feels good now but comes at the cost of impairing, to a degree, the market's ability to properly discover the appropriate price for value, growth, and risk. As monetary authorities redefine the measurement of their objectives from actual unemployment and inflation with politically-malleable concepts like participation-adjusted unemployment and inflation averaging, a bias toward easy policies is apparent. We hope they find a balance that helps mitigate the amplitude of economic cycles without creating outsized distortions and risks potentially caused by loose, asymmetric policies.

We appreciate your trust in our management of your capital and would welcome further discussion of our outlook and the strategy reflected in your portfolio. Please contact us with any questions. We welcome your call or email.

Best regards!

Jeffrey E. Bernardo CFA   Gregory M. Estes CFA   Steven M. Herbert CFA   Neil J. Sullivan CFA

Milena D. Spasova CFA CIPM   Austen P. Cornell CFA   Frederick M. Blum   Franco Cirelli CPA CFP®