MV CAPITAL MANAGEMENT

Weekly Market Flash

Our 2018 Investment Thesis

January 19, 2018

We will be publishing and distributing our Annual Outlook next week, a 24-page opus reflecting not only our analysis of the quotidian variables likely to be at play in the economy over the coming twelve months, but also a commentary on today's world in a larger historical context. Meanwhile, we will use the opportunity of this week's regular commentary to share with you the executive summary from the forthcoming Outlook, to give you an advance look of what you will read in further detail next week.

- "Moderate growth, low inflation, improving labor market": this would have been a reasonable way to characterize US economic trends in 2013. And in 2014, 2015 and 2016. So it was not exactly an earth-shaking surprise when 2017 delivered…yes, moderate growth, low inflation and a still-improving labor market, if the latter slowed down just a bit in net new job creation. Tracking the macroeconomy has become something akin to watching daily episodes of *Seinfeld*. Not much of any consequence ever happens, and every now and then some amusing diversion appears to briefly engage one's attention. Try as we might to unearth some new piece of information suggesting the approaching end of this placid state of affairs, we cannot. The data say what the data say. 2018, for the moment, looks set to deliver more of the same.

- The key difference between 2017 and earlier years in this recovery cycle was that the rest of the developed world came on board. Organic demand and consumer confidence perked up in the Eurozone, Britain managed to at least temporarily forestall a reckoning with the consequences of Brexit, Japan stayed positive while ex-Japan Asia Pacific countries did just fine. China, meanwhile, met its growth benchmarks by initially going back to the tried and true mix of debt-sourced spending on infrastructure and property. Beijing reversed course midyear, though, with a concerted program to reduce borrowing and recommit to economic rebalancing (this coincided with a further consolidation of power by President Xi Jinping). Elsewhere in emerging Asia and beyond, concerns about looming trade wars faded and domestic assets, including long-beleaguered currencies, perked up for a winner of a year. Again – while there are plenty of geopolitical variables that could form into tangible threats at any time – the basic macroeconomic variables appear stable. Markets ignored geopolitics last year, we expect them to do the same in the year ahead.

- Calendar-gazers are filling up the airwaves with the observation that the current recovery – from July 2009 to the present – is one of the longest on record. If we manage to avoid a recession between now and May, the current growth cycle will move ahead of that of 1961-70 as the second-longest, trailing only the ten years of good times from 1991 to 2001. To those nervously ticking off elapsed calendar days we offer two ripostes. First, markets and economies don't pay attention to calendars, which are entirely a human construct. Second, there are potentially valid reasons why the current uptrend could go on for longer. From 2009 to 2014, arguably the main force behind continued growth was the Fed and its quantitative easing mechanics that flooded the world with money. Only more recently has the growth started to look more traditional – more like actual improvements in business and consumer sentiment begetting a virtuous cycle of increased supply feeding increased demand. If anything, the perky demand trends we see today more resemble those of an early than of a late stage in the cycle. The uniqueness of that multi-year experiment in unorthodox monetary policy may make comparisons with other growth periods less meaningful.

- So if the default assumption is that 2018 will be a year of very few changes to the presiding macroeconomic trends, what alternative scenarios could upend the base case? The key X-factor, we believe, is the one that nobody from Fed governors to that fellow holding court at the end of the bar completely understands; namely, the curious absence of inflation. The inflation rate has fallen short of the

Fed's explicit target of 2 percent throughout the entire recovery to date (when excluding the volatile categories of energy and foodstuffs). This despite the dramatic fall in the unemployment rate from 10 percent at its peak to just 4.1 percent today. The economic models built over the decades following the Second World War baked in the fundamental assumption of a trade-off between inflation and employment: be prepared to sacrifice one in pursuit of the other. That assumption has not held up at all in recent years. But before pronouncing last rites on the Phillips Curve, we again draw your attention to our observation in the previous bullet point: the kind of growth one normally sees early in a recovery cycle may only now be showing up. If so, then a sudden surge of higher than expected inflation would not be entirely implausible.

- The second alternative scenario that could disrupt the smooth sailing of most capital markets asset classes would be, perhaps, the other end of the spectrum from a growth-fueled resurgence of inflation. The Fed intends to raise rates again this year – three times if the stated expectations of the FOMC's voting members are to be believed – and to begin winding down the balance sheet that grew to $4.5 trillion over the course of the QE years. These intentions reflect a confidence that the economy is fully ready to stand on its own two feet – which confidence, of course, proceeds from those same steady macro trends we described a few bullet points ago. But there is still a chance, and not necessarily a small one, that today's bubbly sentiment is ephemeral and will dissipate once the crutch of monetary policy is finally and conclusively removed. Specifically, not one of the three structural drivers of long-term growth – population, labor force participation and productivity – are demonstrably stronger now than they were two years ago when we devoted some number of pages in our Annual Outlook to the concept of secular stagnation. There may be less to the current growth uptick than meets the eye. If so, a Fed misstep on the pace of unwinding easy money – too much, too soon – could be the trigger that boots the Goldilocks economy to the exit door.

- What both those alternative scenarios – an unexpected inflation surge and a Fed policy fumble – have in common is the potential to wreak havoc on credit markets. From an asset markets perspective, credit markets hold the key to how virtually any asset class – debt, equity or alternative – will perform. Here's why. The risk-free rate – in general practice the yield on intermediate / long Treasury notes – is employed in just about every standard asset valuation model. All else being equal, an increase in interest rates has the effect of decreasing the present value of future cash flows. Asset managers will reprice their models if reality outstrips expectations about yields. A likely ripple effect resulting from a Treasury rate repricing would be widened risk spreads (affecting, for example, corporate investment grade and high yield bonds), a pullback in equity prices and a commensurate uptick in volatility. Whether the riskier conditions persist would be situation-specific, but there would very likely be at least some damage done.

- Again, we view these as alternative scenarios to be a more benign base case. Even if one of the other were to come to pass, though, it would not necessarily start the clock on a countdown to the end of this long bull market. For that to occur, we believe one of three events would have to emerge: a full-blown recession (which is different in nature from a periodic surge in inflation), a crisis such as the implosion of the financial system that led to the 2008 crash, or the outbreak of an actual hot war somewhere in the world that significantly involved the US and/or other large powers. The risk of any of these things happening in 2018 is not zero, but we would ascribe a probability of less than 25 percent to any of them.

- US equity valuations are stretched, particularly for the large cap growth segment of the total market that has consistently outperformed over the past several years. Relying on relative valuations alone would potentially lead investors to other areas, like Europe or emerging markets, that still have some catching up to do even after a strong performance in 2017. In the long run valuations matter – there is no coherent way to view a share price as anything other than the present value of a series of future cash flows. In the short run, valuations don't always matter. Relative geographic performance in 2018 will be subject to other influences, not least of which will be the direction of the US dollar.

- The dollar was one of the big surprise stories of 2017. Long before equity shares in financial institutions or resource companies snapped out of their "reflation-infrastructure trade" myopia, the US currency had done a U-turn from its rapid post-election ascent. The dollar fell by nearly 10 percent against a basket of other major currencies last year, and that soft trend has continued thus far into 2018. Currency strength was a major force driving performance for developed and emerging market equities and debt last year. Whether a reprise of that trade is in store for the year ahead depends – again – on that tricky combination of alternative economic scenarios. If US interest rates rise substantially, with the ECB and the BoJ at the same time proceeding more cautiously, then a stronger dollar would be a rational expectation as investors pursue higher yields. That outcome is not set in stone, however. Major foreign investors – most notably China – may look to diversify their foreign exchange assets if their perception of US risk changes, which would, all else being equal, have a negative effect on the dollar.

- Commodities may stand on the other side of the dollar's fortunes. A weaker dollar makes commodities more affordable in other currencies; that, along with the return of strong organic demand, may supply a tailwind to a range of energy and industrial commodities. But oil, which has recently surged to its highest levels in three years, remains vulnerable to the prospect of increased shale production in the US. As with currencies, there are many factors at play that could work either for or against key commodity classes.

- In conclusion, we could sum up the essence of our views thus: Things Don't Change, Until They Do. The benign tailwinds of moderate, steady global growth will not last forever. Neither we nor anyone else can point with certainty to the date when the sea change happens. What we can do is pay close attention to the things that matter more. Farmers know how to sense an approaching storm: the rustle of leaves, slight changes in the sky's color. In the capital marketplace, those rustling leaves are likely to be found in the bond market, from which a broader asset repricing potentially springs forth. Pay attention to bonds in 2018.

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