February 14, 2019

Dear Fellow Investor:

We had a nice month to start the year as our value positions made a comeback versus the broader market. We don't like to talk about our performance over such a short period of time but do so because it highlights the notion that value stocks have been very under-appreciated for a long time. We think the growth versus value dynamic is like a rubber band that has been stretched quite far, making it possible for value to snap back quickly on a relative basis without much of a catalyst.

The Fed is very confused because it now realizes that what we have been warning about for years is taking place. Normalizing monetary policy is impossible because the financial system has become completely dependent on its ridiculous liquidity support efforts of the last decade.

The fed funds rate on an inflation-adjusted basis is close to zero after a couple hundred basis points of tightening, yet Powell and Co. are feeling compelled to re-think plans about future policy. It used to take 2-3% real rates to slow the economy. However, because of the damage done by years of ultra-easy policy, GDP growth potential is not what it used to be. Enormous levels of debt have been accumulated on an aggregate basis at an unsustainable pace and now must be serviced. That is a big burden for the economy to carry.

Given the alternatives, we have no problems with a pause in further tightening **if** it means the Fed would just step to the background. That is likely wishful thinking on our part. A less active Fed would force market participants to figure things out for themselves and weigh risks with the notion that the central bank will not provide a backstop. At the same time, if it remains too restrictive now, that might mean that it would ultimately turn to aggressive measures like more QE in response to recession fears. Avoiding that is the other potential benefit of waiting for a while.

As it stands, the Fed over-reacted to year-end pressures in the markets as numerous players needed to shrink positions by 12/31 at a time when buyers are usually scarce. It went too far into the dovish camp. The arrival of 2019 alone would have caused the extremely oversold markets to rally without the Fed becoming so clearly an enabler of unstable market dynamics. Now it is has trapped itself into a clear stock price-supporting function.

Weakness emanating from China is impacting businesses everywhere. While the U.S. economy is weaker than it had been a few months ago, it is able to stand on its own two feet. Investors should learn to do the same. Short-term, momentum investing has caused them to become as impatient as we can ever recall.

The major net buyers of stocks in this cycle have been companies themselves as they managed their EPS in the low growth environment and made sure executives' stock options were in the money. At the same time, investors gravitated in a big way away from active management to passive indexing and ETF’s, causing stocks that dominate the major indices and sector funds to become momentum names that were chased. What this has meant is that buyers who do little or no fundamental analysis have dominated the flows. That is why valuations have approached between two and three times normal.

A few big things get in the way of many investors understanding how overvalued stocks remain. The first couple are the use of forward earnings estimates and pro-forma, non-GAAP numbers. Wall Street’s old habit of discounting peak earnings at peak margins far into the future is the reason stocks typically broadly correct 40% around recessions. At the same time, the debt side of the balance sheet is mostly being ignored. That is leading to enterprise values (stock plus debt) that are commonly north of 15 times EBITDA. That is wildly overvalued versus historic numbers.

We expect more rational market behavior because, sooner or later, investors will feel compelled to seek the better returns offered by that which is currently out of favor and more cheaply priced. We are now 117% long and 51% short with a 19% net equity exposure without including option positions. Closed-end bond fund holdings comprise a 43% total position (14% municipals, 5% TIP’s, 5% mortgages, and the remaining 19% in diverse sectors). We continue to employ options to increase short equity positions and further reduce net risk exposures.

We expect some sort of trade deal with China that fails to address the most difficult issues like technology sharing. It will take pressure off both sides while further negotiations continue. We still wonder why the Chinese would agree to anything too harmful to themselves when it’s likely that the next U.S. President will not be as willing to fight a hard battle on these issues.

Basing a higher equity allocation on a shift to friendlier monetary policy may prove as unwise as it did late in past cycles. On the other hand, the Fed may once again be forced to sound more hawkish in coming months given the stock rally and a likely improvement in the data. That may lead to more market volatility.

Importantly, one needs to consider the broader and long-term impact of QE and zero-rate policy on global equities. Japan has tried these extreme policies in an enormous way for a couple decades without ever achieving prior equity market highs. In addition, European stocks have been relatively sluggish after years of negative rates and QE. In other words, extreme monetary largesse is no guarantee of higher stock prices.

While some would like to credit the Fed and other central banks for this cycle’s bull market in the U.S., it’s important to keep in mind that the main net buyers of stocks in the U.S. have been corporations that levered themselves to the hilt in the process. Companies also benefited in a big way from China’s incredible $30 trillion debt binge that made corporate revenue growth less sluggish than it otherwise might have been. The continuation of both these as powerful future key drivers seems unlikely. At the same time, we expect it to become more difficult for investors to continue to turn a blind eye to risk when the earnings picture deteriorates and corporate credit issues are front and center.

We are late in the economic cycle and central banks have exhausted a bag of tricks that proved futile in creating sustained growth and hindered future growth prospects. Equity valuations remain at extreme levels that rival past peaks that were followed by years of poor returns. The most compelling risk-adjusted trade we can find is a bet on the normalization of the relative valuations of growth and value stocks because the gap between the two is historically quite wide.

Sincerely,

Scott E. Brown, CFA