June 19, 2019

Dear Fellow Investor:

Today the Fed chose to leave rates unchanged for now, but it did its usual hand-holding routine to assuage investors' concerns by promising to be there for them if they were to even get so much as a tummy ache, sunburn, or a hangnail at the pool this summer. The Fed knows there is no room to error on the side of being too tight because equity investors would rebel. Though the reliance is repugnant, it has become quite clear again in recent months that global stock markets need what is termed monetary "stimulus" to keep from collapsing. However, this "stimulus" is an economic depressant in so many ways.

Markets are in the process of slowly figuring out that the downside of overactive central bankers is that stocks and other risky assets have once again become divorced from economic reality. This has not historically gone on forever. Assets tend to revert back to GDP over time.

The bond market has become enormously concerned about growth prospects. It seems to have a view that is more in line with a lot of bank stocks, some cyclicals, and other value stocks. There is likely a message for the broader stock market in this, especially as most rallies are still being led by a narrow group of market favorites with fading growth profiles. A large portion of stocks remain below key moving averages and small caps are lagging.

Numerous coincident and leading indicators suggest the cycle has peaked and meaningful softness is ahead. A few pundits now think we are already in a recession, though the jury is still out on that. Overseas the growth slowdown is more pronounced than in the U.S. China is of particular concern to us.

While central bankers think they are riding to the rescue, you can almost see the eyes rolling in recent weeks when the ECB and BOJ promised more of the same tired monetary policies that were once portrayed as the equivalent of monetary bazookas. This bears watching because it could mark the onset of investors becoming entirely disenchanted with central bankers.

The bond market is conveying the thought that current efforts to stoke animal spirits with monetary jawboning are falling far short of targets with the 10-year Treasury near a 2% yield from over 3% a few months ago. Interest rates have broadly collapsed in recent weeks as a giant safe-haven bid has hit the Treasury market on recession fears. Commodities generally remain depressed versus stocks.

Some measures of global trade and industrial production are hitting the weakest levels of the last ten years. Rail carloads in the U.S. have turned decidedly negative. Job growth is weakening. Homebuilding and auto sales still look to have peaked for the cycle. Most retailers' earnings reports for their most recent quarters were dismal. It's not just China tariffs that are at fault because the softness is too widespread across numerous sectors.

It's concerning to us how participants are willing to assign much of the blame for current economic weakness on trade issues without respecting cycle dynamics. In the end, it may not matter, especially if Trump takes a hard line with China. However, we do expect him to back off with a face-saving "deal" if U.S. stocks turn chaotic.

Based on history, the currently inverted Treasury curve usually means risk should be avoided. The front end of the curve is pricing in a lot of Fed easing, so it will have a tough time getting ahead of investors' expectations. The 2-year is trading about 60 bps below fed funds. That's a problem.

At 21 times trailing GAAP earnings for the S&P 500 are stock investors paying any attention to worries expressed in the bond market? Based on how many cyclical stocks in sectors like auto parts, retailing, and energy are hitting the new 52-week low list the answer is yes to a degree. Often the broader market follows suit when this happens.

We find it meaningful, but no one seems to talk much about the fact that many non-U.S. banks trade at depressed valuations below book values despite monetary policies that are supposed to boost lending and growth. The ECB and BOJ have clearly hurt banks' profitability with their extreme policies. In the U.S., banks have sat out much of the rally in recent years as if investors worry about more extreme policies coming here. We just don't understand how central bankers can expect to stimulate growth when they are causing bank stocks so much pain.

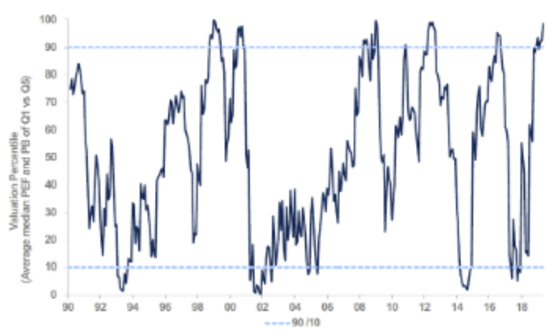
As we have discussed multiple times, lackluster growth and Fed distortions are keeping value stocks, including most financials, relatively inexpensive. Value investors like us are considered completely out of step much like they were in the years leading up to 2000. Rob Arnott of Research Affiliates discussed why in a Business Insider piece with this graph and the comment: "Value has had an 11-1/2-year bear market. Growth has beat value by 4% a year, compounded."

In a recent Barron's piece, we came across this comment: "One of the enduring and puzzling features of this equity cycle has been value's lackluster performance," wrote JPMorgan's Dubravko Lakos-Bujas in a note earlier this month. "Despite intermittent reversal rallies (2009, 2012-13, 2016), value is currently trading at the biggest discount ever and offers the largest premium over the last 30 years." Ever is a long time.

Extrapolation is not an investment process, but that's what many investors do best. They take recent index movement and one or two variables that they think explain the market and make decisions based on those without taking a granular look at other key elements. It's why growth and momentum stocks work until they don't.

Valuing stocks too richly based on unsustainable growth is ultimately a recipe for disaster. Growth stocks have been so dominant simply because they rode the wave of index investing that has become popular. They are the key stocks in the market cap-weighted indices. The same fascination with growth and momentum stocks is also going on in Europe.

Exhibit 4: Expensive: Percentile Valuation of Momentum is at 99% since Dec-89



Source: FactSet, Morgan Stanley Research. Pctl % of average median P/FE & P/B of Q1/Q5. The factors are the top versus bottom quintile from MSCI Europe.

In a world dedicated to index-chasing, discounting future cash flows and individual stock analysis are now considered ineffective though they have been and will be the very foundation of the investment decision-making process. Had we not seen all of this in 2000, we'd be more surprised. Like they ultimately did in that earlier period, we expect value stocks to return to favor simply because they offer much more compelling future return profiles.

The favored growth stocks are seeing revenues slow from peak growth rates. That should weigh on valuations at some point. Perhaps a steepening in the Treasury curve brought about by easier central bank policies will be another catalyst favoring value, but we are simply content knowing we are positioned to take advantage of a return to normalcy.

We also suspect that sooner or later, markets will figure out how important corporate stock buybacks were in this cycle. Without them, the Fed's omnipotence would have been called into question already because investor net flows into stocks have been small on a relative basis. Credit measures have now been pushed to the limit as $4-5 trillion in debt was added to balance sheets. When credit investors turn cautious, the buyback craze will end.

We are now 102% long and 46% short with a 14% net equity exposure without including option positions. Closed-end bond fund holdings comprise a 38% total position (15% municipals, 4% TIP's, 3% mortgages, and the remaining 16% in diverse sectors). Many of our positions in CEF's and mortgage REITS would benefit from the steeper curve that the Fed is attempting to engineer. We continue to think our short book offers a compelling risk-reward profile beyond hedging our long positions.

The current thought that buyers will remain in place for long enough to exit positions before volatility erupts is greater fool theory in play. This can backfire quickly in this market because liquidity is not at all deep. Last December and this May should have made this obvious, but old habits of responding to central bank jawboning die hard. The current tendency for indices to become quite volatile both up and down is a typical late-cycle phenomenon that should be respected.

An additional risk is that Team Trump thinks it is negotiating with China from a position of strength because it does not seem to understand that the economy is stalling. Buying stocks on the notion that trade issues will be resolved fails to account for deteriorating conditions beyond tariff effects. At the same time, a resolution of these issues without much of substance being accomplished would not surprise us either and that would be beneficial to stocks. We think that is what happened with the Mexican tariff threat.

Events of recent months represent a critical juncture in the monetary history of the U.S. The Fed is looking to ease with stock indices near the all-time highs and some of the easiest financial conditions ever recorded already in place. This demonstrates that it has trapped global economies and markets in the Hotel California we have warned about over the years.

The market and the Fed see no room for even a slight move towards the tighter side of the equation. That is how precarious the landscape has become as tremendous leverage has built up in the system. The Fed offers solace to worried investors, but this only encourages more speculation. This is not a good scenario.

We urge caution. Some of the biggest losses of past cycles took place when investors decided that despite clearly deteriorating fundamentals, they would ignore warning signs because "the Fed had their backs" as a new easing cycle began. We think we are near that point, but credit spreads have yet to sound a major alarm. It is important to remember that stocks are broadly valued at two to three times normal levels, so the opportunity cost of remaining well hedged is about as low as it has ever been.

One untold story of this cycle is how value stocks have failed to rally with fervor in response to central bank policy. It's not told because it does not fit the omnipotent Fed narrative. We think value stocks' underperformance speaks to how central bank policies don't drive the economy in a traditional way. At the same time, we think it calls into question how much longer investors will react positively to monetary madness because the growth stocks that have been the leaders of this cycle have been stretched to historic levels versus value stocks while their business momentum is ebbing.

The Fed's problem is that over the last year it became too tight only relative to ten years of ludicrous policies that have left it with much less future flexibility. If you had a crystal ball and told investors in 2009 how poor economic growth would be for ten years given how recklessly and shamelessly central bankers were about to behave, most would not have believed you. That has yet to be discounted by equity holders.

Sincerely,

Scott E. Brown, CFA