Commentary - "The Newport Looking Glass" – October 2018

Portfolio Comments

Although cautious on fixed income, there is a corner of the bond market, floating rate notes, that offers some appeal, and new bond positions were added across accounts. One example was the United Technologies floating rate note purchased in September. The current yield on the bond is 2.45%, a year ago the coupon was 1.97%. The coupon adjusts every quarter based on Libor, which has gone up from 1.32% a year ago to 2.50% today. I expect interest rates, including Libor, will continue to go up. Floating rate bonds protect investors from inflation and rising interest rates. If rates continue to rise so will the interest paid to bond holders. Another way to invest in floating rate bonds is through the Van Eck Floating Rate ETF (ticker: FLTR)

On the equity side, exposure to AutoZone was increased. The shares came under pressure from the "Amazon Effect". However, as with Home Depot and other DIY chains, on-line competitors have not made big inroads into auto parts retailing. More important for the AutoZone story is the aging of the US car park. The average age of a US car is now 12 years, up from 10 years in 2008.

Politics-

It is very hard to invest based on expected political outcomes. Even if you predict what happens in the polls you may still get the market implications wrong. The betting markets seem to have the democrats taking over the House while the Republicans hold onto the senate. This may create legislative gridlock, which may not be such a bad thing.

U.S. trade agreements require only a simple majority in both houses. If the Democrats win the house, there may be some horse trading with regards to tax cuts and the Democrats desire for an infrastructure bill.

I take some comfort that, according to Barron's, the S&P 500 has not declined in the 12 months following a midterm election since Truman was President.

Outlook- Higher Interest Rates

The Barclays Bond Aggregate, the benchmark for the US bond market, is down 1.67% year-to - date. I expect bonds will face continued pressure. Much of this will be related to supply and demand. With the end of Quantitative Easing in September of last year the Fed stopped buying bonds; however, three months later the Trump tax cuts came into play, and the US Treasury is now issuing bonds at an historic pace to cover the growing Federal deficit. To compound the demand/supply imbalance, foreign governments have reduced their holding of US debt.

In addition to the heavy supply of Treasuries hitting the market there is also the risk of inflation. This comes from three sources –

1) wage pressure (unemployment at 1970 level)
2) higher energy prices (oil at 4 year high)
3) tariffs placed on goods coming into the US (washing machine prices up 20%)

Add the risk of inflation to the mix and bonds look increasingly unattractive.

Reflecting some expectation of inflation, the yield on the ten-year treasury moved up from 2.45% at the start of the year to 3.20% last week. The increase is not enough to derail growth in the economy, or the stock market. More than likely the economy will continue its strong growth into the fourth quarter and the stock market will continue to march forward, albeit at a slower pace than witnessed in the third quarter.

2019

The market is supposed to be forward looking. Individual stocks, or the market, may start trending down in expectation of the economy, a sector of the economy, or interest rates, changing for the negative. In 2019 the year over year comparisons will get harder. Earnings growth for the S&P 500, based on commentary from UBS, is expected to end this year up 19% from last year. Looking forward, earnings are expected to be up 6% in 2019.

Slowing growth next year, the possibility of continued trade issues with China, and the possibility that inflation picks up, suggest that we may be in the late innings of this bull market. As a result, adding to the equity exposure of portfolios will be dependent on finding something like the AutoZone opportunity.

Ten Years Since the Lehman Brothers Bankruptcy and the Financial Crisis.

On Thursday September 9, 2008 the shares of Lehman Brothers, which were already down 70% that year, fell another 45% when The Korean Development Bank walked away from a potential purchase. Over the weekend the Fed and leading banks failed to put together a rescue package. On Monday Lehman went into bankruptcy, marking the beginning of the Financial Criss.

A lesson from the Financial Crisis is the durability of the US economy. If you had bought the S&P a week before the bankruptcy filing, despite a further one-third drop in the S&P 500, ten years later your investment would have gained almost 130% on price basis and approximately 180% including dividends.