JULY 17, 2019

At first glance, the second quarter of 2019 was straightforward for investors. Equities as measured by the S&P 500 advanced 4.3%, the 10-year Treasury returned 3.9%, and junk bonds returned 2.6%. Our fixed income portfolios benefited from the decline in interest rates, and our equity portfolios outpaced the broad market.

A closer look, however, reveals a more complicated reality. At the same time that the equity markets in the U.S. were making new highs, the Treasury curve was just nine basis points away from inverting, and the Treasury market futures now suggest that a Fed Funds rate cut at the end of July is a sure thing.

These bond market indicators are suggestive of a slowing economy, with a recession potentially on the horizon. We entered 2019 with a base case that the year would be characterized by slowing growth and possibly a mild recession. However, if a recession can be avoided, it will be a “goldilocks” environment for equities. Monetary policy is extremely accommodative, growth is slow but still positive, employment data is strong, and inflation is low.

We continue to believe that any recession in the near term will be a shallow one and will not represent a crisis. Consumer and corporate balance sheets are positioned to withstand a period of retrenchment, and despite its length, this economic cycle has not been overly exuberant.

Among the biggest conundrums we see in the market today is the $12.9 trillion of global debt that traded at a negative yield at quarter end. Said differently, there are $12.9 trillion of bonds where borrowers are knowingly entering into a contract to receive less money at some point in the future than they currently have today. The only lenses through which this makes any sense are the ones where the likelihood of deflation is seen as greater than the possibility of inflation, or where regulation and monetary policy have forced buyers to make uneconomic decisions.

We do not believe that it is a coincidence that at the moment bond markets seem to be throwing in the towel on the threat of future inflation, political populism is on the rise.

In the U.S., the Federal Reserve has a dual mandate of low unemployment and stable, moderate inflation. Historically, it has been generally accepted by central bankers that these two are linked as described by the Phillips curve, which posits an inverse relationship between the unemployment rate and the rate of inflation. To increase inflation, the Fed eases monetary policy to stimulate the economy and lower unemployment. As the labor market tightens, workers gain bargaining power, thereby putting upward pressure on wages and inflation.

This historical inverse relationship between unemployment and inflation seems to have broken down. Central bankers in the U.S., Japan and most of Europe have undertaken unprecedented monetary stimulus over the past decade, improving employment yet consistently failing to produce inflation that reaches their targets.

SPEARS ABACUS

147 EAST 48TH STREET, NEW YORK, NY, 10017
T 212-230-9888 SPEARSABACUS.COM

In retrospect, this failure should perhaps not be surprising against the backdrop of a growing and increasingly sophisticated global pool of labor, workers remaining in the workforce longer and increased potential for automation. In the U.S. and Europe, a large portion of the workforce is not the finite resource that it once was, and the ability for these workers to demand higher wages has diminished.

Populist political candidates have gained influence by tapping into voter frustration with a prolonged period of stagnant real wages. This trend has wide reaching implications for trade, immigration and foreign policy. It will also impact policy domestically.

More of the same (monetary stimulus) is likely beneficial for financial assets and unlikely to cause inflation. We will be watching for whether rising populism leads to an increase in free spending by governments that could then stoke higher inflation. Were this to occur, it would represent a major challenge to the supportive backdrop that has helped propel equity markets higher this year-to-date, and indeed over the last decade.

Anytime investors are certain something won't happen (in this case inflation), it is good to be mindful of the risks that the opposite occurs. We feel our portfolio is well balanced with ample cash, thoughtfully crafted bond portfolios where appropriate, and equity holdings characterized by strong market positions, high profit margins and conservative balance sheets.

Important Note About SA Investor Commentaries

This letter should not be relied upon as investment advice. Any mention of particular stocks or companies does not constitute and should not be considered an investment recommendation by SA. Any forward-looking statement is inherently uncertain. If you would like to learn more about SA and its investment program, please contact us at www.spearsabacus.com.

Please contact SA if your financial situation or investment objectives have changed in any way or if you wish to impose new restrictions or modify existing restrictions on your accounts. You should be receiving, at least quarterly, a statement from your custodian showing transactions in your accounts. SA urges you to compare your custodial statements to any statements that you receive from SA.