

# NEWSLETTER

*THE*

MILES *Capital* • UPDATE

*2018*

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# NEW ROADS AHEAD MANAGING THE CURVES

U.S. fundamentals have remained strong, as evidenced by solid third quarter 2018 Gross Domestic Product (GDP) growth of 3.4 percent. Several leading economic indicators suggest we should continue to see solid growth over the coming quarters. These measures include continued low unemployment at 3.7 percent and moderately strong housing. We also see some pressures that could lead to wage growth.

A few potential longer term challenges do include the housing market, as pricing is increasing at a reduced level due to rising mortgage rates and declining home affordability. The consumer represents approximately two-thirds of U.S. GDP, so we are

watching these trends carefully. There are also potentially longer term pressures on earnings growth after experiencing over 25% percent overall earnings growth for the members of the S&P index for the last three quarters. The tax cut bump we experienced in early 2018 may be winding down.

Volatility in the financial markets has risen considerably since September. A key factor contributing to the selloff was a high level of uncertainty surrounding political policy and more specifically policy around trade and tariffs. In addition, worry that the US Federal Reserve (Fed) policy of raising rates has gone too far has begun to create some anxiety with investors.

The Fed has raised rates nine times since December 2015, after maintaining rates effectively at zero for several years due to the 2008 financial crisis. The rate hikes include four increases during 2018. They have indicated they will be raising rates 2 times in 2019 (previously they indicated three raises during 2019) and potentially one raise in 2020. The Fed is keeping close tabs on inflation which is running on the lower side of their 2% range, as well as watching for economic changes as the result of recent market volatility.

The risks to the economy include tariffs, inflation and global uncertainties.

## 4TH QUARTER *snap shot*

9x

THE FED HAS RAISED RATES NINE TIMES SINCE DECEMBER 2015, AND FOUR TIMES ALONE IN 2018.

0.18%

THE DIFFERENCE BETWEEN THE 10 YEAR AND 2 YEAR YIELDS HAS SHRUNK TO LEVELS NOT SEEN IN OVER A DECADE.

### TREASURY CURVES



Source: Bloomberg

# MARKETS TAKE CENTER STAGE INVESTORS SHAKEN

Just as 2018 started with a roar, it ended with a whimper as markets across the globe experienced significant volatility and sold off over the last few quarters. While much of the volatility was concentrated in the equity markets, the fixed income markets did not escape the risk reduction trades. The “risk-off” positioning of investors caused a fairly dramatic divergence in returns across the different fixed income market sectors. The trade and policy uncertainty caused many investors to pull back from the market segments that could be impacted the most such as the credit sectors. Defensive sectors such as U.S. Treasuries performed much better than credit sectors.

Changes in the overall level of interest rates drove fixed income returns for the quarter and the year. Interest rates, as measured by the 10 year U.S Treasury note, declined significantly for the quarter and ended the year at 2.69 percent which was 0.38 percent lower than where it started the quarter. For the year, interest rates actually rose modestly for longer maturities and rose more dramatically for short term bonds due to the four Federal Reserve increases during 2018. The difference between the 10 year and 2 year yields has shrunk to levels not seen in over a decade, resulting in a very flat interest rate curve. A partial inversion of the interest rate curve (between the two-year and five-year) and the prospect for a full inversion, defined as the environment when long term interest rates have lower yields than short term interest rates, added to investors’ worries as historically that condition has preceded many U.S. recessions.

The Bloomberg Barclays Aggregate index, a broad measure of the investment grade U.S. bond market, ended higher by 1.64 percent for the quarter largely due to falling interest rates but returns for the full year were essentially flat as rising rates in the first half of 2018 and increasing risk premiums during the second half eroded total returns. Most major credit sectors including corporate, municipal, mortgage backed, and agency bonds significantly underperformed similar duration U.S. Treasury securities for the quarter and overwhelmed any gains realized during the first three quarters of the year. Within the investment grade corporate sectors, lower quality assets underperformed higher quality and longer duration underperformed shorter duration securities.

The recent market turmoil has understandably created some anxiety. But, we at Miles Capital believe it’s important to step back and assess the longer term fundamental and economic trends, which remain solid, especially in the U.S. We expect 2019 will bring additional volatility while the markets contend with more political turmoil and further rate increases. While we are constantly monitoring the markets and the economy for new opportunities and risks, it is these longer term themes and trends which drive our major investment decisions. Clearly the markets have entered a new level of volatility but those investors who stick with their long term investment plan will likely be better served.



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CORPORATE BUYBACKS WERE ANNOUNCED TO BE A RECORD OF \$1 TRILLION FOR THE YEAR

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# EQUITY THE BULL TAKES A BEATING

U.S. stocks had a rough fourth quarter to cap off the first calendar year with a negative return since 2008. Long standing “buy the dip” trades burned out, as the particularly crowded FAANG (Facebook, Amazon, Apple, Netflix, and Google) trade fell hard during the quarter. Corporate buybacks were announced to be a record of \$1 Trillion for the year, exceeding the prior record of \$781 Billion in 2015.

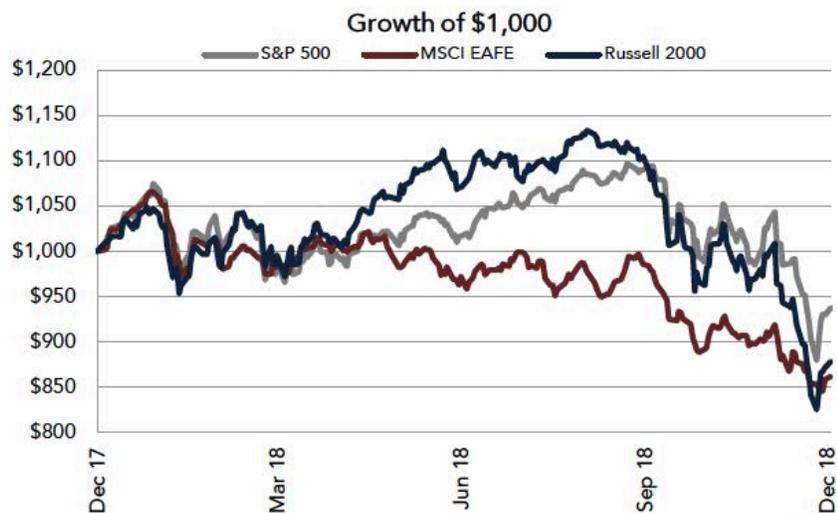
Earnings growth for the third (most recently reported) quarter was 26 percent growth year-over-year. That is the highest growth since Q3-2010 and exceeds the prior two quarters’ 25 percent growth. For Q4-2018, earnings are expected to grow at nearly 12.5 percent, which would be the fifth consecutive quarter of double digit earnings growth. Earnings growth in 2019 is estimated to be in the mid to high single digits; valuations (12-month forward P/E ratio) now look particularly attractive, as they have dipped below the 10-year average (15.78x).

## U.S. EQUITIES SOLD OFF SIGNIFICANTLY IN THE FOURTH QUARTER.

For most of 2018, the markets largely ignored the drama surrounding the President and focused on the tailwinds of tax cuts and deregulation. This sentiment seemed to change in the fourth quarter with the publicity around “Tariff Man,” the Cohen guilty plea, Mattis resigning on the Syria troop decision, continued criticism of the Fed and Chairman Powell, and the partial government shutdown over the border wall.

Despite the December Trump-Xi truce on trade, the U.S. has imposed tariffs on \$250B of Chinese imports, and there are still further structural changes that China is resisting. Tensions beyond trade also exist, with the administration accusing China of meddling in U.S. democracy, using “debt diplomacy” to broaden influence, and engaging in currency manipulation and IP theft. While the ending net impact of a trade dispute is not detrimental to the U.S., it has shaken investor confidence.

We continue to watch for all emerging and developing risks and opportunities, keeping our focus on long term investing for clients.



Source: Bloomberg

## HEDGE FUNDS

# OUTPERFORM BUT ARE NOT IMMUNE TO MARKET TRENDS

Hedge funds fared better than equities during the volatility of the fourth quarter, but still felt the impact of the “risk off” movement. After a hawkish posture in September, the Federal Reserve made mildly dovish comments in advance of the December meeting, only to disappoint the markets by projecting two additional hikes in 2019.

The ongoing trade war between the U.S. and China resulted in downgrades to global growth estimates for 2019, while the positive sentiment from the trade war truce was short lived. Broad equity market performance weighed on long/short equity strategies, as did an exodus from some widely held hedge fund names.

Event driven strategies benefitted from the completion of several mergers. The acquisition of Aetna by CVS, one of the more widely held deals by merger arbitrage managers, resulted in a return for the quarter of nearly +5%. Deals involving Shire Pharmaceuticals and Express Scripts, additional widely held healthcare names, also closed. Rockwell Collins, Forest City Realty, Pinnacle Foods and CA Technologies were a few of the other companies that saw transactions completed. The decline in the equity markets resulted in deal spreads widening, particularly for all cash deals

which make up about half of all outstanding deals.

Macro strategies were mixed. While still negative, overall macro funds produced the best performance. Emerging markets performed better than developed markets, enabling discretionary managers to post better relative returns. Systematic strategies struggled as they still maintain long exposure to equities, although less than earlier in the year. Net short exposure to interest rates also detracted, as U.S. Treasury bonds gained over concerns around global growth, resulting in rates declining 30-40 basis points. Energy, another persistent long exposure, provided additional headwinds. The price of oil declined nearly 40% amid oversupply concerns. OPEC struggled to agree on production cuts while the U.S. became a net exporter of oil for the first time since 1973. Falling industrial metal prices provided a partial offset to the negative performance, as did strength in the U.S. dollar.

With the challenges, hedge funds still outperformed, demonstrating their purpose and usefulness during market volatility. We do not expect the volatility to end as we head into 2019, suggesting a continued benefit of the risk mitigation characteristics of these funds.

## 4TH QUARTER *snap shot*

# 26%

EARNINGS GROWTH FOR  
THE THIRD QUARTER WAS 26  
PERCENT GROWTH YEAR-  
OVER-YEAR

# 25%

WTI CRUDE OIL DROPPED  
NEARLY 25 PERCENT DURING  
THE FOURTH QUARTER

### EARNINGS GROWTH



Source: Bloomberg

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*Contact us at 800.343.7084 if you have additional questions or would like to visit with any of our team members.*

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