March 2019

From the front page of this weekend's WSJ:

By Akane Otani

U.S. stocks notched their biggest quarterly gains in nearly a decade, lifted by bets that central banks would hold interest rates at low levels as global growth slows. (U.S. 4Q GDP increased at a 2.2% annualized rate, the Commerce Department reported on Thursday, down from the 2.6% pace estimated in February.)

Major indexes have now recouped almost all of the losses they suffered in the final months of 2018, when fears about an economic downturn sent markets around the world sliding.

Much of this year’s rally was fueled by relief that central banks were willing to back off their rate-increase campaigns after growth cooled from the eurozone to China and stocks swooned ....

The S&P 500 added 13% for the quarter, its best showing since 2009, and rose 0.7% to 2834.40 on Friday. The Dow Jones Industrial Average on Friday jumped 211.22 points, or 0.8%, to 25928.68, finishing the quarter up 11%. The Nasdaq Composite rose 60.16 points, or 0.8%, to 7729.32 and added 16% for the quarter.

Gains were broad, with all 11 S&P 500 sectors ending higher for the quarter for the first time since 2014.

Technology shares extended a streak of gains that have made them the strongest-performing sector in the S&P 500 this year. ...

Another standout in the first quarter: energy stocks. ...

Despite the rally of the past couple months, U.S. stock indexes have yet to climb above the highs they hit last fall. Major indexes have flitted close to records, only to retreat as fears about cooling economic momentum sparked a slide across stocks, commodities and bond yields.

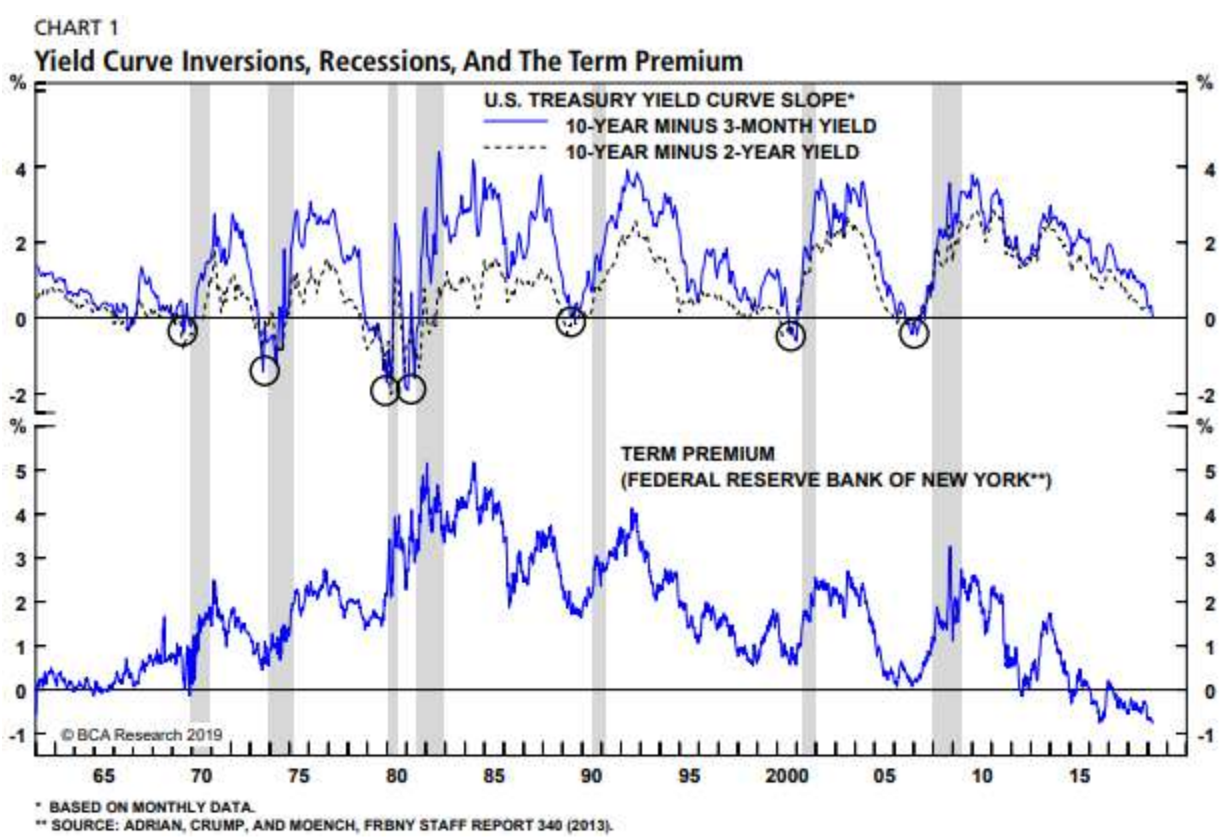
The yield on the benchmark 10-year U.S. Treasury note—considered a bedrock for global finance because it is used to help set borrowing costs—settled at 2.416% Friday .... (Chart from Bespoke.)

Two events toward the end of March need to be addressed. First, the inversion of the yield curve. This is thoroughly analyzed in Friday's Global Investment Strategy's "Second Quarter 2019 Strategy Outlook: From Dead Zone to End Zone":

Here We Go Again?

... In the beginning of March, we wrote that "having rallied since the start of the year, global stocks will likely enter a 'dead zone' over the next six-to-eight weeks as investors nervously await the proverbial green shoots to sprout."

Last Friday's release of disappointing European PMI data poured some herbicide on the green shoots thesis. Germany's manufacturing PMI hit a six-year low, with the new orders component registering the weakest



reading since the Great Recession. This took the 10-year German bund yield into negative territory for the first time since 2016. The U.S. 10-year Treasury yield also fell to a 15-month low, causing the 3-month/10-year curve to invert. Historically, an inverted yield curve has been a reliable predictor of U.S. recessions (**Chart 1**).

President Trump's decision to appoint TV commentator Stephen Moore to the Fed's Board of Governors did not help matters. Recommended by fellow supply-side "economist" Larry Kudlow, Moore is best known for dismissing concerns over the state of the housing market in 2007, his spot-on 2010 prediction that QE would cause hyperinflation, and his belief that the Trump tax cuts would lead to a smaller budget deficit.

Global Growth Will Accelerate In The Second Half Of The Year

Given all these worrisome developments, is it time to turn cyclically bearish on the economic outlook and risk assets again? We do not think so. ... sentiment should improve as global growth finally accelerates after a series of false starts. Indeed, some positive signs are already visible: The diffusion index of our global leading economic indicator, which tracks the share of countries with rising LEIs, has moved higher. It leads the global LEI. Service sector PMIs have also generally improved, suggesting that the weakness in global growth remains concentrated in trade and manufacturing. And even on the trade front, a few forward-looking indicators such as the Baltic Dry Index and the weekly Harpex shipping index, which measures global container shipping activity, have bounced off their lows.

We would downplay the signal from the yield curve, as it currently is severely distorted by a negative term premium. If the 10-year Treasury term premium were back to where it was in 2004, the 3-month/10-year slope would be more than 200 bps steeper, and nobody would be talking about this issue. In fact, given today's term premium, the curve would have almost certainly inverted in 1995. Anyone who got out of stocks back then would have missed out on one of the greatest bull markets in history.

It should also go without saying that some of the decline in the U.S. 10-year yield reflects a positive development: The Fed has turned more dovish! If one looks at the 10-year/30- year portion of the yield curve, it has actually steepened. This is a sign that the market is seeing the Fed's actions as being reflationary in nature.

There is no clear causal mechanism by which an inverted yield curve slows economic activity, apart from it potentially becoming a self-fulfilling prophecy where the yield-curve inversion scares investors, thereby leading to a tightening in financial conditions. Such "doom loops" are conceptually possible, but as we discussed earlier this year, they are unlikely to occur in the current environment. At any rate, financial conditions have eased since the start of the year. This should boost growth in the coming months.

Chinese Credit Growth Set To Rise

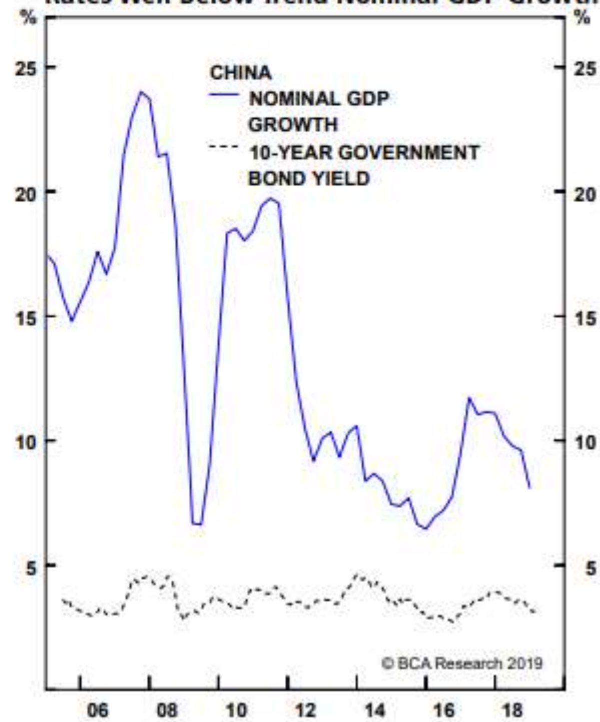
Global growth has been weighed down by a slowing Chinese economy. Last year's deleveraging campaign led to a significant deceleration in investment spending, which had negative repercussions for capital equipment and commodity producers all over the world.

Historically, China has loosened the reins on the financial sector whenever credit growth has fallen towards nominal GDP growth. It appears we have reached this point. Despite a weak seasonally-distorted February print, credit growth has finally accelerated on a year-over-year basis.

We do not expect Chinese credit growth to rise as much as in past releveraging cycles. However, this is because the economy is in better shape, not because there is some intrinsic constraint to increasing debt from current levels.

China's elevated savings rate has kept interest rates well below trend nominal GDP growth, which is the key determinant of debt sustainability (**Chart 6**). As long as the central government maintains an implicit guarantee on most local and corporate debt, as it is currently doing, default risk will remain minimal. In any case, given that total debt stands at 240% of GDP, even a one percentage-point increase in credit growth would generate a hefty 2.4% of GDP in credit stimulus. ...

CHART 6
China's High Savings Rate Has Kept Interest Rates Well Below Trend Nominal GDP Growth



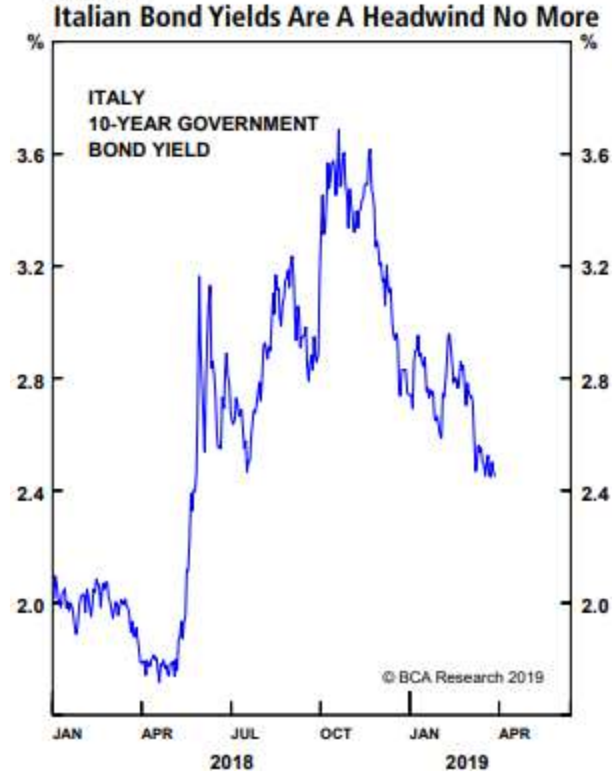
A Lull In The Trade War?

A de-escalation in the trade war would help matters. As a self-professed master negotiator, Donald Trump needs to secure a deal with China before next year's presidential election, while also convincing American voters that the agreement was concluded on favorable terms for the United States.

Reaching a deal with China early on in his term would have been risky for Trump if it had failed to bring down the bilateral trade deficit – an entirely likely outcome given how pro-cyclical U.S. fiscal policy is. At this point, however, Trump could crow about making a great deal with China while reassuring voters that the product of his brilliance will be realized only after he has been re-elected. Thus, the likelihood that Trump will seek to strike a deal has risen.

For their part, the Chinese want as much negotiating leverage as they can muster. This means being able to convincingly demonstrate that their economy is strong enough to handle the repercussions from turning down a trade deal that fails to serve their interests. Since the credit cycle is the dominant driver of Chinese growth, this requires putting the deleveraging campaign on the backburner.

CHART 8
Italian Bond Yields Are A Headwind No More



Faster Global Growth And Stronger Domestic Demand Will Benefit Europe

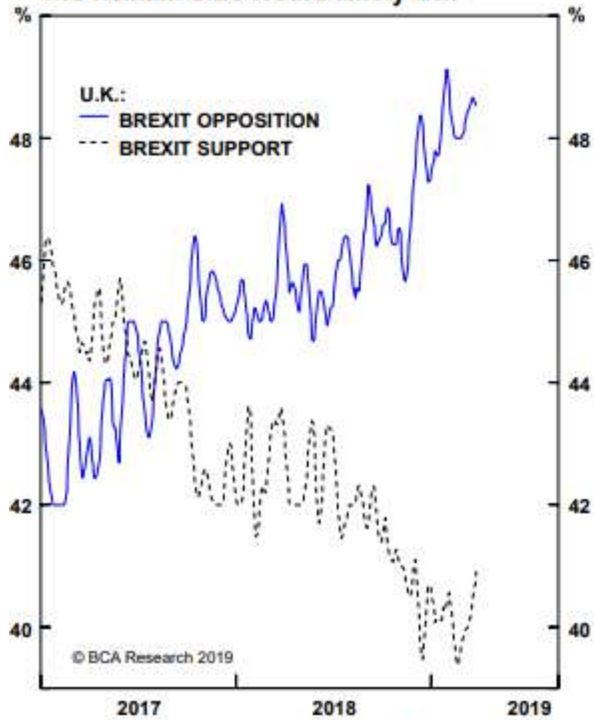
Stronger Chinese growth will help the European export sector later this year. ... Meanwhile, euro area domestic demand will benefit from a more accommodative fiscal policy and lower bond yields.

The decline in bond yields will be especially helpful to Italy. The spike in yields and loss of business confidence following the election of a populist government last March plunged the economy into recession (**Chart 8**). Now that the 10-year BTP yield has fallen more than 100 bps from its highs, the Italian economy should start to perk up.

The ECB will not raise rates this year even if domestic growth speeds up, but the market will probably price in a few rate hikes in 2020 and beyond. This will allow for a modest re-steepening of yield curves in core European bond markets, which should be positive for long-suffering bank profits.

Brexit remains a concern. The ongoing saga has reached the farcical stage where: 1) The U.K. has voted to leave the EU; but 2) Parliament has voted to stay in the EU unless it reaches a satisfactory deal with Brussels; while 3) rejecting the only deal with Brussels that was on offer. Given that most British voters no longer want Brexit (**Chart 9**), we think that the government will kick the proverbial can down the road until a second referendum is announced or a "soft Brexit" deal is formulated. Either outcome would be welcomed by markets.

CHART 9
U.K.: In The Case Of A Do-Over, The Remain Side Would Likely Win



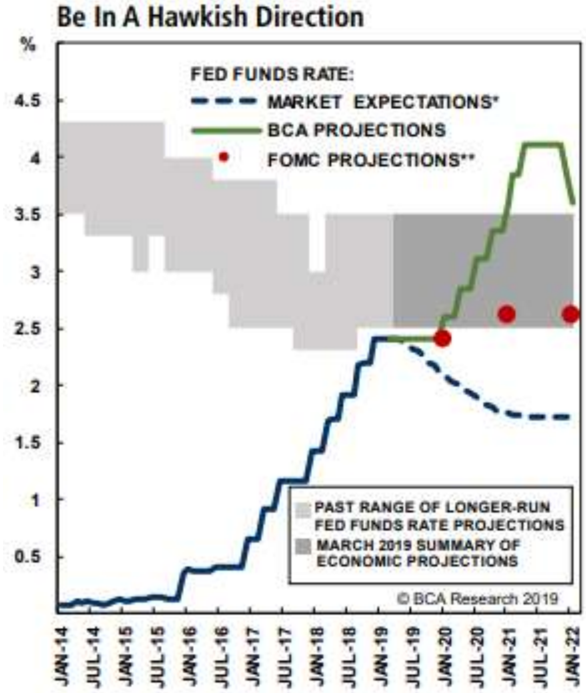
THE QUESTION ASKS "IN HINDSIGHT, DO YOU THINK BRITAIN WAS RIGHT OR WRONG TO VOTE TO LEAVE THE EU?"
NOTE: BOTH SERIES SHOWN AS A 15-DAY MOVING AVERAGE.
SOURCE: WHAT U.K. THINKS.

What Will The Fed Do?

Last year's "Christmas Crash" clearly shifted the Fed's reaction function in a more dovish direction. We do not expect Jay Powell to raise rates over the next few months, but a reacceleration in global growth is likely to prompt the Fed to tighten anew in December. The Fed will continue raising rates once per quarter in 2020, before accelerating the pace of tightening in 2021 in response to rising inflation.

In all, we see the fed funds rate increasing to around 4% by the end of this cycle. This represents nine quarter-point hikes more than the market is currently discounting (**Chart 10**). ...

CHART 10
The Next Fed Pivot Will Be In A Hawkish Direction



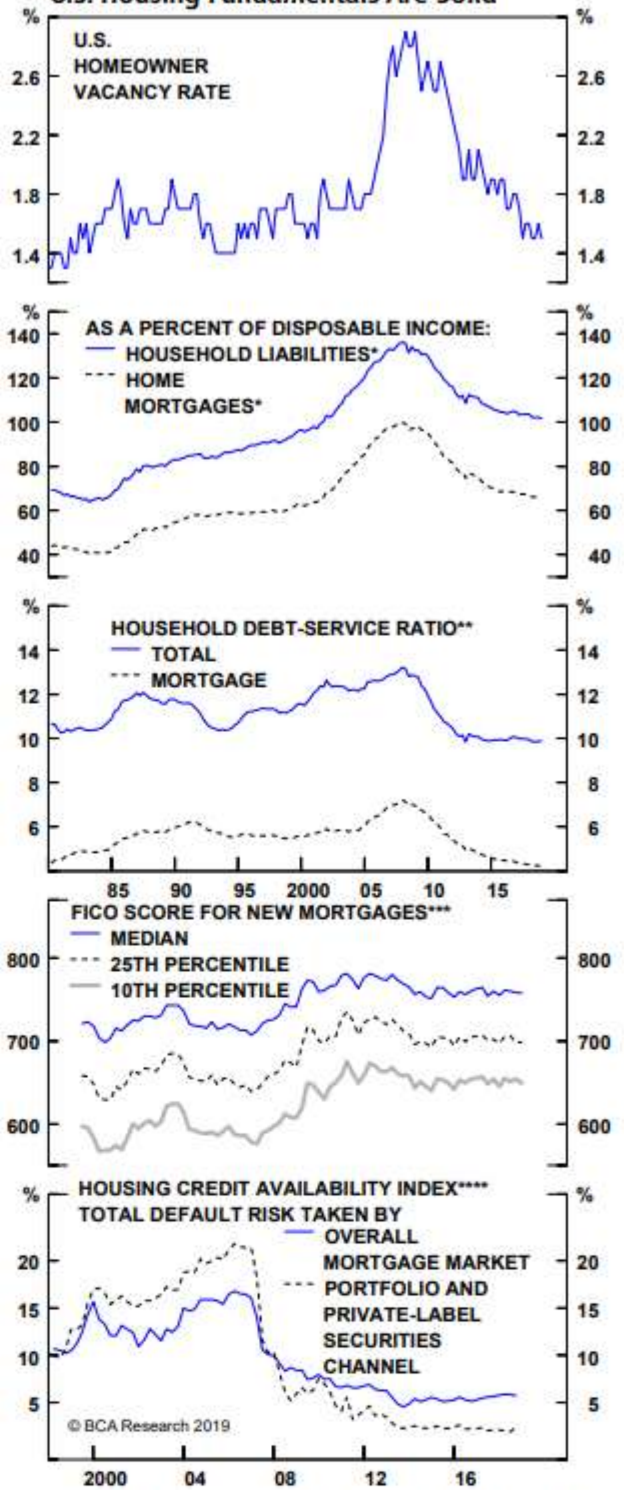
* REFERS TO EXPECTATIONS OF THE AVERAGE DAILY FED FUNDS RATE DURING THE MONTH AS DISCOUNTED BY THE FED FUNDS FUTURES MARKET.
** FOMC MEDIAN PROJECTIONS FROM MARCH 2019.
SHADED AREA DENOTES THE RANGE OF FOMC PROJECTIONS FOR THE LONGER-RUN FED FUNDS RATE.

The U.S. Economy: Great Again

Fundamentally, the U.S. economy is on solid ground and can handle higher interest rates. Unlike a decade ago, the housing market is in good shape (**Chart 11**). The homeowner vacancy rate stands near a record low. Judging by FICO scores, the quality of mortgage lending remains high. The labor market is also firm, with job openings hitting another record high in February (**Chart 12**). The combination of a healthy housing and labor market is invariably good for consumers.

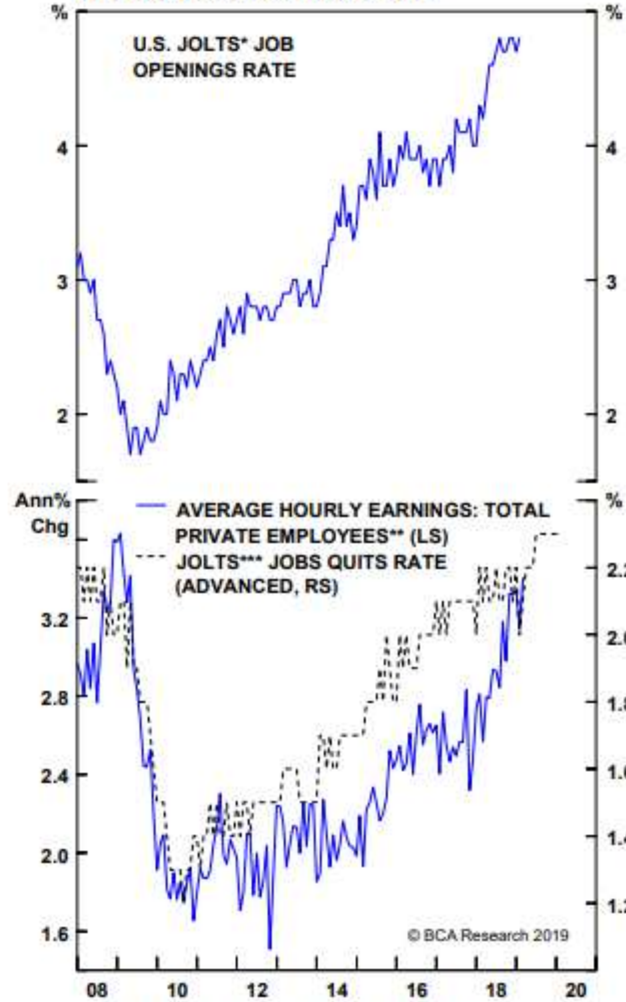
The personal savings rate currently stands at 7.6%, notably higher than one would expect based on the ratio of household net worth-to disposable income (**Chart 13**). A decline in the

CHART 11
U.S. Housing Fundamentals Are Solid



* SOURCE: FEDERAL RESERVE (FINANCIAL ACCOUNTS OF THE UNITED STATES).
** SOURCE: FEDERAL RESERVE.
*** WHERE 10% OF NEWLY ORIGINATED MORTGAGES ARE TO BORROWERS WITH CREDIT SCORES UNDER THE 10TH PERCENTILE, AND A QUARTER OF NEWLY ORIGINATED MORTGAGES ARE TO BORROWERS WITH CREDIT SCORES UNDER THE 25TH PERCENTILE. SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
**** SOURCE: URBAN INSTITUTE HOUSING FINANCE POLICY CENTER.

CHART 12
The U.S. Labor Market Is Firm

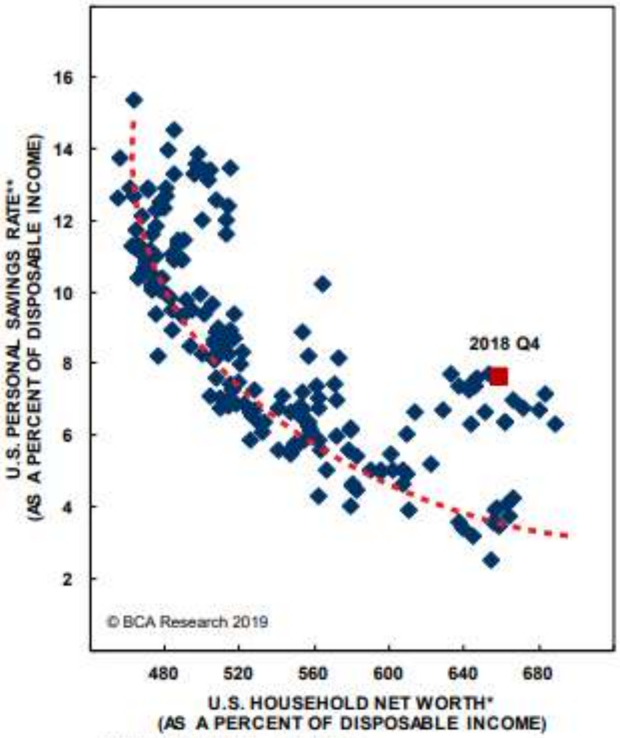


* JOB OPENINGS AND LABOR TURNOVER SURVEYS (JOLTS). SOURCE: BUREAU OF LABOR STATISTICS.
** NOMINAL EARNINGS, PRIVATE NONFARM PAYROLLS.
*** JOB OPENINGS AND LABOR TURNOVER SURVEYS (JOLTS), ADVANCED BY 12 MONTHS.

savings rate would allow consumer spending to increase more quickly than income. With the latter being propped up by rising wages, this will be bullish for consumption.

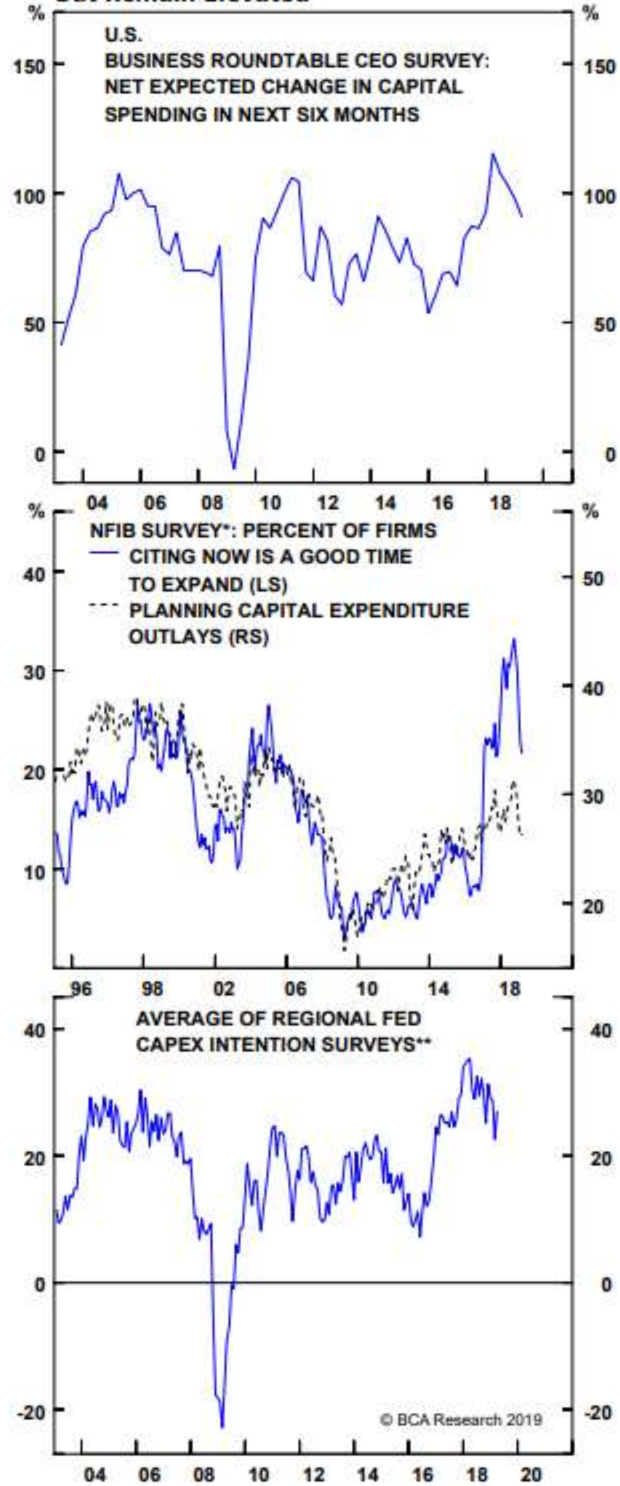
Capital spending intentions have dipped over the past few months, but remain elevated by historic standards (**Chart 14**). The real nonresidential capital stock has grown by an average of only 1.7% since the start of the recovery, down from 3% in the pre-recession period. A cyclical upswing in productivity growth, rising labor costs, and low levels of spare capacity should all motivate businesses to invest in new plant and equipment.

CHART 13
The U.S. Savings Rate Has Room To Fall



* BASED ON FLOW OF FUNDS DATA.
** BASED ON BUREAU OF ECONOMIC ANALYSIS (BEA) DATA. LATEST DATA POINT IS DECEMBER 2018.

CHART 14
Capital Spending Intentions Have Softened, But Remain Elevated



* SOURCE: NATIONAL FEDERATION OF INDEPENDENT BUSINESS. SHOWN SMOOTHED.
** SOURCE: AVERAGE OF CAPITAL EXPENDITURE EXPECTATIONS INDEXES (IN 6 MONTHS) FOR THE DALLAS, KANSAS CITY, NEW YORK EMPIRE, PHILADELPHIA, AND RICHMOND FED REGIONAL SURVEYS.

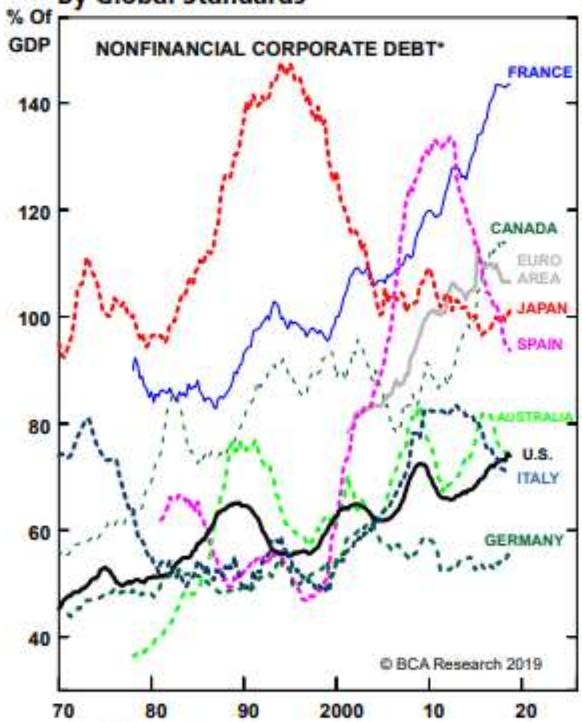
Corporate Debt: How Much Of A Risk?

Corporate debt levels have increased significantly in recent years, while underwriting standards have deteriorated, as evidenced by the proliferation of covenant-lite loans. Nevertheless, the situation is far from dire.

Relative to other countries, U.S. corporate debt is quite low (**Chart 16**). At 143% of GDP, corporate debt in France is twice that of the United States. This is not to suggest that everything is fine in the French corporate sector; but the fact is that France has not had a corporate debt crisis. This signals that the U.S. is not at imminent risk of one either.

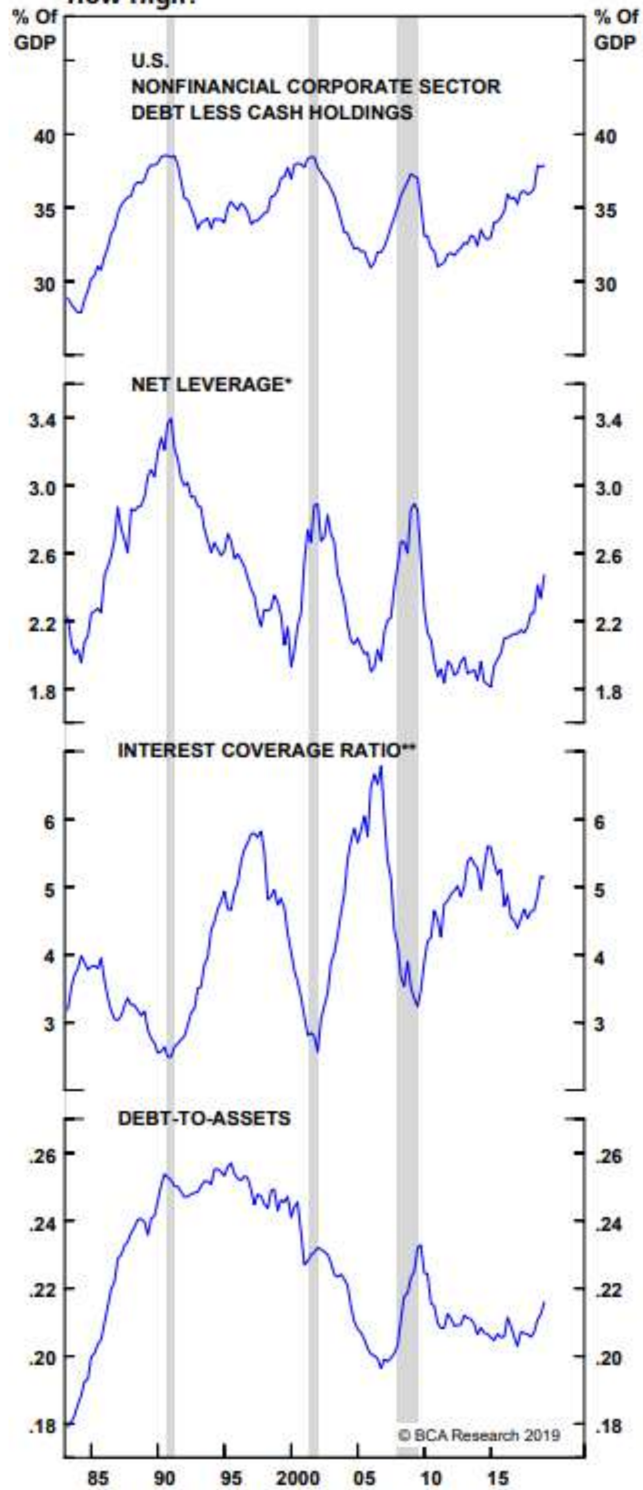
Netting out cash, U.S. corporate debt as a share of GDP is at the same level it was in 1989, a year in which the fed funds rate was close to nine percent. The ratio of corporate net debt-to-EBITD remains reasonably low. The interest coverage ratio is above its historic average. In addition, corporate assets have also risen quite briskly over the past few years, which has kept the corporate debt-to- asset ratio broadly stable (**Chart 17**).

CHART 16
U.S. Corporate Debt Is Not Extreme By Global Standards



* SOURCE: BIS.

CHART 17
U.S. Corporate Debt: How High?



* TOTAL DEBT LESS NET WORKING CAPITAL (EXCLUDING INVENTORIES) DIVIDED BY EBITD.
** EBIT-TO-INTEREST PAID.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

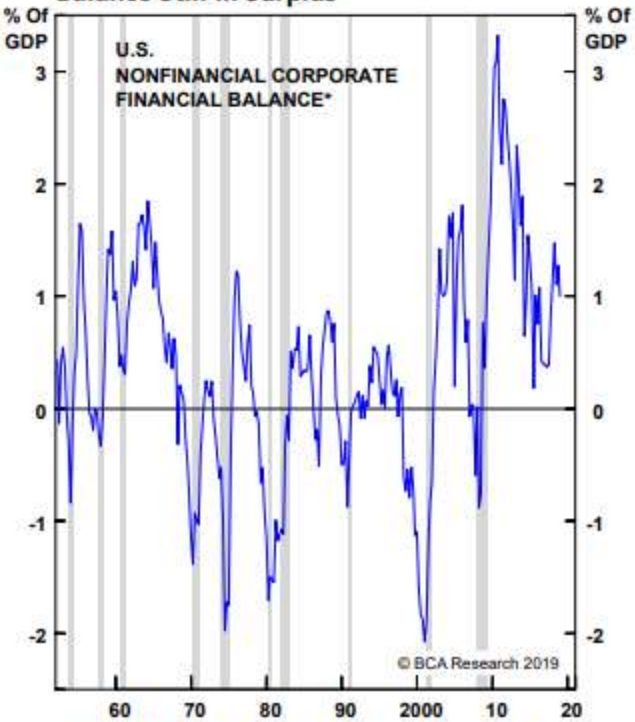
The corporate sector financial balance – the difference between corporate income and spending – is still in positive territory at 1% of GDP. Every recession in the past 50 years began when the corporate sector financial balance was in deficit (**Chart 18**).

Unlike mortgages, which are often held by leveraged institutions, most corporate debt is held by unleveraged players such as pension funds, insurance companies, mutual funds, and ETFs. Bank loans account for only 18% of nonfinancial corporate sector debt, down from 40% in 1980 (**Chart 19**). The share of leveraged loans held by banks has declined from about 25% a decade ago to less than 10% today. Moreover, banks today hold much more high-quality capital than in the past (**Chart 20**). This makes corporate debt less systemically important for the economy. ...

Everyone Agrees With Larry

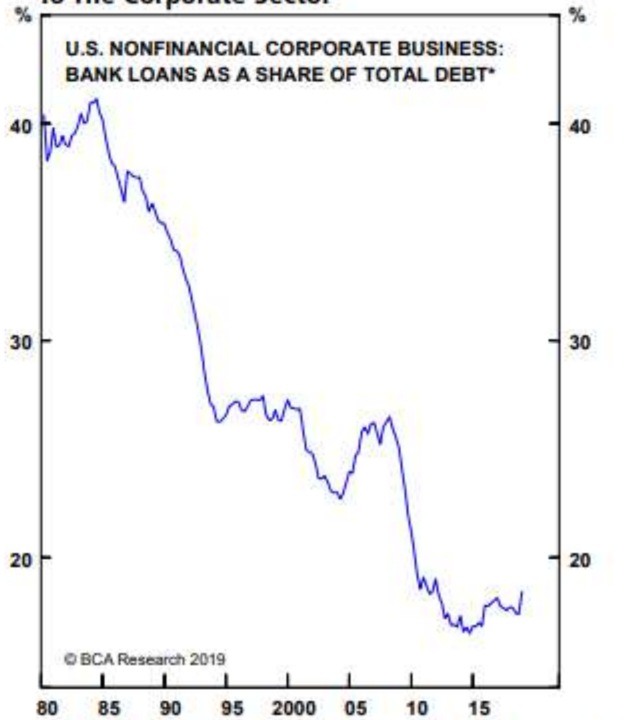
Given the lack of major imbalances in the U.S. economy, why do investors believe that the Fed cannot raise rates further even though the Fed funds rate in real terms is barely above zero? The answer is that investors appear to have bought into Larry Summers' secular stagnation thesis, which posits that the neutral rate of interest is much lower today than it was in the past.

CHART 18
Corporate Sector Financial Balance Still In Surplus



* FINANCIAL BALANCE IS CALCULATED AS GROSS SAVINGS LESS NET CAPITAL TRANSFERS PAID LESS CAPITAL EXPENDITURES (EXCLUDING INVENTORY CHANGE).
Q4 2017 DATA POINT EXCLUDED DUE TO THE IMPACT OF THE TAX ON FOREIGN EARNINGS RETAINED ABROAD (2017 TAX CUTS AND JOBS ACT) ON CAPITAL TRANSFERS.
NOTE: SOURCE: FEDERAL RESERVE (FINANCIAL ACCOUNTS OF THE UNITED STATES).
SHADED AREAS REPRESENT NBER-DESIGNATED RECESSIONS.

CHART 19
Banks Have Reduced Their Exposure To The Corporate Sector



* BANK LOANS DEFINED AS THE SUM OF DEPOSITORY INSTITUTION LOANS AND MOTRGAGES; CORPORATE DEBT DEFINED AS THE SUM OF DEBT SECURITIES AND LOANS.
SOURCE: FEDERAL RESERVE (FINANCIAL ACCOUNTS OF THE UNITED STATES), AND BUREAU OF ECONOMIC ANALYSIS.

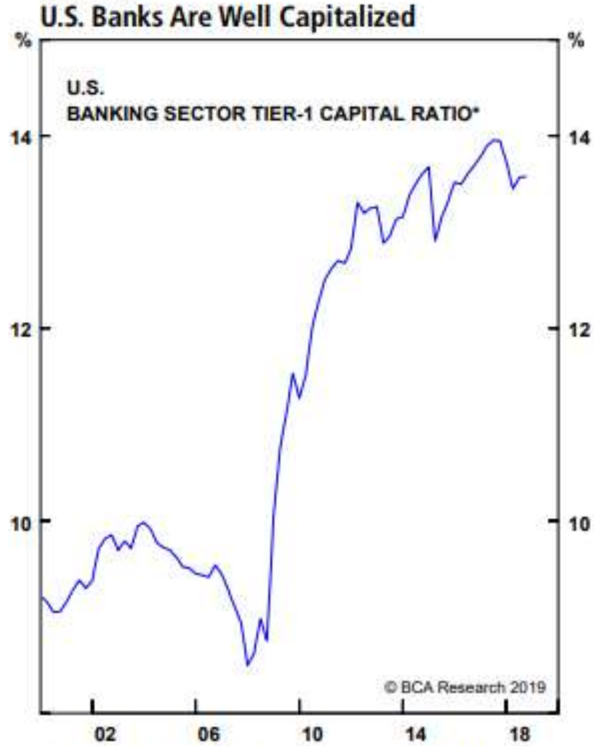
We have some sympathy for this thesis, but it is important to remember that it is a theory about the long-term determinants of interest rates such as productivity and demographic trends. The theory says little about the cyclical drivers of interest rates, including the amount of spare capacity in the economy, the stance of fiscal policy, credit growth, and wage trends.

Earlier this decade ... one could have plausibly argued that the economy needed extremely low interest rates: The output gap was still large; the deleveraging cycle had just begun; home and equity prices were depressed; wage growth was anemic; and fiscal policy had turned restrictive after a brief burst of stimulus during the Great Recession.

Far From Neutral?

All of the forces mentioned above have either fully or partially reversed course over the past few years. Take fiscal policy as one example. The IMF estimates that the U.S. structural budget deficit averaged 3.3% of GDP in 2014-15. In 2019-20, the IMF reckons the deficit will average 5.6% of GDP.

CHART 20
U.S. Banks Are Well Capitalized



* TIER-1 CAPITAL AS A PERCENT OF RISK-WEIGHTED ASSETS, SOURCE: FEDERAL RESERVE BANK OF NEW YORK.

To what extent has easier fiscal policy raised the U.S. neutral rate of interest? Let us conservatively assume that every $1 of additional fiscal stimulus adds $1 to aggregate demand. In this case, fiscal policy has added 2.3% of GDP to aggregate demand over the past five years. Suppose that a one-percentage point increase in aggregate demand raises the neutral rate of interest by 1%, which is in line with the specification of the Taylor Rule that former Fed Chair Janet Yellen favored. This implies that fiscal policy alone has raised the neutral rate by over two percentage points.

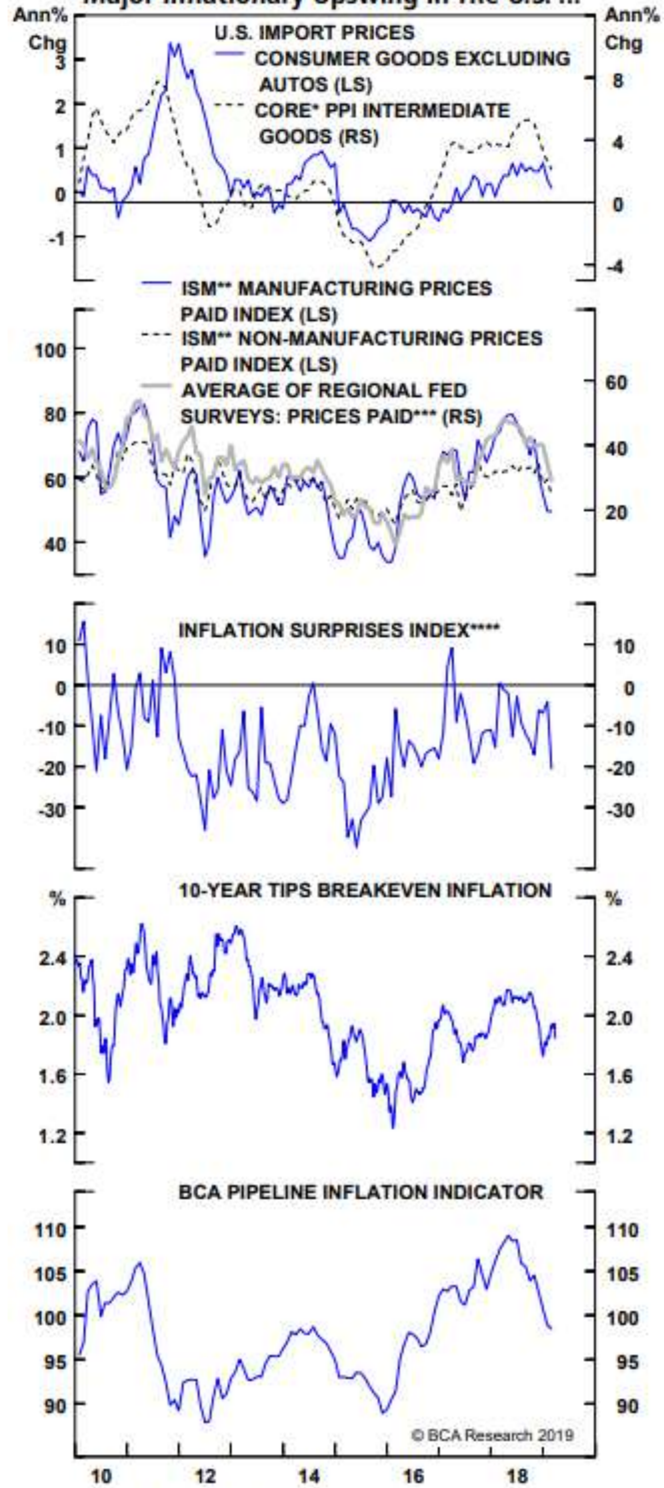
The discussion above suggests that cyclical factors may have pushed up the neutral rate considerably, even if long-term structural factors are still dragging it down. Since the Fed is supposed to set interest rates with an eye on what is appropriate for the economy over the next year or two, rates may end up staying too low for too long. This will cause the economy to overheat, eventually leading to a surge in inflation.

The Inflation Boogeyman

The good news is that none of our favorite indicators point to a major imminent inflationary upswing (**Chart 22**): Despite higher tariffs, consumer import price inflation has slowed; core intermediate producer price inflation has decelerated; the prices paid components of the ISM and regional Fed surveys have plunged; inflation surprise indices have rolled over; and both survey and market-based measures of inflation expectations remain below where they were last summer. In keeping with these developments, BCA's proprietary Pipeline Inflation Indicator has fallen to a two-and-a-half-year low.

Wage growth has accelerated, but productivity growth has increased by even more. As a result, unit labor cost inflation has been coming down since the middle of last year. Unit labor costs lead core CPI inflation by about 12 months (**Chart 23**). This implies that consumer price inflation is unlikely to reach uncomfortably high levels at least until the second half of next year.

CHART 22
No Symptoms of An Imminent Major Inflationary Upswing In The U.S. ...

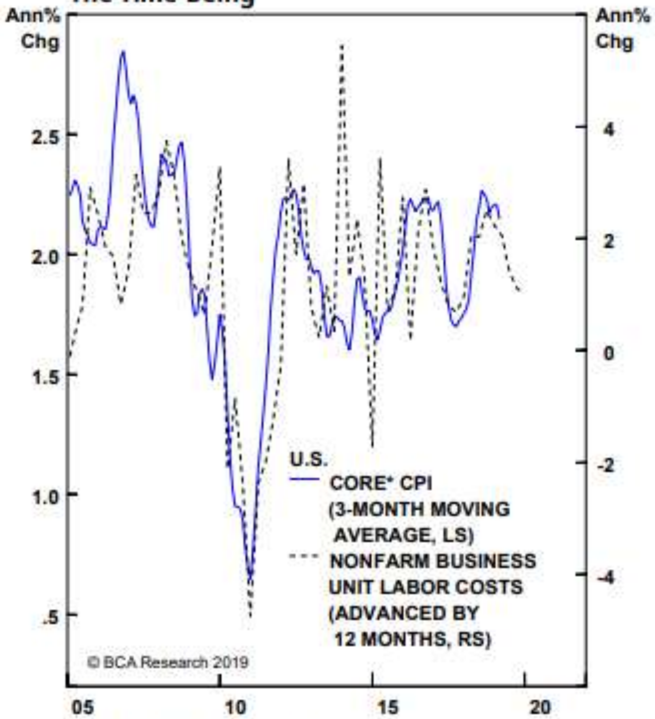


* EXCLUDING FOOD AND ENERGY.
** INSTITUTE FOR SUPPLY MANAGEMENT.
*** SOURCE: AVERAGE OF PRICES PAID EXPECTATIONS INDEXES (IN 6 MONTHS) FOR THE DALLAS, KANSAS CITY, NEW YORK EMPIRE, PHILADELPHIA, AND RICHMOND FED REGIONAL SURVEYS.
**** ROLLING 3-MONTH STANDARD DEVIATION OF DATA SURPRISES. SOURCE: CITIGROUP GLOBAL MARKETS INC.

At that point, risks are high that inflation will move up. This could force the Fed to start raising rates aggressively in early-2021, a course of action that will push up the dollar and cause equities and spread product to sell off. The resulting tightening in financial conditions will probably plunge the U.S. and the rest of the world into recession in mid-to-late 2021.

CHART 23

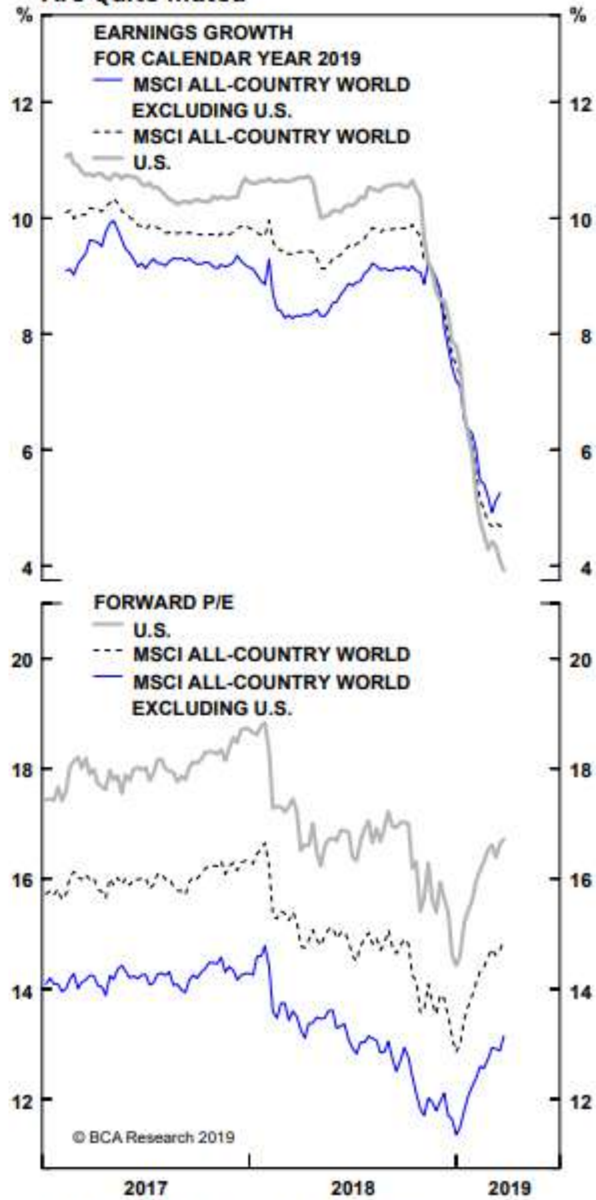
... And Decelerating Unit Labor Costs Will Dampen Inflationary Pressures For The Time Being



* EXCLUDING FOOD AND ENERGY.

CHART 24

Analyst Expectations Are Quite Muted



SOURCE: IBES/THOMSON REUTERS AND MSCI INC. (SEE COPYRIGHT DECLARATION).

Stay Bullish Global Equities For Now, Turn Defensive Late Next Year

The two-stage Fed tightening cycle discussed above – gradual rate hikes starting in December and continuing into 2020, and more aggressive hikes thereafter in response to rising inflation – shapes our investment views over the next few years. ...

We suspect that equities and other risk assets will be able to digest the first stage of rate tightening, albeit with heightened volatility around the time when the Fed starts preparing the market for another hike later this year. Unlike last September, earnings estimates are much more conservative. Bottom-up estimates foresee EPS rising by 3.9% in the U.S. and 5.4% in the rest of the world in 2019 (**Chart 24**). The combination of faster growth, easier financial conditions, and ongoing share buybacks implies some upside to these numbers.

Perhaps more importantly, unlike in September, the Fed will only start hiking rates if the economy is performing well. Powell erred in saying that “rates were a long way from neutral” just when the U.S. economy was starting to slow. Had he uttered those words when U.S. growth was still accelerating, investors would have probably disregarded them.

Jay Powell won’t make the same mistake again. Rather, he will make a different one: He will let the economy overheat to the point where the Fed finds itself clearly behind the curve and forced to scramble to catch up. The resulting stagflationary environment – where growth is slowing due to a shortage of available workers and inflation is on the upswing – will be toxic for equities and other risk assets.

While it is difficult to be precise about timing, we recommend that investors maintain a modestly pro-risk stance over the next 12-to-18 months. However, they should pare back exposure to equities ... late next year before the Fed ramps up the pace of rate hikes.

Prepare To Temporarily Upgrade International Stocks

The U.S. stock market tends to be "low beta" compared to other bourses. If global growth accelerates in the second half of this year, international stocks will outperform their U.S. counterparts. ... and now recommend being outright long EM equities. We will be looking to upgrade both EM and European equities to overweight in the coming weeks in currency-unhedged terms once we see more confirmatory evidence of a global growth revival.

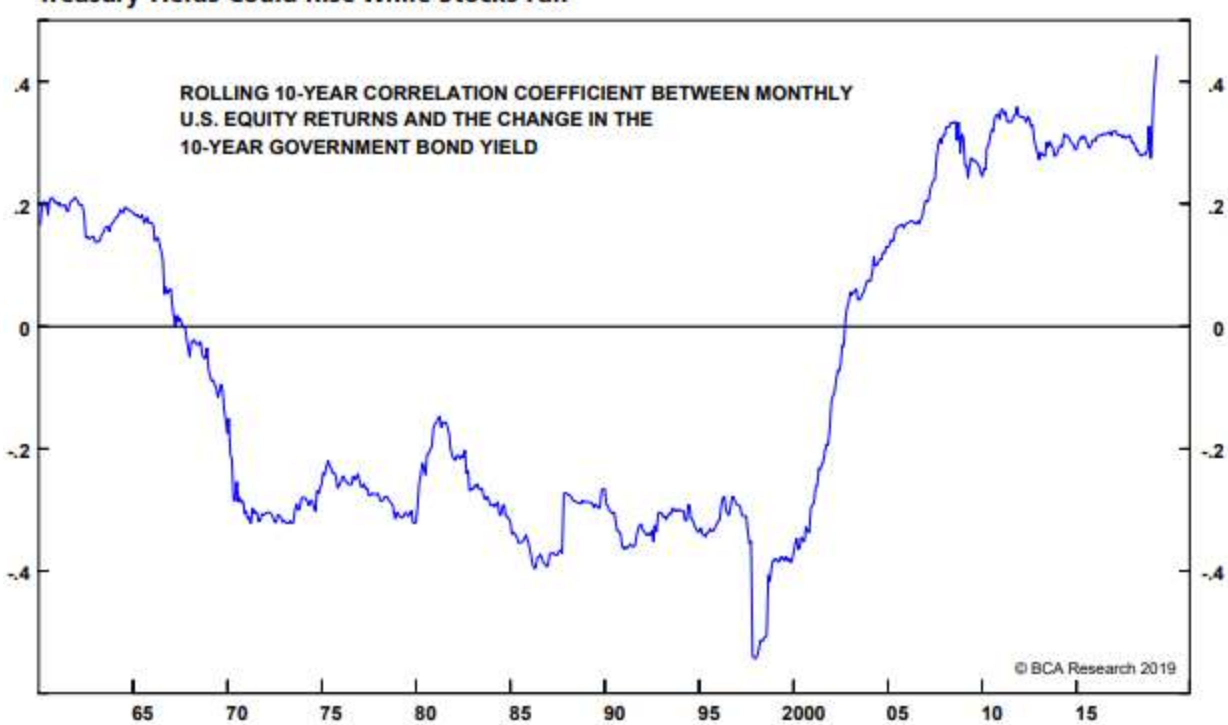
We have mixed feeling about Japanese stocks. Stronger global growth will benefit Japanese multinationals, but firms focused on the domestic market may suffer if the government goes ahead and raises the sales tax in October. We would hold off upgrading Japanese stocks for the time being. ...

Global Bond Yields Likely To Rise

Global bond yields are likely to rise over the next 12-to-18 months as growth surprises on the upside. Yields will continue rising into the first half of 2021 as inflation accelerates.

Unlike in past risk-off episodes, Treasurys will not provide much of a safe haven in the lead up to the next recession. As noted above, one of the reasons that bond yields are so low today is because the term premium is very depressed. The cumulative effect of Fed bond purchases has probably depressed the term premium, but the bigger impact has stemmed from the fact that investors see Treasurys as an insurance policy against various macro risks. Investors are accustomed to thinking that when an economy slides into recession, equity prices will fall, the housing market will deteriorate, wage gains will recede, job prospects will worsen, but at least the value of their bond portfolio will go up!

CHART 25
Treasury Yields Could Rise While Stocks Fall



The problem with this reasoning is that it is only valid when the Fed is hiking rates in response to stronger growth. If the Fed is hiking rates because inflation is getting out of hand, Treasury yields could end up rising while stocks are falling. This was actually the norm between the late-1960s and early-2000s (**Chart 25**).

If Treasurys lose their safe-haven status, the term premium will move higher. A vicious circle could develop where rising bond yields weaken the stock market, causing investors to flood out of both stocks and bonds and into cash, leading to even higher bond yields and lower equity prices. ...

The U.S. economy is at the greatest risk of overheating. In currency-hedged terms, the 10-year U.S. Treasury yield is among the lowest in the world (**Table 1**). Japanese 10-year bonds, for example, offer 2.72% in currency-hedged terms, while German bunds command 2.94%.

TABLE 1

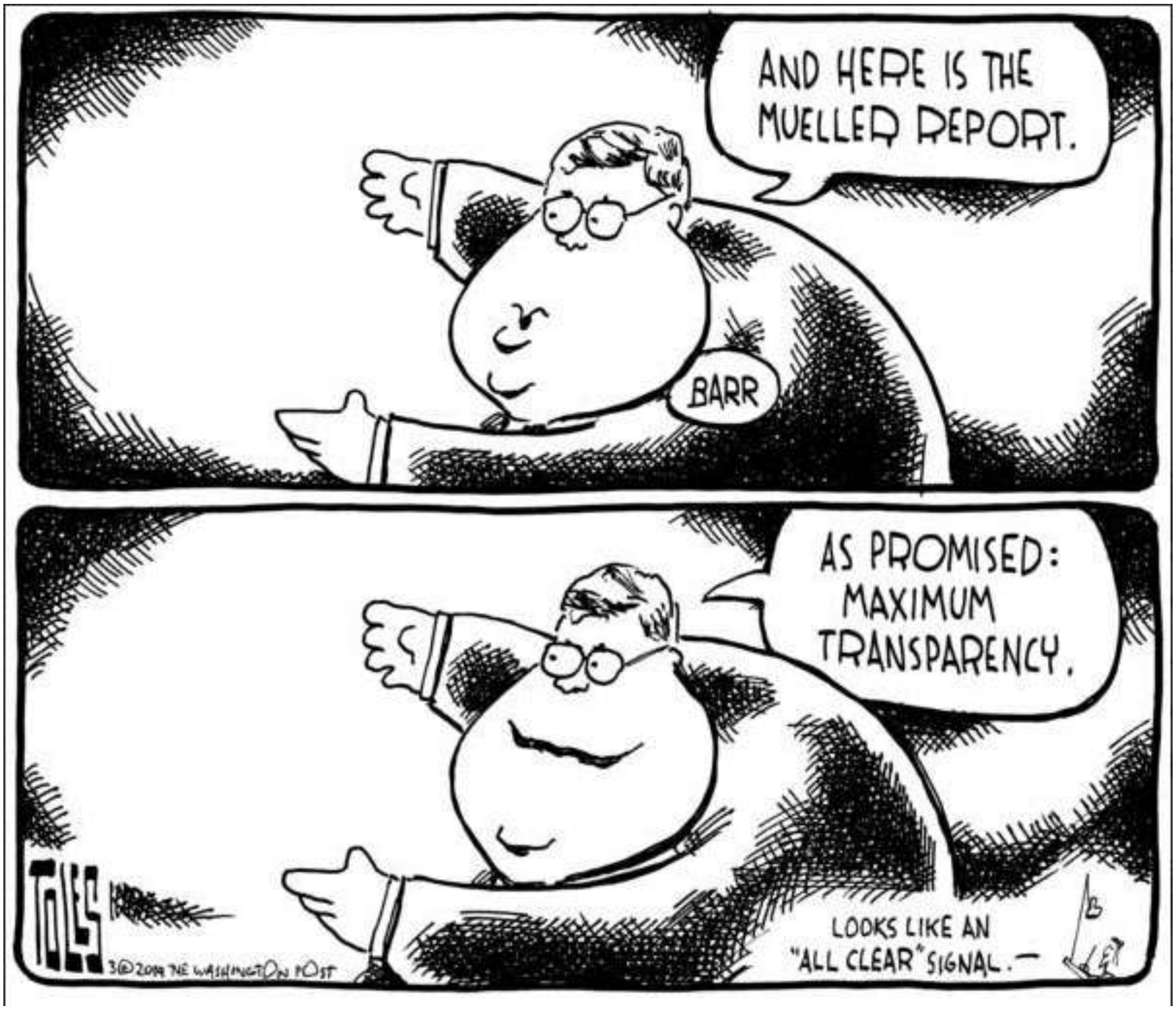
Bond Markets Across The Developed World

10-YEAR GOVERNMENT BOND YIELDS

REGION	YIELD MARCH 27, 2019	HEDGED YIELD* USD	GBP	EUR	JPY	CAD
U.S.	2.37	2.37	0.57	-0.75	-0.50	1.45
GERMANY	-0.08	2.94	1.20	-0.08	0.16	2.05
FRANCE	0.30	3.32	1.58	0.30	0.54	2.43
SPAIN	1.06	4.08	2.34	1.06	1.30	3.19
ITALY	2.45	5.47	3.73	2.45	2.69	4.59
JAPAN	-0.07	2.72	0.97	-0.31	-0.07	1.83
U.K.	1.01	2.78	1.01	-0.28	-0.04	1.88
CANADA	1.53	2.44	0.66	-0.65	-0.40	1.53
AUSTRALIA	1.77	2.40	0.62	-0.69	-0.45	1.49
NEW ZEALAND	1.76	2.42	0.64	-0.67	-0.42	1.51
SWEDEN	0.30	3.00	1.25	-0.03	0.21	2.11
SWITZERLAND	-0.43	2.95	1.21	-0.06	0.18	2.06
NORWAY	1.55	2.93	1.16	-0.15	0.10	2.02

* HEDGED OVER 3-MONTH HORIZON USING 3-MONTH FORWARD EXCHANGE RATE

Second, the end of the Mueller investigation, with Trump claiming "total and complete exoneration". While the odds of impeachment have decreased, our view that the date of Trump's departure from the Oval Office will be determined by the voters, not congress, hasn't changed, as we detailed in our March 10th Worth Sharing, "Politics: Should we be Concerned?"



From PredictWise:

When will Trump stop being President of USA?

Finishes 1st Term	86 %
2020 to 1/20/2021	9 %
2019	5 %

Follow-ups

Firms to Pay $125 Million to Clients Over Fee-Disclosure Practices

Almost 80 firms settle claims as part of SEC program emphasizing self-reporting

By Dave Michaels

WASHINGTON—Almost 80 investment advisory firms agreed to pay back more than $125 million to clients who were steered into higher-cost mutual funds without being clearly told about cheaper versions, the result of a government effort to persuade financial firms to self-report misconduct.

The Securities and Exchange Commission announced on Monday the settlements, which included divisions of Wells Fargo and Deutsche Bank over a fee—usually 0.25% or less of the amount invested—that is paid to brokers for selling mutual funds.

Wells Fargo agreed to refund about $17.4 million, the highest of any company that settled. (No surprise there.) The company's chief executive, Tim Sloan, is scheduled to appear before a House committee on Tuesday to testify about a string of investigations into the company's business practices and what he is doing to address them.

The firms that settled avoided a penalty while agreeing to pay the fees back to clients, marking the biggest example so far of the SEC waiving penalties over misconduct. ...

Investment advisers, who pick portfolios for clients, are supposed to disclose when they choose mutual funds that tack on the fees, particularly if there are versions of the same fund that don't levy the charge.

In many cases, individual clients likely paid hundreds of dollars of potentially avoidable fees. LPL Financial LLC, which agreed to repay $9.3 million, said the average client would get a refund of $126.

"An adviser's failure to disclose these types of financial conflicts of interest harms retail investors by unfairly exposing them to fees that chip away at the value of their investments," said Stephanie Avakian, co-director of the SEC's enforcement division. ...

The SEC settled similar cases against 12 other advisory firms in 2017 and 2018, levying penalties in every instance. ...

Monday's settlement doesn't end the initiative over the fees. The SEC had pushed to settle many of the cases in early February, but anticipates resolving more in the coming months, according to people familiar with the matter.

The cases involve ongoing fees, known as 12b-1 charges, that are levied against investor assets and used to reward financial advisers who sell mutual funds. They are considered a conflict of interest because an adviser's employer can profit from recommending some funds over others.

The fees have become unpopular in recent years. More investors are choosing cheaper index funds that don't have them, while others opt for accounts that can avoid them. ...

About 20% of mutual-fund assets are in products that charge the ongoing fees, according to the Investment Company Institute.

The firms that settled investigations on Monday neither admitted nor denied the SEC's allegations.

They agreed to correct disclosure shortcomings and to determine whether clients should be moved to a version of the mutual fund without the fees.

Ten firms agreed to return $6 million or more in fees to customers. RBC Capital Markets LLC agreed to pay back about $11.7 million.

A spokesman for Wells Fargo said the fees stemmed from certain mutual funds sold from 2014 to 2015. The firm is refunding the fees with interest and has updated its disclosures, spokesman Shea Leordeanu said.

A spokesman for RBC Wealth Management said the firm independently identified "most of the issues outlined in the settlement" and is committed to ensuring compliance with regulations.

A spokesman for LPL Financial said most of the fees it will give back stem from a period about five years ago, before it streamlined its fund offerings.

A Deutsche Bank spokesman declined to comment.

Raymond James didn't respond to requests for comment.

Our 3rd Worth Sharing of 4 on Alternative Investments, all of which can be found on our website, was "Private Equity - The Crown Jewel of Alternatives - 2/25/18". From Verdad's Dan Rasmussen on Mar. 25th:

Lessons from Oregon

The Oregon Public Employee Retirement Fund (OPERF) was one of the first major public funds to invest in private equity in 1981. Since then, OPERF has committed $46 billion to the private equity asset class, generating a net IRR of 15.5% and a 1.7x net multiple of money.

Industry veterans John Hershey and Michael Langdon do an annual review of Oregon's performance and strategy, and make it publicly available online, much to the benefit of investors like us. Their annual report is one of the best and most informative reads on private equity, because OPERF has the benefit of almost 30 years of experience investing in the asset class.

The focus of the recent two years of reports has been the downshift in returns in private equity. OPERF's portfolio has trailed its internal benchmark (the Russell 3000 + 300bps) over the past decade.

Figure 1: OPERF Private Equity Returns

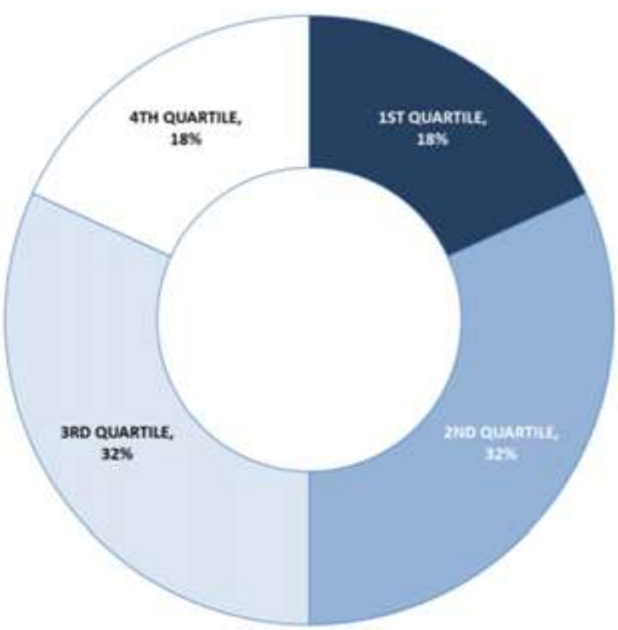
6/30/2018	*1 YR.*	*3 YR.*	*5 YR.*	*10 YR.*	*20 YR.*	*SINCE INCEPTION*
OPERF Private Equity	17.3%	10.9%	13.0%	9.9%	10.4%	15.5%
Policy Benchmark - Russell 3000 + 3%	18.3%	14.3%	17.0%	13.9%	10.2%	15.4%
OPERF PE Value Add (bps)	*(100)*	*(340)*	*(400)*	*(400)*	*20*	*10*
MSCI ACWI IMI + 3%	15.7%	10.9%	13.9%	10.3%	9.1%	N/A
OPERF PE Value Add (bps)	*160*	*0*	*(90)*	*(40)*	*130*	*N/A*
Custom + 3%*	16.2%	12.1%	15.0%	11.5%	9.4%	14.5%
OPERF PE Value Add (bps)	*110*	*(120)*	*(200)*	*(160)*	*100*	*100*

**Uses a combination of the MSCI North America, Europe, & Asia Pacific indices to approximate OPERF PE's regional exposures*

Source: OPERF 2019 Annual Report

The issue is not manager selection. In most vintage years, OPERF has been slightly above the Cambridge Associates median of private equity performance. But despite 30 years of experience and the best advisors money can buy, OPERF has been unable to consistently identify top-quartile managers. In fact, only 18% of the funds they've invested in have been top quartile.

Figure 2: OPERF Funds by Quartile

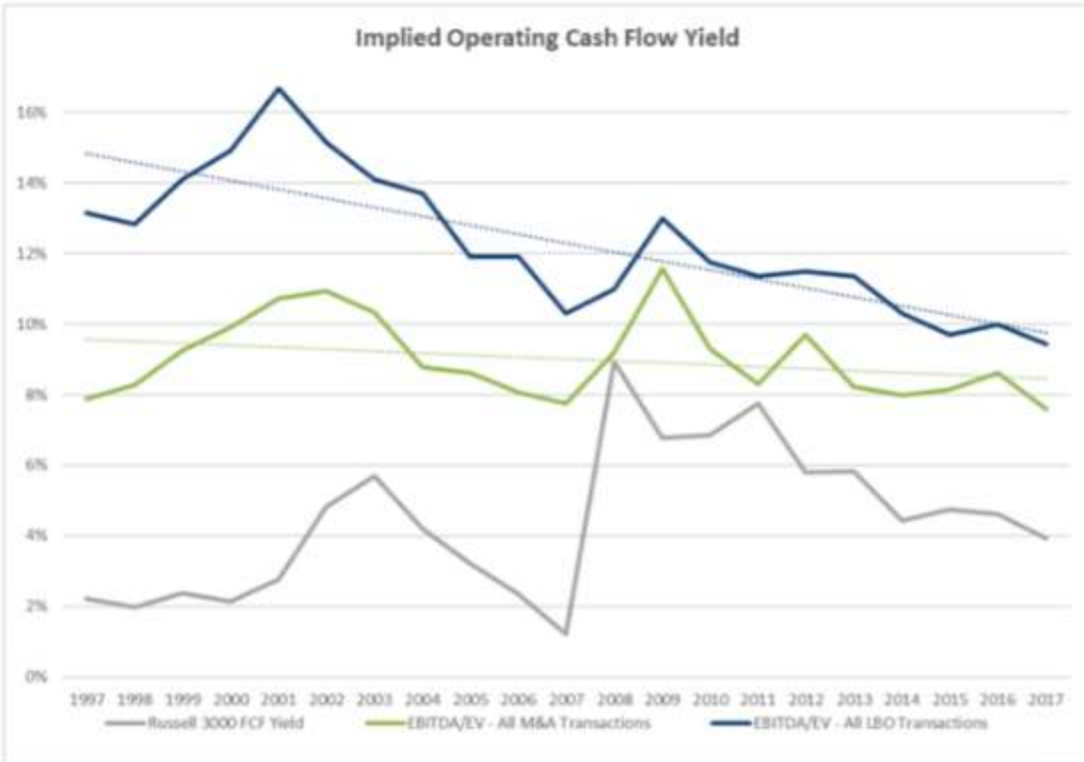


Source: OPERF 2018 Annual Report

Rather, the answer seems to lie in changes in the asset class as a whole.

OPERF attributes the downshift in returns to the growing size and competitiveness of the LBO industry. Prior to 2006, LBOs were often bought at significant discounts to the value at which comparable public companies traded. And because the LBO firms were paying such low prices, they could fund these buyouts mostly with debt. But as more money flowed into the market, prices for LBO deals went higher. OPERF found a steep slope of decline for LBO free cash flow yields since the mid-2000s.

Figure 3: Implied Operating Free Cash Flow Yield



Source: OPERF 2018 Annual Report

The blame for this increase in prices is both the general increase in market valuations and big inflows into private equity as an asset class. “Since 2005—as massive new AUM flowed into the asset class and with the backdrop of both the GFC and subsequent QE, returns relative to public equities become very challenging,” they wrote in their 2018 report.

And these flows created problems for OPERF. Their deployment of capital was highly pro-cyclical, with a much larger amount of money deployed in the most expensive and lowest returning vintage years. Though the performance of their more recent vintage years post-crisis has been strong, that performance has been overshadowed by the continued drag of the pre-crisis vintages.

The below chart shows OPERF’s capital deployment relative to the alpha generated by the private equity asset class as a whole.

Figure 4: OPERF Capital Deployed vs. Asset Class Returns to Private Equity

Source: OPERF 2019 Annual Report

Relatively little capital was deployed in the most attractive vintages relative to the least attractive. The chart ominously shows a sharp rise in capital deployment and the start of a decline in asset class alpha since 2014.

The actual experience of a large investor in PE tells a different story—a more honest and insightful story—than Wall Street's slick marketing pitches. Top-quartile returns are hard to achieve: most investors get returns that look like the median, even with top-tier advisors calling the shots. Meanwhile, OPERF's 2018 report acknowledged that, "In most vintages, top-quartile outcomes were required to capture a meaningful return premium." Private equity returns have been disappointing over the past decade. The low returns have been the result of deploying too much capital in the most expensive, and thus underperforming, vintages. And massive capital inflows have driven purchase prices to the lowest levels in history.

Positions

IRT - On 2/21 this Apartment REIT had an 8.6% positive earnings surprise. However, the stock dropped 3.9% on 1.9 times average volume. By 3/26 1 out of 8 analysts had lowered their earnings estimate for both the 1st & 2nd Quarters. Among analysts that had updated their recommendations post earnings, there were 4 Buys and 3 Holds, and an average Target Price of 11.2, with 5 maintaining their TP, and 1 lowering. Forbes Real Estate Investor rates the stock a Hold, with a Current Value of 8.5, while High Dividend Opportunities considers IRT a Buy under 10.4. On 3/27 we sold for all 4 clients @ 10.79.

UVE - On 3/1 this P&C Insurer had a 104.6% negative earnings surprise. The stock dropped 16% on 6.2 times average volume. By 3/26 the 1 analyst following UVE had lowered his earnings estimates for both the 1st & 2nd Quarters, and rated it a Hold, with a Target Price of 39, which they had also lowered. On 3/27 we sold for all 3 clients @ 30.7.