KayneCast
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Market Review Fourth Quarter 2018

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Jordan: Hello this is Jordan Greenhouse, Client Portfolio Manager with Kayne Anderson Rudnick. Along with me today I have Doug Foreman, Chief Investment Officer. Doug, first and foremost thanks for setting the time today to review 2018 with us. If we can, let's start with a look back at the fourth quarter of 2018 along with the year-to-date performance for the key U.S. markets along with the international markets.

Doug: Sure. The last three months of the year in 2018 were very, very difficult for equity investors. The stock market declined double digits, 13.5% in the quarter, bringing the full-year return to slightly more than a 4% loss and the index during the course of the quarter was on the cusp of a bear-market territory that's down 20% for the quarter before starting to stabilize somewhat at the last week of the year essentially. Virtually all domestic equity classes saw their fourth-quarter returns wipe out the gains that they had over the first 9 months. Small stocks were hit particularly hard finishing down 11% for the year. Growth stocks were hit very hard in the quarter, declining about 15.9% as measured by the Russell 1000® Growth benchmark but they still managed to outperform value stocks throughout the course of 2018 by declining only 1.5% versus 8.2% for value stocks in the course of 2018.

Emerging markets stocks also continued to decline—it had lead the decline earlier in the year. We're posting negative returns by the end of the third quarter. They went down a further 7.5% in the quarter, bringing the year-to-date losses to about 14.5%. European equities also were very poor performers as well. The European index falling almost 13% in the quarter and down about 14.5% for the year due to really continued economic weakness at the continent incurred pretty much during the entire year of 2018.

10-year Treasuries did their job in the quarter—they actually hung in there fairly well. Interest rates actually dropped. The 10-year dropped a lot from 3.06% down to 2.68%. Barclays Aggregate actually had a positive return—it rose 1.64% during the quarter. California Muni's advanced about 1.45% during the quarter. Credit-sensitive area of the bond market such as high-yield didn't fare as well and registered losses of about 4.6% for the quarter and down about 2.2% for the full year. So that's sort of a summary of what happened. Overall, a very challenging quarter for equity investors. First one we've had in quite a while, really in about 10 years to have a magnitude of declines like this. So it was a difficult fourth quarter and it ended up being a more difficult year because of the tremendous volatility that we saw in the last three months of the year.

Jordan: What were some of the key drivers during the fourth quarter? Because we saw a substantial uptick in overall volatility across all markets.

Doug: Well the first thing that happened during the course of the quarter was the Federal Reserve chairman, Jay Powell, in early October came out and said that short term interest rates were still far from neutral which implied a whole series of future rate increases at the short end of the yield curve and I think these comments really spooked investors who were already worried about the weakness—as I mentioned earlier, we've been seeing all year in Europe—and China started to see some weakness in May and was slowing as well. Even in the U.S., areas that are really sensitive to interest rate increases like housing and automobile sales, because of their such large purchases and people typically finance to buy, was starting to show some signs of weakness as well, even in the U.S. So I think a combination of this overseas weakness, some interest rate-sensitive parts of the U.S. economy that were weakening, and then the Federal Reserve coming out and saying we're not even close to being done and we need to raise rates more, 3 or 4 or 5 times into the future, just spooked investors and started to trigger some selling as people were worried about the rate of growth that was going to be sustained into 2019.

The second thing that happened during the quarter was (after Powell's comments) were that third-quarter earnings started to come in and what investors paid attention to— even though the overall earnings number was as good as expected if not better in many companies— the quality of the earnings, the way the companies got there, a little bit more dependent upon financial engineering, things like buyback and debt paydown and a little less on revenues and clearly in most companies/cases revenues decelerated somewhat from the second quarter, that sort of indicated to a lot of investors that business activity in the U.S. had started to moderate already too. This, combined with the comments earlier (Chairman Powell) about further rate increases I think just added more fuel to the fire that rates were going up at the same time, earnings were starting to decelerate and slow down dramatically and this is always a really bad combination for equities.

There was some minor progress made on trade talks with China during the past quarter but nothing was really totally resolved and obviously, this is continuing into 2019 and this is in the short run just continued to negatively impact business confidence globally. Also, energy prices declined materially during the quarter, which is great for people that buy gas and for you and I and consumers at the gas pumps, but there's a lot of energy producers domestically these days and their earnings prospects are going to be hurt by falling prices too. So basically the market lost confidence in the outlook for profit growth in 2019 and into 2020 and of course the market is always looking ahead and trying to understand what's likely to happen next and so as investors lost confidence in the sustainability of earnings because of a continued increase in short term interest rates as slowing in corporate profitability and an inverting yield curve. A combination of those things caused investors to take significant profits during the course of the quarter.

Jordan: Approaching December, there have been discussions around concerns related to an inverted yield curve. Can you explain what is meant by this inverted yield curve and the potential impacts if this were to occur?

Doug: The bottom line is for an inverted yield curve (what that means is, without getting too technical because we don't have time here today) is that short term interest rates are higher than long term interest rates. So short term interest rates, let's say, could be 3% and long rates as measured by the 30-Year bond could be 2.5%. So short rates higher than long rates. Very unusual, doesn't happen very often, doesn't make any economic sense because why would you charge people more to borrow money from you for 6 months than you would if they wanted it for 30 years? Normally you're going to charge somebody more money for more interest if they want your money longer—that's sort of standard behavior, that's the way the economy usually works. Why this is important is because what happens is the way that banks make money and the way that banks make loans to consumers and small businesses and everything else that creates grease that skids the economy and economic growth is, the banks borrow money at the short end from me and you when we make deposits at a bank at hopefully a low rate, and then they go out and they lend it to a business that needs the capital to expand or grow, hopefully a small business that's becoming larger and they do this at a higher rate because they're taking credit risk and what they earn on that is a spread which is a difference between what they have to pay you and I on deposits and what they can actually earn from the business, assuming the business pays the loan off over a reasonable amount of time. So let's say the short end is at 2%. They borrow money at 2% and then they go make a loan to small business at 6%. So they have a 4% spread and they make 4% on the amount of that loan if the business pays them back because they have credit risk and businesses don't always pay them back. So what happens when the yield curve inverts and this is something that the Fed chairman and others have discussed and academics discuss all the time about an inverted yield curve and why it's occurring? To me, it misses the entire point. It doesn't matter why it's occurring.

If it's occurring then nobody's going to make a loan. They're not going to borrow money from you and I at say 3% and make a loan to a business at 3% and incur a credit risk. There's no way they can possibly make money. In fact, all they're doing is destroying shareholder value when they do that and destroying a business. So nobody's going to make a loan and therefore the economy ultimately dries up. So that's how the yield curve works and what we're seeing historically is the batting average of future recessions once you go into a full-blown inversion (and we're not there yet by the way) that 7 out of the last 8 times we have slipped into a recession. So it's a very good forecaster of recession if and when that happens. So one of the key things that happened also during the quarter was that the curve is close to inverting and then that combined with the latest Federal Reserve meeting in December when Chairman Powell came out and was dismissive of the yield curve, dismissive of market signals which clearly indicated that the market was concerned about future growth prospects whether it was the price of oil or fixed income rates or the yield curve shape, the signals were all over the market that things were very concerning about future growth and international market weakness as well. It's rare that you see so many signals all combining saying the same thing to somebody and then the Federal Reserve chairman came out after their December meeting, sort of was very dismissive of the shape of the yield and dismissive of the market signals which are loud and clear screaming at him, in my opinion, to slow down the rate of increase in interest rates if at all for the future. So I think what we saw last week, late last week on Friday, one of the key reasons the market rallied so much was that Chairman Powell came out and sort of backed off what he said in December and said he would be more flexible, more open-minded about what's actually happening and not so dismissive of everything that's happening in these markets. Not to bail out equity investors, but the fact is these investors in fixed income, investors in equities, investors in commodities—they're all saying the same thing. This isn't political statements. This is people betting their hard-earned dollars every day on what they believe is going to happen next. So it's important for the Fed to have some respect for that because in my experience the market more frequently than not is correct.

Jordan: Moving into 2019 Doug, can you provide a sense of broad market expectations along with key factors you and your team at Kayne Anderson Rudnick are most focused on?

Doug: Sure. I think the big thing is—can corporate profitability continue to improve, not only be sustained, but continue to improve into 2019 and 2020 in a slower growth environment, which we're highly likely to see in 2019 and 2020 versus 2018, and my answer is yes. I think that they can do that. I think that corporate profits can grow in the 5%, 6%, 7% range this year (2019) and I think that we can see continued growth and without a recession. It's really difficult to pinpoint exactly where the excesses are in the system that would cause a domestic recession. There aren't a lot of excesses domestically. We can talk about China and debt levels over there and certainly some of that is concerning and China has already slowed materially and their market is already in a bear market, but as far as the U.S. goes, it's difficult to see where these massive excesses are—whether it's property prices or inventories of businesses or sort of the standard suspects that would drive and create a recession. So our belief is that growth will be slower next year for sure. Best guess is in the 1.5%-2.5% range down from 3%+ this year. So probably about half the growth of what we had last year but still positive and companies should be able to generate reasonable earnings. We'll have more earnings disappointments I think in 2019 than we had in 2018 overall. But I think that's our job at Kayne Anderson Rudnick is try to isolate those companies that can continue to thrive and do well even in a slower growth environment. That's what we're going to be focused on doing, as we always are. Obviously, this year will be more important than ever I think to be focused on that.

Additionally, I think that earnings growth and stock market returns don't always go lockstep with one another. As we saw last year, earnings growth was very robust for 2018, probably in excess of 20% when everything's counted up by year end, and this year in 2019 (as I mentioned earlier) I think earnings growth will be slower but that doesn't mean returns match it one-for-one. As you saw last year we had negative returns on the S&P 500® even though the earnings for the S&P 500® was very significant and this year I think we can see the opposite, where the earnings growth is really not as robust (in the 5%, 6%, 7%, 8% range) but I think we can actually end up seeing low double-digit returns if that materializes because so many investors are discounting a recession or more as we move into 2019 and 2020.