Market Commentary Quarterly

4Q2018

DOUSING THE DAMAGE

The most destructive wildfire in history took place in the picturesque, old gold mining and agricultural town of Paradise, California in November 2018. What became known as the "Camp Fire", was started by fire underneath power transmission lines owned by Pacific Gas & Electric (PG&E). The fire's rapid growth was then fueled by extreme weather conditions including 50-mile per hour winds carrying embers onto thick, dry grass and stressed trees and brush, due to the lack of recent rains and several years of drought. The fire was contained after seventeen days, but only after the death of eighty-six people and destruction of almost 14,000 homes.

The damage was reportedly exacerbated by poor decision making well before and during the early stages of the response. These include dated electrical towers, failure of steel hooks holding up the high voltage lines, uncorrected deficiencies in the PG&E system, the lack of oversight by the California Public Utilities Commission, the decision to not turn off power when fire risks were high, old structures lacking adequate fireproofing materials, limited evacuation routes and bottlenecks caused by a road system overwhelmed by the number of cars evacuating the area, a weak public alert systems and a loss of numerous cell towers, limited 911 staff, and inaccurate communications to callers regarding the extent of the fire during its early stages. Unfortunately, emergency response plans had only been developed based on an event of a much smaller and calmer scale.

Facing a wide variety of cumulative challenges, investors were overcome by the decline in risk assets during the fourth quarter of 2018. For the quarter, the S&P500 declined by 14%, the worst quarterly performance since 2011, while falling in price by 9.2% in December alone. This was the worst December equity market performance since 1931 and largest monthly loss since February 2009. High yield bonds and similar below investment grade credit securities also were damaged, with yield spreads over the 10-year Treasury widening from 3.1% in early October to 5.3% by year end. So much for the year-end Christmas rally. Government bonds and other safe-haven asset classes were beneficiaries of this flight from risk, with the 10-year Treasury moving from its peak level of roughly 3.25% in November, down to 2.7% on December 31. Except for cash and short- term instruments, it was virtually impossible to escape the damage

IN THIS ISSUE

'Camp Fire' in California

To date, California's Camp Fire was the deadliest and most destructive wildfire in the state's history, and it is the sixth deadliest wildfire in US history. With a death toll that reached 87, over 14,000 homes were burned and the estimated destruction cost was $1.6 billion (photo courtesy of CBS News)

PG&E Pacific Gas and Electric Company

PG&E Files Bankruptcy

Pacific Gas and Electric Company, California's largest public utility, has since filed bankruptcy due to its potential liability for its role in the starting and spreading of the fires.

as most asset classes had losses. Planning and broad diversification were of limited value.

Just as there were many factors influencing the Camp Fire's widespread damage, there were numerous factors one could point to influencing market declines. The outcome of the midterm election resulted in the Democratic Party taking control of the House of Representatives, while the Republican Party retained control of the Senate. This raised legitimate concern for renewed efforts to block initiatives of the Trump administration, even greater political infighting in Washington, and a further breakdown of communications between party leaders. The Kavanaugh Supreme Court confirmation hearings provided a prelude to what was likely to come. Progress is unlikely to take place under these conditions.

SHUTDOWN IMPACT: ECONOMY

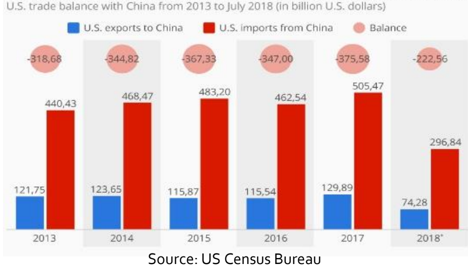
- **$1.2B Per Week**
- **Q1 Growth: -0.25%**
- **Taxpayers: $2B**

Source: CBS News

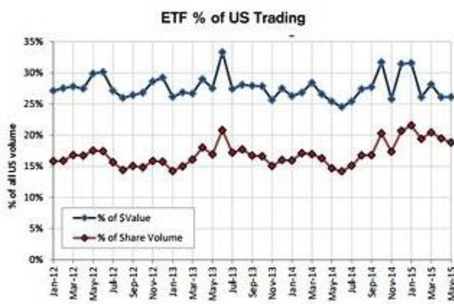
The government shutdown, initiated in late December due to Trump's demand for border wall funding, represents the ongoing disfunction in Washington D.C. Rather than working together to solve known challenges, both parties have moved toward extreme policies, an effort to cater to their supporters and position themselves for the next Presidential election. The government shutdown created a new wrinkle into the equation. In addition to the likely slower economic growth from federal workers not receiving timely paychecks, certain economic data is not being released, limiting the flow of updates from the Commerce Department, Labor Department, Department of Agriculture, the Commodity Futures Trading Commission, and other departments. Economists, investors, traders, and companies rely on this ongoing data flow to analyze and make judgements affecting their businesses. Although not fatal, the lack of timely information is causing indecision, and potentially suboptimal assessments.

116TH US CONGRESS

Following the 2018 elections, the House of Representatives now consists of 235 Democrats and 199 Republicans (one vacant seat). The Senate has 53 Republicans, 45 Democrats, and 2 Independents.



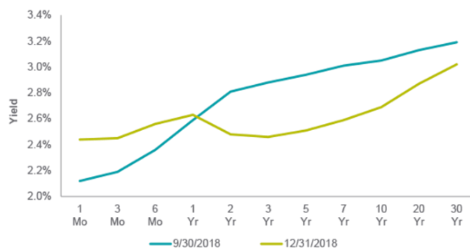
Source: US Census Bureau



The ongoing negotiations with China have caused global trade activity to slow, economic growth estimates to fall, and indicators of CEO and consumer confidence to decline. While there appears to be progress, including a delay in proposed tariff increases going into effect, this remains an overhang to world economic growth. Similarly, as economic activity slows and with uncertainty in the outcome, business leaders and consumers have been more hesitant to make investment and purchase decisions.

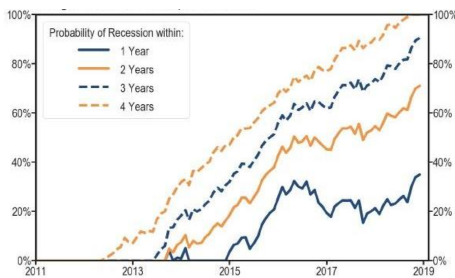
Much of the volatility has been blamed on algorithmic, computer driven, high frequency trading, led by quantitative investment management strategies. The swelling influence of index-based ETFs, representing baskets of securities, are more sensitive to intraday short-term trading activity than traditional, fundamentally driven, longer term investment strategies. Some have

Q4 CHANGE IN TREASURY YIELDS



SOURCE: Northern Trust Fixed Income; U.S. Department of the Treasury

Recession Probabilities



Source: Various government and non-government sources, J. P. Morgan

FAST FACTS

Yield Curve

The Yield Curve is the line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

Inverted Yield Curve

The yield curve is said to be 'inverted' in an interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality. This particular type of yield curve is the rarest of the three main types and is considered by many to be a predictor of economic recession.

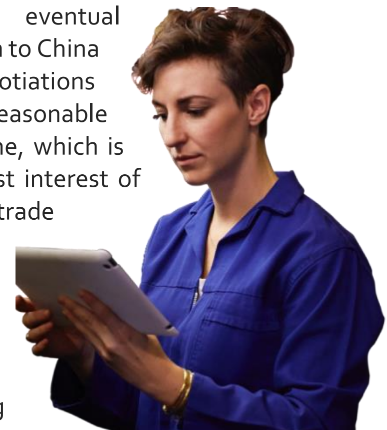
estimated volumes from these strategies now represent over 70% of daily trading activity. Heavy redemptions from nervous equity mutual fund investors combined with margin calls from overleveraged accounts added fuel to the fire, and bottlenecks for exiting positions efficiently.

Similarly, many have pointed fingers at the Dodd-Frank act, Volker Rule, and Basel III, put into place after the financial crisis and aimed at reducing risk-taking by financial institutions. These rules restrict proprietary trading by investment firms, to reduce "gambling", and the potential need to be bailed out with taxpayer money should these banks fail. Making markets has historically served as a shock absorber for securities prices. These new rules have reduced the amount of liquidity provided to market makers, thereby suppressing these activities. As an example, corporate bond inventories held by investment banks are a small fraction (estimated at roughly 15%) of what they were prior to the financial crisis. Banks are now limited to holding only what traders expect to sell to clients in the "near term". While poor liquidity and market volatility have always been correlated, periods of market stress are only likely to see greater volatility due to thinner markets and the limits placed on investment banks.

Finally, the most likely cause for the market's downdraft in the 4th quarter was due to Federal Reserve Chairman Powell's ineffective communications. As widely expected, the Fed raised rates by another 25 basis points (0.25%) in December, bringing the borrowing rate up to 2.5%. The increase was in response to solid 2018 economic growth figures, and the diminished need for excessive monetary policy accommodation. However, the Fed also highlighted their intention of continuing to raise rates at least several times in 2019. This hawkish stance was conveyed despite signs of slowing global economic conditions, along with financial markets reflecting an increasing concern for a policy mistake (represented by falling equity prices and lower Treasury yields). As an example, the "yield curve", illustrated by comparing the yield on a two-year Treasury to the yield on a ten-year Treasury, has become very "flat" (now at roughly 15 basis points, or 0.15%). Historically, an inverted yield curve, an environment where short-term rates are above intermediate/long rates, has implied a higher probability of a recession. This "plow ahead at any cost" communication by Chairman Powell caused investors to fear a higher probability of a recession, especially should the Fed funds rise above what is perceived to be "neutral." Consistent with these concerns, the one-year probability of a recession has risen from 15% to now 25%.

Fortunately for investors, Chairman Powell tempered his remarks regarding future increases in the funds rate, recently reflecting a willingness to be "patient and flexible." We view this approach as prudent, as do other investors, with the markets responding favorably and recovering some of their fourth quarter losses. We expect investors will be accepting of higher rates should economic growth estimates improve, but also would expect a reduction in rates if conditions deteriorate sufficiently. These are all within the mandates of Federal Reserve, an attempt to stabilize economic conditions.

We viewed the 4th quarter downdraft as an overreaction and an opportunity to increase equity exposure. We anticipate the eventual resolution to China trade negotiations in a reasonable time frame, which is in the best interest of global trade and growth. We expect the reopening of



Government shortly. However, we don't anticipate any improvement in Washington politics, unless a unifying

event should occur. Our near-term favorable market outlook is based on the expectation the economy will continue to grow, albeit at a slower rate in 2019 than 2018, and lower valuations are now more supportive of attractive future gains over the next year. We anticipate interest rates as range bound, with the sell-off in credit also a near term buying opportunity.

We do consider longer term issues for investors to be aware, including high debt to GDP levels, trade and budget deficits, out of control entitlement spending, and extreme views contrary to capitalist principles. These principles include competition in a free and open market, wealth creation through efficient allocation of resources along with providing products and services satisfying consumers' interests, as well as business failure when not operating effectively. Unfortunately, there are an increasing number who enjoy the beautiful vistas and have a utopic view of how they want the world to be, without understanding the risks and potential consequences.

Mark Teichner

TMI Market Trax is written by TMI Trust Company's Mark Teichner. Questions or comments on TMI Market Trax, TMI Agency portfolios or other investment services distributed by TMI Trust Company, contact Mark Teichner at mteichner@tmico.com. *The material herein is based on data from sources considered to be reliable, but it is not guaranteed as to accuracy, does not purport to be complete and is subject to change without notice. This communication is for informational purposes only. Use by other than intended recipients is only allowed prior to TMI Trust Company's consent. Sender accepts no liability for any errors or omissions arising as a result of transmission. Any comments or statements made herein do not necessarily reflect those of TMI Trust Company or its affiliates.*

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