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THE MARKET MATTERS

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The Long and Short of It

“Long or short?” It’s a ubiquitous question among trading floors, investment committees, and media pundits. Especially these days, given all the different ways the question can be used to kick-start a feverish debate. In the investment arena, “long or short?” is an open-ended question requiring context. The individual posing the question may be referring to long and short as a measurement of time. He or she may be trying to quantify an investor’s bullish or bearish expectations in a particular security or asset class. Or, the purpose of the question may be to examine a fixed income portfolio’s sensitivity to interest rate movements. If asked “long or short?” a respondent would be wise to demand more information before answering. This month, we refract the “long or short?” question through three different prisms to shed light on the current investment landscape.

Global Macro View – Should we utilize a long or short time horizon when evaluating the opportunities and challenges we expect? Which one we choose has significant implications on one’s optimism in 2019. Potential stumbling blocks are crowding the near-term path. The U.S. government just concluded its longest shutdown in history – and maybe only temporarily with President Trump agreeing to a spending bill through just February 15. Though the economic impact has been mild, the shutdown – and the extent of the discord it underlines – will erode business and consumer confidence, drag on U.S. growth, and damage equity markets should the stalemate return. The daily vitriol from inside the beltway suggests cordial, productive leadership is pure fantasy. From that standpoint, damage has already been done to confidence in U.S. leadership on both sides of the aisle. On the trade front, the U.S. and China remain in a 90-day negotiation window, but there is little we can label as progress following the first 30 days. Although U.S. stock indices have demonstrated resilience to the shutdown drama, they are still highly sensitive to trade uncertainty. The U.K.’s attempts to leave the European Union in an orderly fashion are failing. Discussions of extending Brexit talks beyond their March deadline (where a no-deal Brexit could be a major disruptor) add new uncertainty around a formal divorce and its timing. However, the longer-term view may be a more optimistic one. The U.S. Federal Reserve is laying the groundwork for a more supportive year in 2019 versus its hawkish approach in 2018. U.S. corporate earnings still look solid, if also a step back from last year’s exceptional results thanks to tax reform. U.S. employment trends are quite healthy and still have room to improve. Household spending, the largest component of U.S. GDP, remains robust and wages have shown recent signs of life. Despite the short term threats, the long view provides a basis for positivity. To which time horizon should we apply more weight – short or long? We believe some of the near-term challenges will find positive resolutions (i.e., a U.S.-China trade agreement, a re-opened U.S. government) and provide a boost to riskier assets. We are expressing this belief in our Global Core ETF Strategies by maintaining tactical exposures in sectors such as developed and emerging market equities, MLPs, high-yield debt, and preferreds. We are monitoring the short-term closely. Its outcomes are difficult to predict. However, we find reason for optimism when we emphasize the months ahead as opposed to the days.

Duration – To be short or to be long duration? That is the question. Duration is the measure of an individual bond’s or a bond portfolio’s sensitivity to changes in the U.S. yield curve. A longer duration portfolio will outperform in a falling interest rate environment and underperform as yields rise. One of our biggest concerns is the current shape of the U.S. yield curve. Only 15 basis points separate the yield offered by a 2-Year (UST 2) and 10-Year U.S. Treasury note (UST 10). In other words, the yield curve is extraordinarily flat. The past five times the yield curve has inverted at those two spots (i.e., the UST 2 out-yields the UST 10), a recession has arrived within 15 months on average. There is very little wiggle room right now, which is a primary reason the Fed is signaling a pause in raising short rates. An inverted yield curve would increase expectations of a downturn, which fuels demand for haven assets like U.S. Treasuries and forces long rates down (i.e., bond prices up). That scenario would support favoring longer duration to capture the positive price performance. But we are not there yet. As it stands today, shorter duration portfolios are appropriate for many investors. 2-Year U.S. Treasury notes capture roughly 85% of the income of 30-Year U.S. Treasury bonds with



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90% less duration (Bloomberg). That relationship translates similarly in other debt sectors, such as Corporates and Municipals. The first five years of the yield curve sit near their highest points in a decade. The risk-reward balance (i.e., the attainable income versus the sensitivity to interest rate volatility) favors a shorter duration portfolio. Some future steepening of the curve could support extending duration longer, but the short duration narrative is the more compelling read today.

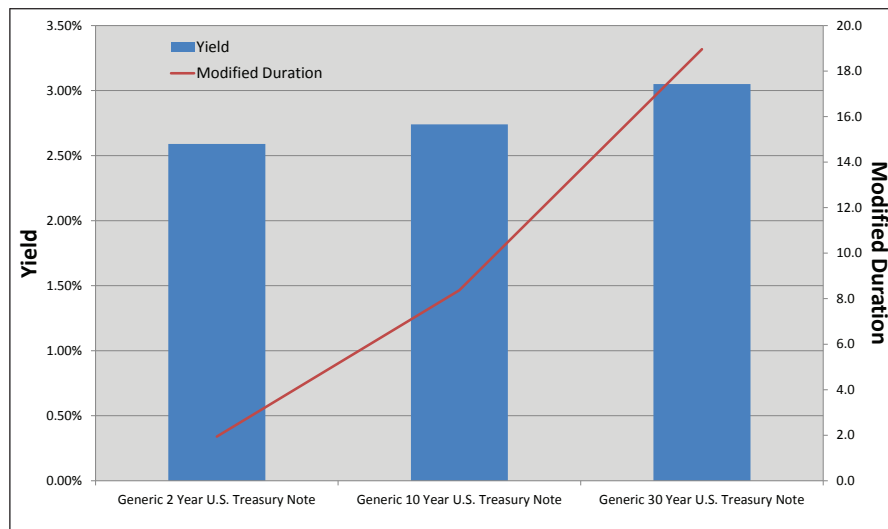


Figure 1: U.S. Treasury Debt Securities Yield and Duration Comparison (as of January 25, 2019)

Source: Bloomberg

U.S. Equities – In this context, the question “long or short?” can be interpreted as “bullish or bearish?” The answer probably depends on how far we look ahead. In the next month or two, there are reasons to temper expectations and expect a bumpy ride. We are in the midst of major geopolitical developments that carry significant implications for equity performance. Should the U.S. and China come to terms on the trade imbalance and create enforceable laws against intellectual property theft before the late-March deadline, we would expect a positive reaction in U.S. equities. The threat of “no deal” is dragging down growth expectations and beginning to emerge in manufacturing activity, especially in China. China is unveiling additional economic stimulus to combat its slowest growth in 10 years. Chinese President Xi and President Trump are both being exposed to rising political pressure to find common ground. These factors are creating a sense of urgency we believe will ultimately lead to a trade deal. But when? March will arrive in short order. It’s possible the two parties extend the deadline to continue talks or push away from the negotiating table without an accord. An extension would increase uncertainty, but no deal would likely have a significant negative impact on equities. Our base case scenario that an agreement will be reached leaves us “long” U.S. equities, but not without the expectation of greater volatility in the process. If we look beyond 2019, the risk of recession is growing. The Federal Reserve Bank of New York currently places the probability of a recession within the next 12 months at 21.35%, up from 3.74% one year ago (Federal Reserve Bank of New York). While we expect to avoid a recession in 2019, evidence is mounting for a GDP downturn around the 2020 timeframe. This expansion will soon become the longest in U.S. history. The next pullback is inevitable. Its probability increases the longer we go without it. But in the meantime, there remains fertile ground for risk investments. It is also an opportune time to perform portfolio diagnostics to ensure they are properly weighted. The S&P 500 Index is up 295% since its 2009 low (Bloomberg), or roughly 15% annualized. Equities’ outstanding performance had lulled many investors to sleep until Q4 2018’s big jolt. In January, the S&P 500 recovered more than half of those Q4 losses. For those who felt exposed a few months ago, now is an opportune time recalibrate fixed income exposures and implement some protection for the long-term.

Between long or short, balance is the key.