KARMIN CAPITAL

March 2019 – Aversion to Inversion

For the last three years the U.S. Federal Reserve (the "Fed") has implemented a tighter monetary policy, taking the Federal Funds Rate from 0% to a target range of 2.25% - 2.50%. By historical standards, these are low rates (as can be seen in the below chart).[1] However, many investors and commentators – most notably President Trump – are concerned rates are too high given that inflation remains under 2% and that slack remains in the labor market.[2] Amidst this benign inflationary and labor market backdrop, the Fed was roundly criticized for raising interest rates at its December 2018 meeting, sparking a sharp stock market sell-off to end last year.

U.S. Federal Funds Rate
(shaded areas denote recessions)

As 2019 began, concerns over global growth faded and the Fed backed off from its intentions to continue raising rates and reducing the size of its ~$4 trillion balance sheet. Given this improved macroeconomic backdrop, the stock market sharply rebounded to start the year, with the S&P 500 up over 12% (through March 22).[3] The Fed further reversed course in its recent meeting on March 20th, when Fed Chairman Jerome Powell announced that rate hikes are entirely off the table for 2019 (with one hike expected in 2020) and that the Fed will stop its balance sheet reduction in September. Initially, investors responded positively to this data, as it suggested that monetary policy would remain supportive of risk assets. Lower rates and a larger Fed balance sheet mean more liquidity in markets and – all else being equal – higher valuations for risk assets. However, as the week unfolded and investors digested the implications of the Fed's cautious stance, along with troubling economic data out of Europe (showing sharp declines in Eurozone manufacturing activity),[4] investors again turned pessimistic.

The concerns are multi-faceted. One: what does the Fed see in its data and projections that have caused it to reverse course and conclude that the economy can't handle higher interest rates? (Per the below chart, many worry the Fed sees an increased likelihood of a recession.)[5] Two: can the U.S. economy continue growing if the

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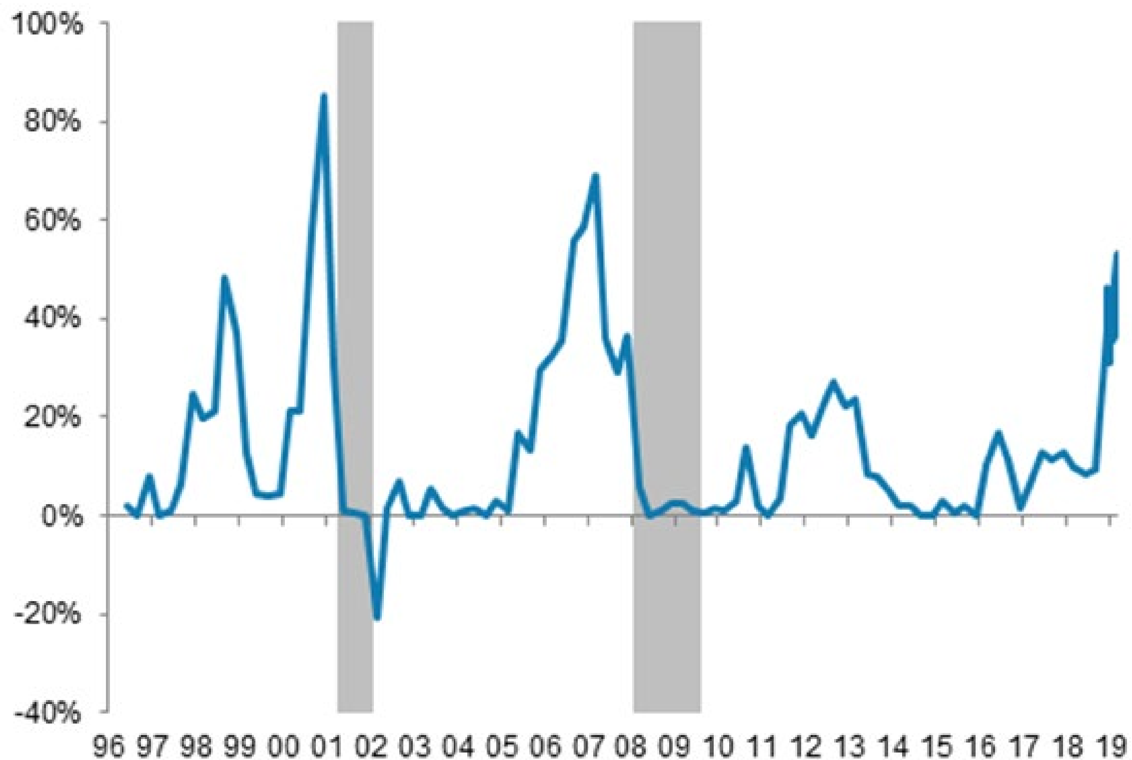
rest of the developed world and China are seeing their economies slow down? Three: if the U.S. economy were to slow down what tools could the Fed and Congress implement given that rates are already low, the Fed balance sheet is already large, and Congress seems too divided to pass any fiscal stimulus like an infrastructure bill? Not to mention that the budget deficit is its largest ever and fiscal hawks might not agree to more unfunded spending.



These concerns resulted in investors bidding up "risk-free" securities after the March Fed meeting, particularly U.S. Treasuries. With the influx of both U.S. and foreign investors purchasing U.S. government bonds, the yield on the U.S. 10-Year Treasury briefly fell below the yield on the U.S. 3-Month T-Bill. This phenomenon is known as a yield curve inversion. As the graph below shows, every prolonged inversion since 1982 has been followed by a recession within a few years.[6] When investors are willing to receive less compensation for holding a 10-year security than a 3-month one, it usually signals that investors have longer-term concerns over growth and implies that the Fed may need to cut rates to stimulate the economy.

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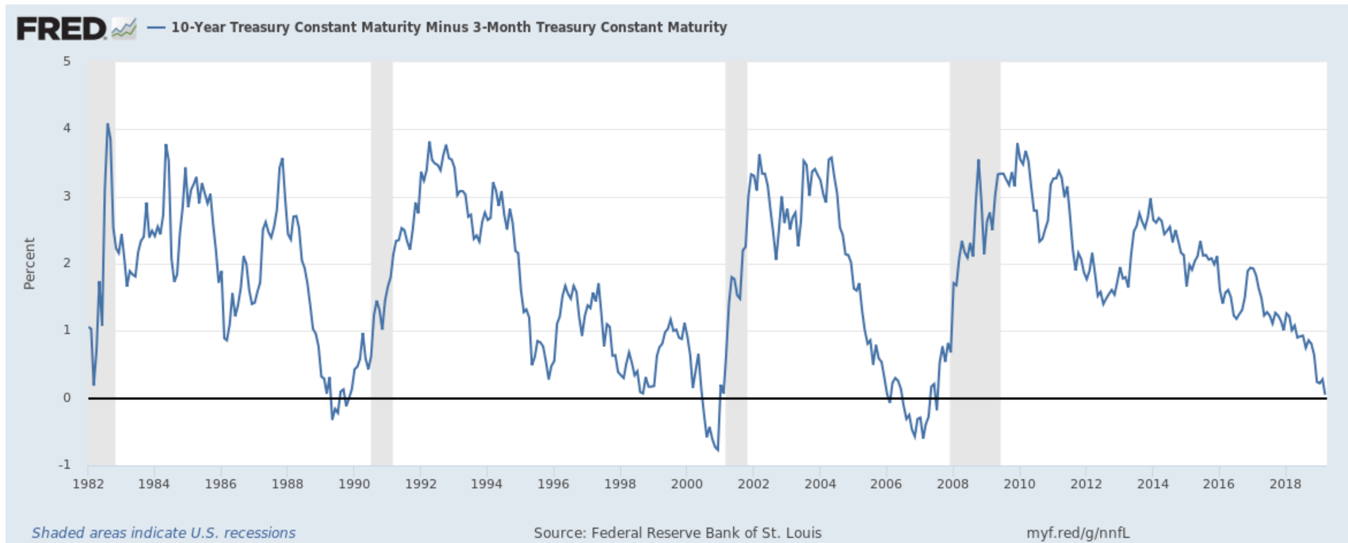
U.S. 10-Year Treasury Minus 3-Month Treasury Yield Curve
(shaded areas denote recessions)



There are several reasons to take the current inversion with a grain of salt. For one, the inversion thus far has been brief (one day). A more sustained move lower in longer-term treasury rates would be required for the inversion signal to have much meaning. Secondly, with over $11 trillion of global government bonds yielding less than 0% (meaning that investors are essentially paying governments to hold their debt),[7] there is reason to question the economic signals investors can interpret from the yield curve. Global investors may be purchasing longer duration U.S. treasuries due to a lack of attractive alternatives rather than as a sign of concern over longer-term growth. And thirdly, even if the yield curve were to invert for a sustained period, it is not a law that a recession must follow or that stocks must sell off (though most times this does happen in the subsequent 1-2 year period).

While there are certainly reasons to remain cautious on the global economy, some recent indicators both internationally and in the U.S. suggest that we are still in a positive environment for growth. For example, global trade appears to have bottomed out in late January (as can be seen in the following chart depicting global trade shipping activity).[8] Relatedly, the Trump administration and Chinese government appear to be making progress in their trade talks. If the two sides came to an agreement in the next month or two (which would be politically expedient for each) we would expect a strong recovery in global economic indicators. And as interest rates have come down in the U.S., mortgage rates have followed lower. This has been positive for U.S. housing data. The latest U.S. housing data release for February showed that existing home sales jumped 11.8% from January, as many buyers likely took advantage of attractive financing.[9] Finally, on the stock market front, earnings in the first quarter were not as bad as feared and the consensus expectations for 2019 are still for growth above 5%.[10]

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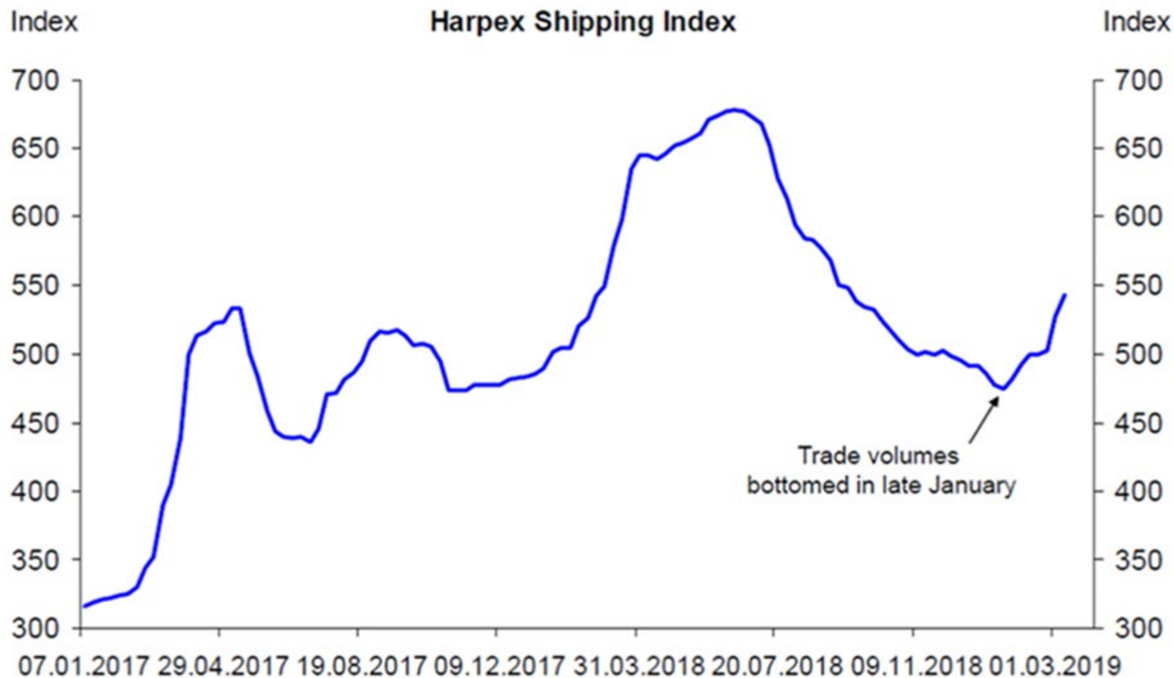
Container shipping index pointing to some rebound in global trade recently



Note: The Harpex shipping index tracks worldwide international container shipping rates for eight classes of container ships. It is used as an indicator of global shipping activity.

Source: Harper Petersen & Co. http://www.harperpetersen.com/harpex/harpexVP.do , DB Global Research

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Our expectation is that growth will slow in the U.S. this year (as the stimulus of tax cuts wears off), but not contract. Additionally, we expect that the global economic slowdown caused by trade uncertainty recovers as the U.S. and China agree to a trade deal and China perhaps attempts to stimulate its economy to avoid a prolonged slowdown. President Trump surely knows that his reelection chances are slim if the economy enters into a recession before 2020 and as much as he seems to love tariffs, we think he loves economic growth and a positive stock market even more. With the Fed on indefinite hold and interest rates in perhaps a structurally lower range, the backdrop is generally positive for stocks – particularly growth companies and ones with strong cash flows and high dividends.

At a fundamental level, stocks are worth the present value of future cash flows. Unless there is a recession that reduces investors' long-term cash flow expectations, lower interest rates should result in higher stock valuations. If a company is expected to generate $100 of cash flows in the future and interest rates are high, the present value of those cash flows will be low (resulting in a lower stock valuation). Conversely, if interest rates are lower, then the present value of those cash flows will be worth more to investors. This is illustrated below.

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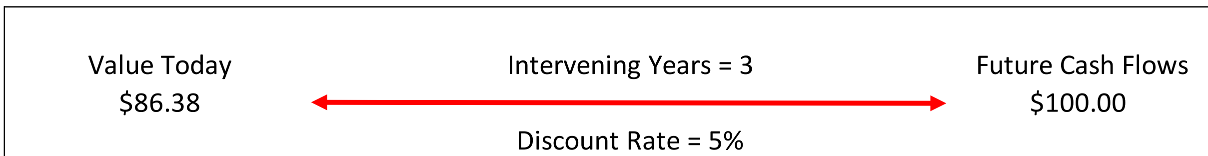
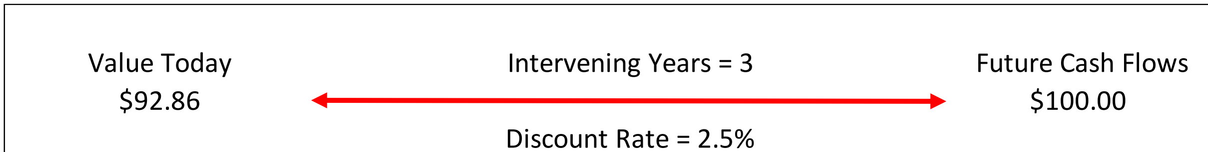
Present Value of $100 in High Rate Environment



Present Value of $100 in Lower Rate Environment



Lower rates, therefore, should be quite beneficial for growth stocks, much of whose values are predicated on cash flows far into the future. Additionally, lower interest rates should benefit stocks with consistent and sustainable dividends. If investors can't get yields higher than 2.5% in "risk-free" U.S. treasuries, then we expect a significant influx of capital into stocks that pay out steady dividends as yield-hungry investors (from pensions to retirees) seek to provide themselves a steady income stream. Beneficiaries of this allocation shift would likely include real estate investment trusts, utilities, companies with a long-term history of dividend payouts and growth and – in particular – U.S. midstream energy firms (which we think would be attractively valued even in a higher rate environment given their improved balance sheets and operating fundamentals). Emerging markets may also benefit from a lower U.S. rate environment, as it is unlikely the U.S. dollar can appreciate significantly more if monetary policy has shifted to a dovish regime. For conservative investors, we also favor owning three- and six-month Treasury bills.

On an unrelated note, we continue to monitor the outlook for Boeing following the global grounding of its 737 MAX 8 fleet in the aftermath of the recent Ethiopian Airlines crash (and last year's Lion Air crash). While tragic for passengers and their families, we currently do not anticipate a long-term degradation in Boeing's business outlook. Per the Wall Street Journal, U.S. regulators have tentatively approved software and pilot-training changes aimed to address the plane's automated stall-prevention feature, known as the Maneuvering Characteristics Augmentation System (or "MCAS").[11] The MCAS system is at the center of both crashes, as investigators believe faulty sensor readings indicating a potential stall resulted in the MCAS system pointing the plane nose down. Unfortunately, the Lion Air and Ethiopian Airlines pilots were unable to override this automatic maneuver and each flight crashed shortly after takeoff. In addition to increased pilot training, the software modification is intended to "create a gentler stall-prevention feature, redesigned so it won't overpower other cockpit commands or misfire based on faulty readings from a single sensor. It is devised to automatically push the nose down only once—for no longer than 10 seconds—if the aircraft is in danger of stalling and losing lift."[12]

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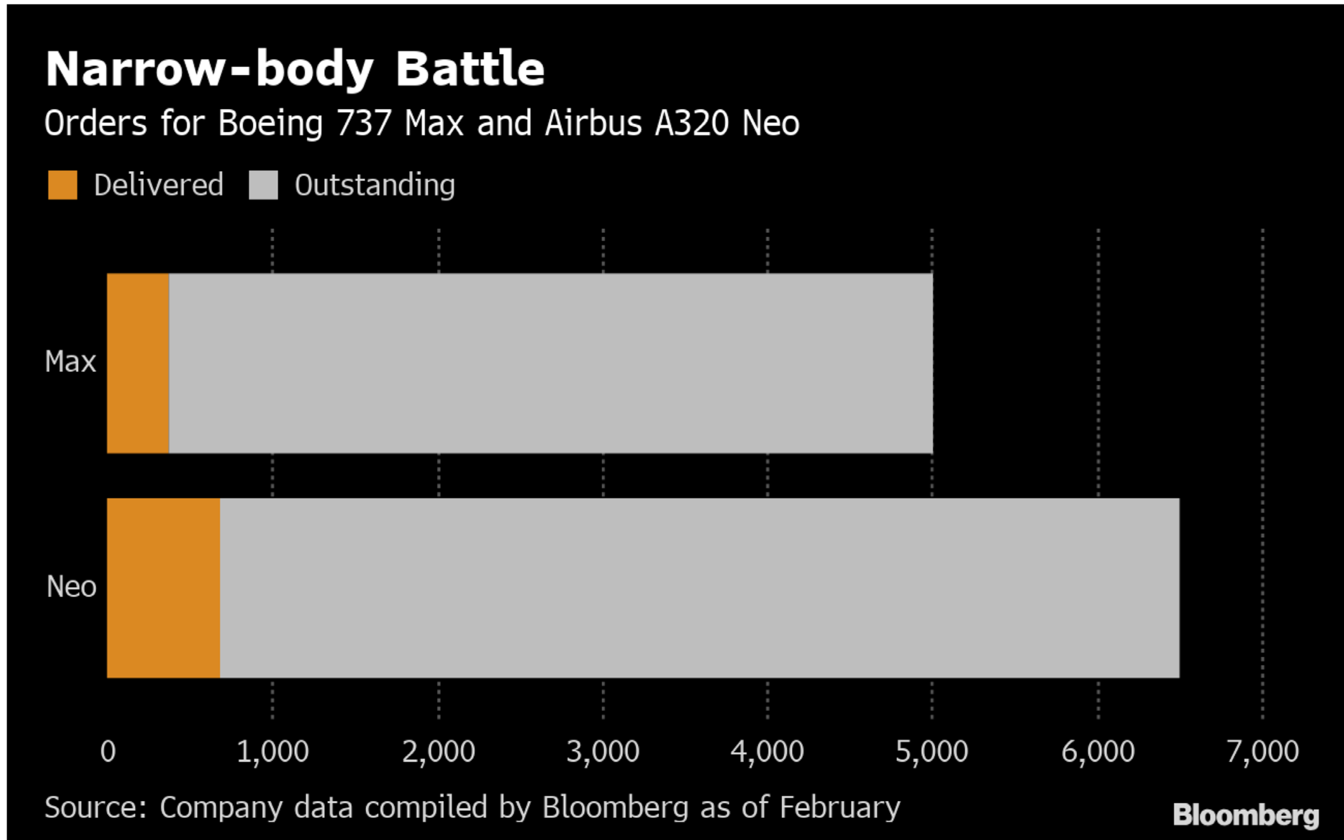
The reality of global aviation today is that airlines only have two viable options when it comes to purchasing new planes: Boeing and Airbus. While China hopes to create a competitive commercial aviation company, the technical challenges of building planes means that the two incumbents will likely enjoy a duopoly for the foreseeable future. Boeing customers who cancel their 737 MAX 8 orders cannot simply shift their business to Airbus. That firm has an estimated seven-year order backlog for its competitor A320 Neo aircraft.[13]



Boeing is likely to face intermediate-term reputational damage from this incident, but short of evidence showing that the 737 MAX has structural design flaws requiring a total engineering revamp or that Boeing criminally withheld potential safety risks from regulators, we do not think the stock has material downside from its current price. Analyst estimates put the cost of the 737 Max grounding at $100-$150 million per month.[14] The 737 Max represents approximately 30% of Boeing's operating profits and cash flows, so a prolonged grounding would weaken the firm's 2019 financial outlook. Litigation is also a risk, with potential liabilities estimated at ~$1 billion.[15] We also expect Boeing to offer price concessions to its customers on new deliveries in the near-term in order to maintain stable business relationships and make-up for increased training costs that airlines may have to bare. The firm currently has $8.5 billion of cash on its balance sheet, so Boeing should be able to weather potential expenses, fines and penalties. However, until Boeing receives the greenlight on its fixes and flights/deliveries of the 737 Max

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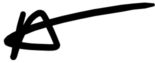
resume, we expect that the company will pause its stock repurchase program and refrain from any dividend increases. Again, we think the longer-term outlook for Boeing will be fine and would encourage long-term investors to maintain their positions. If the facts change, requiring us to reassess the outlook, we will be sure to communicate that to all owners of the stock.

Despite recent market and policy turbulence, we still recommend remaining invested, as valuations are reasonable and economic data – though slowing globally – does show some signs of stability. Please let us know if you would like to discuss your portfolio, Boeing or any of the ideas covered in this month's letter.

Sincerely,



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Citations and Disclosures

[1] U.S. Federal Reserve Bank of St. Louis, FRED Economic Data (March 22, 2019).
[2] As of the end of February, U.S. inflation (or the Consumer Price Index) rose 1.5% over the last 12 months (U.S. Bureau of Labor Statistics, March 12, 2019).
[3] Bloomberg.
[4] Bloomberg, *German Factory Slump Drags Down Euro Area Growth in March* (March 22, 2019).
[5] Source: Morgan Stanley (March 22, 2019).
[6] U.S. Federal Reserve Bank of St. Louis, FRED Economic Data (March 25, 2019).
[7] Bianco Research.
[8] Deutsche Bank Research (March 2019).
[9] Bloomberg, *U.S. Feb. Existing-Home Sales Rise 11.8% to 5.51m Rate* (March 22, 2019).
[10] Bianco Research (March 19, 2019).
[11] The Wall Street Journal, *Boeing Plans Fixes to Make 737 MAX Stall-Prevention Feature Easier for Pilots to Control* (March 23, 2019).
[12] The Wall Street Journal, *Boeing Plans Fixes to Make 737 MAX Stall-Prevention Feature Easier for Pilots to Control* (March 23, 2019).
[13] Bloomberg, *Boeing's $600 Billion Max Orders at Risk as Airlines Waiver* (March 14, 2019)
[14] Bloomberg Intelligence (March 19, 2019).
[15] Bloomberg Intelligence (March 19, 2019).

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