August 16, 2019

Over the last ten trading days, the S&P 500 has experienced a 1% or greater swing in value six times. On Wednesday, every sector in the S&P 500 and every stock in the Dow Jones Industrial Average fell. Investor anxiety predictably ratcheted up as the VIX reached 23. Although stock markets have fallen since the second quarter, returns across stock markets are positive for the year—in some cases meaningfully so. To provide some context, the S&P 500 is down 2.7% quarter-to-date, up 15.1% year-to-date, up 3.1% over the last year, and down 5.7% from its prior high on July 26th.

Bond yields, on the other hand, have completely collapsed. 25% of the global bond market has a negative yield, while the average real yield on 10-year G-10 sovereign bonds is negative 1%. High yield spreads have widened, too, raising the cost of capital for businesses, many of whom are experiencing stagnating margins and reduced earnings. With the real yield spread between the 5-year constant maturity Treasury and the 3-month Treasury Bill having turned negative back in March, there are valid signals in the real economy that consumption growth will slow in the next 12-18 months.

Nonetheless, the difference between earnings yields on stocks and bond yields still favors stocks. Given positive US productivity and the strong retail sales number released yesterday morning, the US economy is in decent shape. Despite weakening somewhat at the margin, the US is supported by a strong consumer. Much of the rest of the world, however, is struggling with growth and persistently low inflation, which explains why central banks are returning to aggressive stimulus--especially when progress on US-China negotiations likely won't occur until after the 2020 US presidential election.

Interesting though these facts and observations might be, the key insight that explains market action over the last few weeks is the change in investor expectations revealed by current market pricing. Two weeks ago, markets anticipated that central banks would dispense stimulus as needed to support real economic growth and extend the long recovery. With reserve currencies and gold up, bond yields collapsing, and commodities and raw industrial material prices down, markets are now discounting concern that central banks are close to tapped out. Recession and deflation are the deeper worries.

The catalyst for what's next will be the inability of central banks to jump start a global economy burdened by excessive debt and unfunded liabilities. Lowering interest rates and engaging in incremental quantitative easing will not get the job done; consequently, policy makers will engage in debt-funded fiscal stimulus monetized by central bank partners, currency depreciations, and tax increases. The political economy will switch to favor debtors at the expense of creditors. The investing game will once again change for some time.

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That point isn't here yet, but it's hard to imagine it won't transpire in the next few years. For investors, these economic and market turning periods reveal who has contrarian DNA. Long/short equity, risk arbitrage, strategies that make money on volatility, Treasury Inflation-Protected Securities, income generating real estate, and even gold (yes, I said gold) will likely be prized investments. With excessive debt loads, lenders paying interest to borrowers, and the expected returns on risk assets closing in on cash yields, a difficult transition and changed playing field is out there in our investing future.

For now, Greycourt's portfolios are well diversified. In stocks, we're using tax-aware solutions and managers that provide downside protection through selection skill and volatility strategies. In bonds, we remain invested where there are meaningful after-tax yields, especially across municipal securities. Out-of-favor diversifiers that include a variety of long/short strategies and statistical and/or risk arbitrage strategies are also part of our current construction. And we remain invested carefully across private markets in investments that we believe create real economic value.

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