Financial Markets Commentary – 1/2/2020

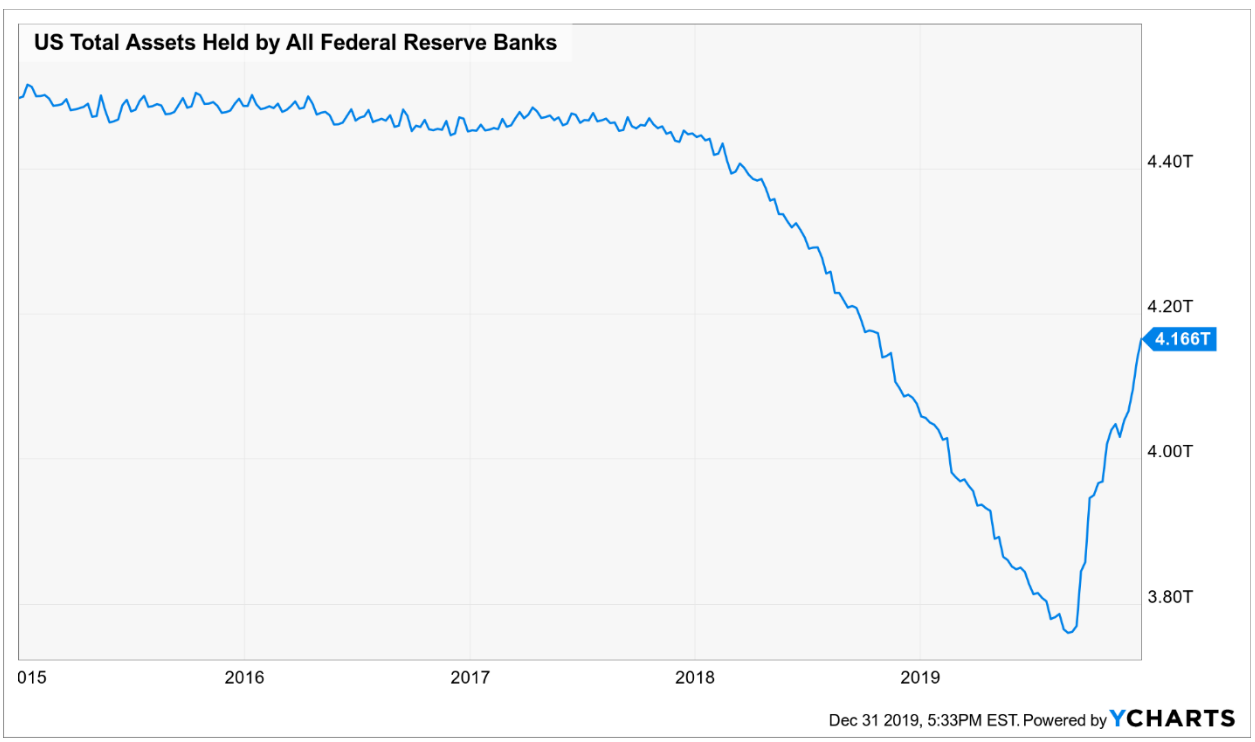
by Robert G. Kahl, CFA, CPA, MBA

Are We Reaching the Limits of Fed Intervention?

From January 2018 to September 11, 2018, the Federal Reserve steadily reduced its total assets by $670 billion from $4.44 trillion to $3.77 trillion. On September 11, there was a spike in the repurchase (or repo) rate, a key overnight lending rate. The repo market is essentially an overnight lending market where securities such as US Treasury and Agency securities are used as collateral and exchanged for cash overnight or a short term. In response to the spike in the repo rate, the Federal Reserve reversed course and has increased assets by nearly $400 billion to $4.17 trillion in just four months.

There are a number of reasons offered for the Fed's intervention in the repo market. Among them are:

1) The large commercial banks lack the free reserves to lend cash for the collateralized securities.
2) Other types of collateral, such as collateralized loan obligations, are being used in the repo market but participants have become more concerned about credit quality.
3) Debt issuance by the federal government exceeds demand from natural buyers. According to Lee Adler of the WallStreetExaminer.com, 90% of US Treasury issuance since September has been purchased by the Federal Reserve.



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Jeff Gundlach, CEO of Doubleline Capital, recently gave an interview to Yahoo Finance. Gundlach now receives much attention when he speaks because of his no nonsense parsing of reality. On December 4, Gundlach had this to say about the financial markets and the economy:

> The markets are at pretty high levels given that GDP has started to look worse. The ISM manufacturing came out today – the only way to characterize the numbers is terrible – across the board. The consensus expected it to bounce back. Instead, we got something different.
>
> What's interesting is that the bond market seems to be showing some trouble signs. The dust-up in the repo market basically, to me, shows that the Fed has manipulated interest rates to a level that the market really doesn't accept because if you can't float overnight money at the level of the Fed funds rate, it means the natural demand isn't there. Which reinforces my thesis that during the next recession, absent the Fed doing massive monetary purchases, interest rates at the long end of the curve would probably go up because of supply problems.
>
> I've been talking about this for a long time – that the growth of the national debt is substantially higher than the growth in nominal GDP. It's pretty amazing when you think about it. We talk about how the economy is so good – in terms of employment, that's true. But in terms of other things, the economy isn't that good. If you weren't expanding the national debt at all, if you were just keeping it constant (a balanced budget), we would actually have negative nominal GDP right now. It's kind of a sobering thought that the entire expansion that we've had in recent several quarters is all debt-based. The national debt and the deficit as a percentage of GDP are at levels that historically have been associated with the depths of a recession in terms of a stimulative policy. So, I think 2019 has turned out to be one of the greatest, easiest years ever for investors in just about anything.

As we start the new year, the US government's fiscal policies and the Federal Reserve's monetary policies will raise questions. Have we reached a point where the US government must rely upon the Federal Reserve's massive purchases of its debt to avoid a Treasury auction failure and default? Is the Fed's ongoing intervention in financial markets necessary? If so, why? Will US fiscal and monetary policies eventually result in a loss of confidence by foreign investors?

Asset Classes - General Comments

I currently recommend a more risk-averse allocation than investors might have over a longer time horizon due to high equity valuation levels and high debt levels throughout the global economy. The equities allocation reflects a US dollar bias to some extent with a 50% allocation to US equities and 50% allocation to non-US equities. For the fixed income portion of the portfolios, I have an emphasis on high credit quality and a relatively short weighted average duration. All portfolios include an allocation to precious metals bullion ETFs as I believe they offer protection against higher inflation and/or a US currency devaluation. Precious metals are likely to be negatively correlated with other asset classes in the future. Supply and demand for physical precious metals also appear to be favorable.

US Equities (Negative)

The current CAPE (cyclically adjusted or Shiller PE) ratio for the S&P 500 is 30.9. The Shiller PE Ratio is calculated by dividing the price of an index or common stock by the average of inflation-adjusted earnings for the last ten years. The S&P 500 has a dividend yield of 1.78% and the Russell 2000 (small cap stocks) has a dividend yield of 1.45%. At current valuation levels, potential returns over a 10-year horizon are modest. Research Affiliates currently has 10-year expected real returns (compound annual growth rates after inflation) of 0.4% and 1.9% for US large cap and US small cap stocks, respectively.

The Vanguard High Dividend Yield ETF (VYM) has a very low operating expense ratio of 0.06% and a dividend yield of 3.23%. The ETF is designed with a tilt to large cap value stocks and a higher dividend yield relative to the S&P 500.

Foreign Equities (Neutral)

The current CAPE ratios for developed Europe and emerging markets are 19.2 and 15.1, respectively. Research Affiliates currently shows annualized real expected returns (after inflation) of 5.1% for EAFE (21 developed markets in Europe, Australasia and Far East – large and mid-cap stocks) and 7.1% for emerging markets over a 10-year time horizon. Although there are potential economic problems associated with high debt levels and the potential dismantling of the European Union, foreign equities are included as a source of income, currency diversification, and protection against potential inflation.

The Schwab Fundamental International Large Company Index Fund (SFNNX) is a large cap value fund that uses the Research Affiliates Fundamental Index (RAFI) methodology to establish weights in the portfolio. As of September 30, the fund had the following geographic distribution: 25% Japan, 16% United Kingdom, 9% France, 9% Germany, 7% Canada, 6% Australia, 5% Switzerland, 3% Italy, and 3% in Spain. Its current distribution yield is 3.67% and it has a low expense ratio of 0.25%.

Wisdom Tree International Small Cap Dividend ETF (DLS) is a mid/small cap foreign stock ETF with 30% of their assets in Europe excluding the UK, 26% in Japan, 17% in the United Kingdom, and 10% in Australia. The weighted average forward P/E ratio is 12.6 and it has a dividend yield of 3.2%. DLS includes only stocks that pay dividends.

Real Estate (Neutral)

Research Affiliates assigns a low expected **real** return of 1.1% annually over the next 10 years for US real estate investment trusts, primarily due to expectations of a reduction in valuations. Returns in the asset class have historically been volatile, partly due to concerns about availability of refinancing during times of financial stress.

Artis Real Estate Investment Trust (ARESF) invests in real estate (53% office, 27% industrial, 20% retail) in Central and Western Canada and in select markets in the United States. 46% of net operating income is now coming from the United States. The trust recently adopted a more conservative financial strategy that involves lower distributions to unitholders, some asset sales, debt reduction, share buybacks, and completion of development projects. The forward dividend yield is 4.5%. ARESF currently sells at an approximate 25% discount to the appraised value of its properties net of debt.

US$ Taxable Fixed Income – Short and Intermediate Maturities (Neutral)

The current yield on the 10-year US Treasury bond is 1.88%, while one-month US T-bills are priced to yield 1.50%. The portfolio models reflect an emphasis on high credit quality and relatively short duration.

Doubleline Low Duration Bond Fund (DBLSX) has a yield of 2.91% and a short duration of 0.97 years. The fund currently has a broad mix of fixed-income securities. As of November 30, the fund had 8% US Government, 24% residential mortgage-backed securities (MBS), 17% commercial MBS, 8% asset-backed securities, 13% collateralized loan obligations, 8% investment-grade corporate bonds, 15% emerging market (US dollar denominated) bonds, and 3% bank loans. It has a low expense ratio of 0.43%.

Doubleline Total Return Fund (DBLTX) holds primarily mortgage-backed securities. It currently has a dividend yield of 3.41% with a weighted-average duration of 3.7 years. The institutional class shares have a relatively low expense ratio of 0.48%.

Doubleline Core Fixed Income Fund (DBLFX) has a yield of 2.70% and duration of 4.8 years. As of November 30, the largest categories in the portfolio were: 21% US Government, 25% residential MBS, 9% emerging market (US$ denominated) bonds, 13% investment-grade corporate, 9% commercial MBS, and 6% international sovereign bonds.

Vanguard Short-Term Investment Grade Fund (VFSUX) has a yield of 2.29% and a short duration of 2.4 years. As of November 30, the fund's largest categories were: 61% in investment-grade corporate bonds, 9% in US Government/Agency securities, 11% in asset-backed securities, 11% in commercial mortgage-backed securities and 5% in foreign bonds. It has a low expense ratio of 0.10%.

US$ Taxable Fixed Income – Long Maturities (Negative)

Given the past suppression of interest rates by the Federal Reserve and other central banks and a relatively flat yield curve, there is not much incentive to extend durations at this point. I believe that long-dated fixed income securities are currently unattractive. I do not include any long maturity taxable fixed income funds in the model portfolios.

US$ Tax-Exempt Fixed Income (Neutral)

Tax-exempt municipal bonds have historically had much lower default rates than corporate bonds as tax revenue of many government entities is less sensitive to the economic cycle. I include tax-exempt fixed income funds in portfolios which are taxable at marginal tax rates of 15% or higher. The core municipal funds that I use have a slightly longer duration than the taxable fixed income funds listed above but the additional after-tax yield justifies a slightly longer duration. Closed-end tax-exempt funds are not included in portfolios at this time due to their longer leverage-adjusted duration and use of leverage.

AB Muni Income National Fund (ALTVX) has a distribution yield of 2.77% with a weighted average duration of 5.5 years. Nearly all the fund's municipal bonds are in the investment grade category (credit ratings of BBB or higher). Only 5% of holdings are rated below BBB and 6% are not rated. There is little credit risk with this fund and moderate interest rate risk based upon the weighted average duration. Morningstar gives the fund a 5-star performance rating.

Vanguard Intermediate-Term Tax-Exempt Fund (VWIUX) has an average duration of 5.2 years with a slightly higher average credit rating compared to ALTVX. The current SEC yield is at 1.57% and the expense ratio is only 0.09%. Morningstar gives the fund a 4-star Silver rating.

Foreign Fixed Income (Neutral)

The European Central Bank and the Bank of Japan have actively suppressed interest rates, so bonds in these regions are not attractive. According to Bloomberg, the market value of global bonds that are trading at negative yields now exceeds US$ 11 trillion. However, some other countries around the world have more rational central bank policies and lower debt/GDP ratios.

I include a modest allocation to the Templeton Global Bond Fund (TGBAX) in most portfolios. TGBAX has a negative average duration of -1.0 years. It has an operating expense ratio of 0.69%. As of November 30, it held local currency government and agency bonds with the following geographic distribution: United States 18%, Mexico 14%, Brazil 12%, Indonesia 10%, India 9%, Japan 5%, Norway 5%, and South Korea 5%. The fund uses a variety of currency derivatives to reduce foreign currency risk.

Precious Metals (Strong Positive)

Given the monetary and fiscal policies of the US, Europe, Japan, and other countries, I continue to believe that portfolios should maintain an allocation to precious metals despite occasional intervention in the markets to suppress precious metal prices.

Sprott Physical Gold and Silver Trust (CEF), Sprott Physical Gold Trust (PHYS), and Sprott Physical Silver Trust (PSLV) currently sell at small discounts to net asset value. The Sprott Trusts hold physical bullion and use the Royal Canadian Mint as custodian. The prices of the Sprott Trusts are normally close to net asset value because it is possible to tender shares in exchange for delivery of physical bullion. Operating expenses are reasonable at 0.40%, 0.38% and 0.45% for CEF, PHYS and PSLV, respectively.

If you have any questions or comments, please contact me.

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