# THE CRASH AND REBOUND OF TINA

*Allen Gillespie, CFA®*
*Managing Partners of Investments*

*Mercer Treadwell, CFA®*
*Senior Vice President*

*David Lewis CFA®*
*Chief Financial Officer*

*Thomas Sheridan*
*Financial Analyst*

*Holland Church*
*Portfolio Administrator*

## EXECUTIVE SUMMARY

- **Monetary Policy:** Neutral. The Federal Reserve has indicated its goal is to move from "accommodative" to "neutral."
- **Fiscal Policy:** Checks and balances. One of the beautiful things about the American political system is the system of checks and balances. With a conservative populist Trump White House, a populist liberal House, and a nearly evenly split moderate Republican/Democrat Senate, we believe we are likely to see the American system of checks and balances at its finest.
- **Watch the Yield Curve:** Historically, the yield curve has a good track record as a leading economic indicator, and it leads other leading economic indicators like the stock market. The stock market, in turn is considered a leading indicator of the economy. **The yield curve inverted in December and again in March.**
- **Deal Activity Accelerates.** There has been a noticeable increase in mergers and acquisitions activity since the Federal Reserve's interest rate pause. In our view, this materially improves the environment for arbitrage and value based strategies.

**2018 Corrected Many Excesses—The Crash of TINA**

**Q1 2019 Has Helped TINA Make A Comeback**

## Q&A WITH THE RESEARCH TEAM

**Q: Allen, you have called 2018 the CRASH of the TINA market, can you explain?**

**A:** TINA, stands for "there is no alternative." TINA was a term traders coined for the market when cash interest rates fell to zero. Since money literally returned nothing, people were forced by the Federal Reserve's zero interest rate policies (ZIRP) to buy anything and everything that offered a yield or prospective return (i.e. stocks, bonds, real estate, bitcoin, etc.), as holding money was guaranteed to be a loosing position. The TINA effect caused investment valuations to reach some of the highest recorded levels in history.

**Q: That sounds scary. Can you elaborate on the levels of valuation?**

**A:** According to data from JP Morgan, entering 2018, equities were in the 99th percentile of valuations on many metrics. For example, on an enterprise value to sales basis, the median stock had never been more expensive, on a forward P/E basis the median stock was in the 97th percentile, on cash flow yield 98th, enterprise value to EBITDA 98th, price to book 99th, and price earning to growth 100th, but fortunately free cashflow yield was in the 55th percentile, so you get the idea. Things were not cheap. As a result of these types of valuations, I truly believed that the TINA bull market might end in another crash event, but more like 1987 than 2007/2008 or 2000-2002.

**Q: You seem to have changed your mind, what changed?**

**A:** In many ways, the markets did crash in 2018. The changes to equity valuations in 2018 were, in many respects, as large as the 41% correction that occurred during the 1987 stock market crash. It is just that

| Major Asset Class Returns | 2018 | 2019 YTD |
|---|---|---|
| T-Bills | 1.8% | 0.6% |
| Investment Grade Bonds | 0.01% | 2.9% |
| Large Cap Stocks | -4.4% | 13.6% |
| Midcap Stocks | -11.1% | 14.5% |
| International Stocks | -13.4% | 10.1% |
| Emerging Market Stocks | -14.2% | 10.0% |

Source: Morningstar Direct as of 3/31/19

## Q&A WITH THE RESEARCH TEAM

*"The data suggests that the bond market leads the stock market, and the stock market leads the economy."*

the market got there a little differently. First, the Trump corporate tax cuts, which lowered tax rates from 34% to 20% increased the cashflows to investors. This increased cashflow, and thereby lowered valuations by about 20%, so that eliminated part of the problem. Secondly, companies generally performed well, so the basic earnings base increased; so that took care of another 5-10% of the valuation problem. Finally, stock prices had a pretty big decline in the fourth quarter, which further adjusted the valuations. By our estimates, 2018 was about a 40% valuation correction from the highs reached in September to the December 24th low, not too dissimilar to 1987.

**Q: What should investors expect going forward?**

**A:** On the monetary side, the Fed says it wants to be "neutral." Politically, we have a populist Republican President, a populist liberal House, and an almost evenly split moderate Republican/Democrat Senate. You can then throw into the mix an almost completely flat yield-curve. It is a really bland sounding view, but the big macro picture looks neutral, and nothing is getting done.

**Q: Mercer, if the big picture outlook is "neutral" - where are the opportunities?**

**A:** We think a lot of the basics.

Cash and cash equivalents, now at least offer an alternative. Though for most risk assets, 2.5% is still not a significant hurdle rate. As a result, we would expect a more modest investment climate, but diversification and regular disciplined rebalancing is still a good plan. Just because most asset classes were negative in 2018 and cash was up, doesn't mean clients should change long-term plans. Diversification works over time, not every time.

We also think there are some more tactical opportunities, specifically in strategies that have modest degrees of correlation to traditional assets. For example, 2017 was the worst year on record for insurance losses, so we think that creates an opportunity in re-insurance. There are also other trends that can be played through tactical positions that otherwise get muted out in large diversified funds.

| Municipal and Treasury Yields (%) | | | | |
|---|---|---|---|---|
| Maturity | Treasury | AA Municipal | A Municipal | BBB Municipal |
| 1 Year | 2.466% | 1.694% | 1.710% | 2.582% |
| 2 Year | 2.459% | 1.729% | 1.735% | 2.636% |
| 5 Year | 2.437% | 1.867% | 1.926% | 2.862% |
| 10 Year | 2.630% | 2.343% | 2.505% | 3.354% |
| 30 Year | 2.996% | 3.302% | 3.423% | 4.323% |

Source: Bloomberg as of 1/31/19

**Q: Can you give us a more specific example?**

A: We believe there is an opportunity in the financial sector because so many investors remember the financial crisis. Interestingly, we are seeing mergers and acquisitions in the space and increased dividends from many companies, but the stock market performance of the sector has been horrible. In fact, there is one manager we track, a true financial sector specialist, who was one of the best performing managers during the 2008 crisis. His recent performance has been down given his more constructive view on the space. We think that creates an opportunity. In addition, if the yield curve steepens, then we believe financials would be the biggest beneficiaries.

**Q: Any other examples?**

A: Based on our modelling, we believe arbitrage strategies offer an attractive risk-return premium above short-term interest rates. Given that we are seeing an uptick in major mergers and acquisitions activity, we would expect it to be a good investment climate for these less correlated strategies. A related strategy that is more directional in nature would be event managers. We have noticed a number of event trades occurring, related to corporate debt, due to both special situations (like the California wildfires), and due to last year's rise in interest cost (like Kraft's announcement that it will be lowering its divi-

## Q&A WITH THE RESEARCH TEAM

dend to paydown debt faster).

**Q: Any final thoughts from the team?**

A: We are always looking for ways to improve the investment program for our advisors and clients, so one of the goals we have set for ourselves this year is to improve our communication. This newsletter is an attempt to do that, and we are also very open to any feedback that will help us serve you better.

## ECONOMIC OUTLOOK

### MONETARY POLICY

Last year was a year that many investors would like to forget. Most asset classes, apart from cash and cash equivalents, finished the year negative. **While not a pleasant year, 2018 did correct many extreme excesses.** The broad-based declines can largely be attributed to the fact that the Federal Reserve enhanced the attractiveness of cash. There is a saying on Wall Street: “money will go, where money is best treated.” By raising short-term interest rates throughout the year and treating cash “better,” the Fed shifted its policy stance from “accommodative” to “neutral.” **In our estimation, the shift to “neutral” is a significant change in policy that alters the investment climate for the foreseeable future. The Federal Reserve has been “accommodative” for 10 years, so we suspect it will be “neutral” for a significant period (though maybe not 10 years) going forward.**

### FISCAL POLICY

The past year also brought political changes, as Democrats regained control of the House of Representatives, while Republicans held on to a slim majority in the Senate. While this was an unsatisfying result to those of a strong political persuasion, we believe checks and balances are a beautiful feature of the American political system. According to Ned Davis research, when a Republican President loses the House, stocks are largely flat over the subsequent twelve months. It appears the stock market, just like many American sports fans—does not like ties, but ties are better than losses. Many people remember when Auburn coach Pat Dye kicked a game tying field goal in the 1988 Sugar Bowl. Coach Dye’s actions are one of the reasons College Football today plays overtime.

### THE INVERTED YIELD CURVE

The yield curve inverted in December and again in March. Historically, the yield curve has a good track record as a leading economic indicator. It can lead other leading economic indicators like the stock market. As a result, the FinTrust research team took a look at all of the yield curve inversions since the 1970s, as defined by five-year Treasury rates being below two-year Treasury rates. What the research team found was a mixed bag of good and bad information for equity investors.

**The Data**

Yield curve inversions have lasted from as short as a month to as long as a couple of years. We found the average length of a yield curve inversion was 7 months. This makes intuitive sense to us because recessions are defined as two quarters of negative Gross Domestic Product (GDP), hence the usefulness of the yield curve as an economic indicator. Naturally, we found that the longer the inversion is maintained by the market, the more severe any subsequent slowdown. For example, during the 2006/2007 period the yield curve was inverted for 19 months.

**The Good**

Our research found that stock market performance during yield curve inversions is reduced but still positive.

**The Bad**

The yield curve is a leading indicator, and it leads other leading economic indicators like the stock market. Once the yield curve re-steepens, a much more challenging stock market frequently results. In short, the data suggest that the bond market leads the stock market and the stock market leads the economy. The equity market downturns of both 2001-2002 and 2008 occurred after the yield curve had steepened after being inverted for a long period.

**The Outlook**

We are continuing to monitor the yield curve and we would be increasing concerned should the yield curve remain inverted for six months or more or if the inversion becomes more pronounced in magnitude. After six months, we believe the bond market will have clearly forecasted a coming recession. Similarly, a severe inversion would suggest a more negative environment as well. Long-term investors should not overreact to business cycle data, but **we would encourage investors to review what we call their ‘vertical risk’: financial plans, risk profiles, and asset allocations. The FinTrust portfolio management team mainly considers horizontal risk moves,**

**which shorten or extend risk within each respective asset class.** A move between stocks and bonds would be a vertical risk shift, whereas a shift in allocation between large capitalization dividend paying value stocks and small capitalization growth stocks would be a horizontal shift.

Given our neutral view, we believe gradual reductions in risk posturing, systematic rebalancing, and less correlated strategies should be emphasized within portfolios.

## QUICK TAKE: MAJOR ASSET CLASSES

### Cash and Cash Equivalents

After nearly a decade of being below the inflation rate, cash and cash equivalents once again offer investors roughly the equivalent compensation as inflation. The Federal Reserve's over-night rate currently sits at 2.4% while the last read on the CPI was 1.9%, but the twelve month average sits at 2.45%.

### Investment Grade Fixed Income

Investment grade bond yields rose more or less in-line with the rise in short term interest rates during 2018, while spreads slightly increased after interest rates reached their December peak. Many are concerned about the large number of investment grade credits that sit just above the high yield category, as any downgrades could lead to forced selling by institutions. Consecutive down years are rare in the bond markets, and the bond market is currently pointing toward deteriorating conditions, but interest rates continue to be very low by historical standards. As a result, we think investment grade bonds still have a defensive roll to play, but they do not offer much in the long run.

### Tactical Fixed Income

Historically, fixed income and equity arbitrage strategies earn a risk premium above cash yields. Over the last few years, when cash rates were very low, these strategies we not as attractive as more traditional credit and interest rate carry strategies. Now, however, given higher short term interest rates, the inverted nature of the yield curve, and the potential for credit spreads to widen, we believe event and fixed income and equity arbitrage related strategies offer a compelling risk return opportunity. We believe the return profile is reasonable and the risk profile is better than either duration or credit.

### Core Equities

In December, the Dow Theory gave a sell signal, but it is not uncommon to see large secondary moves after the change in primary trend. According to Ned Davis Research, when a Republican President loses the House, stock returns are flat for the next year. Based on the yield curve and historical patterns, we are modestly constructive on equities but do not believe investors should chase the market as during the Quantitative Easing (QE) period that ran from 2009-2018. We also believe the neutral outlook in the US will lead investors to seek returns in international markets given their higher yields.

**Index Snapshot**

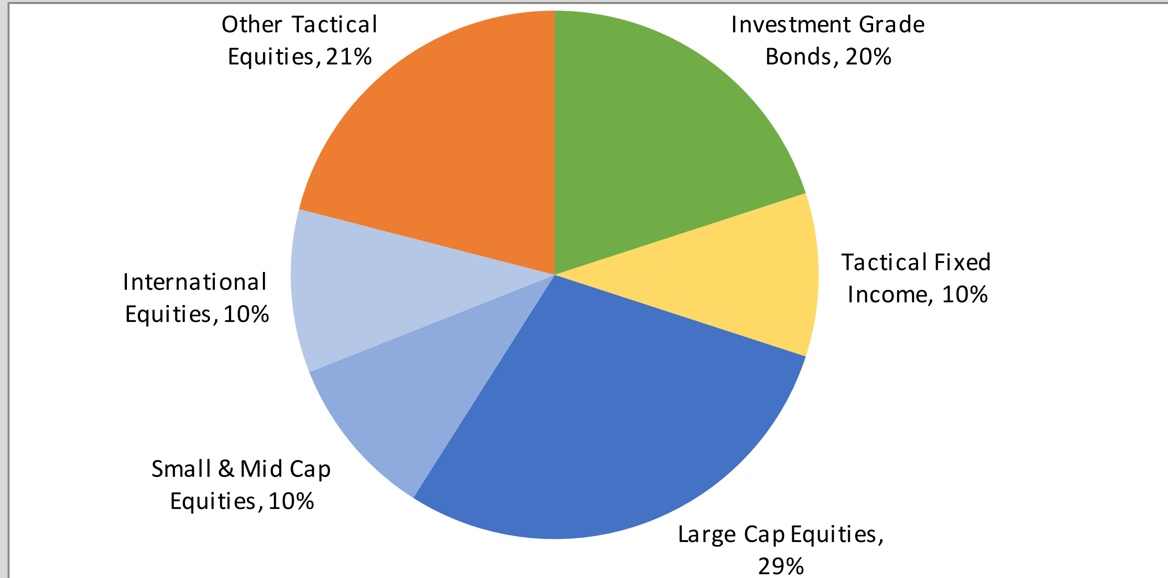
| | Earnings Yield | Dividend Yield | Price to Book |
|---|---|---|---|
| **Large Cap Stocks** | 5.44% | 1.97% | 3.28x |
| **Mid Cap Stocks** | 5.28% | 1.68% | 2.29x |
| **Small Cap Stocks** | 4.50% | 1.56% | 2.06x |
| **International Stocks** | 6.73% | 3.46% | 1.57x |
| **Emerging Market Stocks** | 8.25% | 2.75% | 1.59x |

Source: Bloomberg as of 2/22/19

### Tactical Equities

Nearly every strategy and asset class has underperformed domestic US equities during the fourth quarter of 2018, but we did see some evidence of money returning home to emerging markets on a country by country basis. Other tactical equity strategies, like long/short equity, have historically performed better when short-term interest rates are higher. The duration of long only equities has been estimated to be 30-50 years; so given that we are in an inverted yield curve environment, we believe tactical equity strategies are becoming increasingly attractive on a relative value basis.

**FinTrust Allocations (70/30 Risk Profile) with Tactical**




Positioning as of 2/15/2019. This model displays FinTrust's Funds & ETF Model with Tactical target portfolio guidelines. Each client situation is unique and may be subject to special circumstances including but not limit to: greater or less risk tolerance, classes, and concentrations of assets not managed by FinTrust, investment limitations imposed under applicable governing documents, and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the aforementioned and other factors.

## ABOUT FINTRUST CAPITAL ADVISORS, LLC

*Privately owned and independent, FinTrust Capital Advisors is a Southeastern based financial services firm that serves both personal wealth clients and corporate and institutional clients. Through strategic financial planning, investment management, and other fiduciary consulting, retirement plan consulting, research, capital markets, and other services concerning financial well-being. The FinTrust team of experienced professionals provides solutions to meet both individual and corporate client objectives.*

*Important Disclaimer*

*Securities offered through FinTrust Brokerage Services, LLC (Member FINRA/ SIPC) and Investment Advisory Services offered through FinTrust Capital Advisors, LLC. Insurance services offered through FinTrust Capital Benefit Group, LLC. This material does not constitute an offer to sell, solicitation of an offer to buy, recommendation to buy or representation as the suitability or appropriateness of any security, financial product or instrument, unless explicitly stated as such. Past performance is not necessarily indicative of future returns. This information should not be construed as legal, regulatory, tax, or accounting advice. This material is provided for your general information. It does not take into account particular investment objectives, financial situations, or needs of individual clients. This material has been prepared based on information that FinTrust Capital Advisors believes to be reliable, but FinTrust makes no representation or warranty with respect to the accuracy or completeness of such information. Investors should carefully consider the investment objectives, risks, charges, and expenses for each fund or portfolio before investing. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including but not limited to changes in economic growth, corporate profitability, geopolitical conditions, and inflation. The mention of a particular security is not intended to represent a stock-specific or other investment recommendation, and our view of these holdings may change at any time based on stock price movements, new research conclusions, or changes in risk preference. Index information is included herein to show the general trend in the securities markets during the periods indicated and is not intended to imply that any referenced portfolio is similar to the indexes in either composition or volatility. Index returns are not an exact representation of any particular investment, as you cannot invest directly in an index.*