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HOLBROOK HOLDINGS

January 2, 2019 | Scott Carmack (Portfolio Manager)

THE WALL STREET-MAIN STREET DICHOTOMY

THE MARKET AND THE ECONOMY ARE DISTINCT ANIMALS

Subsequent to The Great Financial Crisis of 2008, U.S. equity markets have marched higher for the better part of a decade. The "wall of worry" that bull markets inevitably climb has been tall and thick. Television pundits have coined the post-Recession run-up in asset prices many things, but perhaps the most apropos is, "the most hated bull market of all time." Indeed, almost every valuation metric pointed to an expensive market by historical standards – not for a day, not for a month, not for a quarter -- expensive throughout this decade ascent. For many it was impossible to fathom that a slog-along economy expanding at 1-2% could ignite one of the longest and robust bull markets in history. Labor participation was low, wage growth was anemic, and capital investment never had the rebound that accompanied other recoveries. And then there was 2018. Capital Investment finally picked up, as did wage growth, and the economy finally eclipsed the 3% growth for which equity markets so yearned. So why is a stronger economy now accompanied by a market plagued with volatility, negative returns and investor panic? How could we have the worst performance for the S&P 500 in the month of December since the Great Depression?

Here is a little secret that many astute investors already know: the market is *not* the economy, and the economy is *not* the market. The underpinnings of Main Street are much different than those on Wall Street. And while there are times that both move in lockstep, often the opposite is true.

The Wall Street fire is fed by liquidity – plain and simple. Moreover, liquidity in the financial markets rarely benefits Main Street. Quantitative Easing (the process by which the Federal Reserve buys longer-dated treasuries from banks, aka "QE"), in retrospect, did absolutely nothing for the real economy. It follows that Quantitative Tightening (the process by which the Federal Reserve does not reinvest maturing bonds on their balance sheet, aka "QT") should have negligible effects on Main Street, and thus far, I would contend that this is true. The effects on Wall Street and asset prices, however, are a much different animal. Consider the mechanics behind QT and the withdrawal of liquidity from the financial system: By not reinvesting $50 Billion per month of maturing treasury and agency debt, the private sector is left to fill the void to finance Federal new issuance. That is $50 Billion per month that would normally find its way into other ventures, whether it be equity, real estate or corporate debt. You get the idea. Now add on top of that, a burgeoning fiscal deficit. The U.S. government could potentially eclipse the $1 Trillion mark in 2019. That is an additional $85 Billion per month in investment funds that would otherwise be earmarked for other asset classes. So -- back of the envelope -- due to QT and Federal deficits, $135 Billion more is spent per month financing the U.S. government than was the case before the onset of Quantitative Tightening. Such a liquidity drain is not conducive to multiple expansion. One could have an optimistic view on earnings, and multiple compression could more than offset it. Earnings multiples will likely be under pressure until QT stops, and/or Federal deficits cease expanding at the margin.

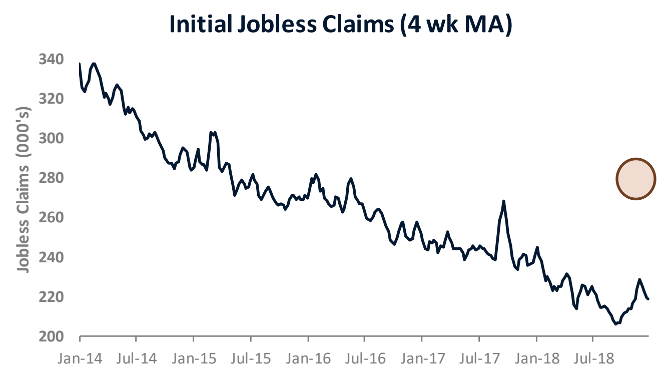
The good news is that while Federal spending may not be the most productive allocation of capital, that money is finding its way into the real economy, whether it is through government investment, social security payments, defense contracts etc. The liquidity drain from Wall Street is paying for the liquidity flow into the real economy. Bad for asset prices, but good for Main Street. I expect this dichotomy to persist throughout

2019, and maybe beyond. The real economy will continue to grow, while markets will be afflicted by multiple compression and volatility. Just like the weak economic recovery was accompanied with robust asset inflation, a stronger economy will now be buttressed with weaker markets. Prepare yourself for the new investment conundrum that will perplex pundits -- how can the U.S. enter a bear market with the absence of a recession? It's simple – a liquidity transfer from Wall Street to Main Street.

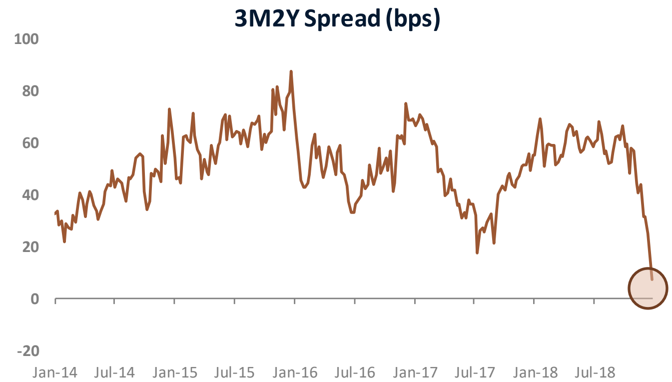
ALL ECONOMIC DATA LEADS TO A FED PAUSE

In our October newsletter we focused on three leading indicators that we thought would be the most important for markets moving forward: high yield spreads, the front-end of the yield curve, and initial jobless claims. At the time, none of those indicators were flashing warning signs. Fast forward three months, and two of those three indicate that there could be trouble ahead for markets. High Yield spreads have spiked to well above 500 basis points, and the front-end of the yield curve has inverted. We take these signals very seriously, and in response, we will be holding additional cash (10-15%) which now pays us 2.3% and enables us to take advantage of market dislocation and sell-offs as they occur. We will also be gravitating towards single-A credits on the margin and upgrading over-all credit quality across the portfolio.

Source: Bloomberg 1.04.2019; Bloomberg Barclays High Yield Corporate Average OAS



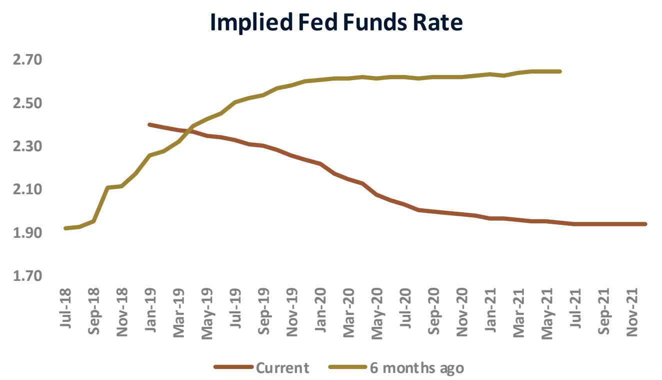
Source: Bloomberg 1.04.2019



Source: Bloomberg 1.4.2019

Interestingly, the one forward-looking indicator that still gives us confidence in economic growth is initial jobless claims, which are still very low. Again, market-based indicators are flashing red, and macro data is not – Main Street is stronger than Wall Street. We will continue to pursue our highest conviction investment, BDC Baby Bonds (Senior Unsecured bonds issued by Business Development Companies that are $25 par value and trade on the exchange), with this theme as our backdrop. These companies lend to the middle market -- smaller companies across America. Their covenants are bond-holder friendly as they limit leverage and mandate buybacks and dividend cuts when asset coverage ratios are tripped. The most recent sell-off in these issues provided us a great opportunity, and we seized it, bringing overall fund exposure from less than 30% to 40%.

What does this mean for the Federal Reserve? After all, their dot-plot implies two more rate hikes in 2019. Yet the market is pricing in rate-cuts by the end of the year.



Source: Bloomberg 1.04.2019

We are of the opinion that the Fed is on hold for at least 6 months. The recent plummet in oil has given them great cover to pause, as inflation readings are likely to be benign near-term. And although Jay Powell is managing monetary policy for the real economy – not Wall Street – and much of the data could support further normalization, the fall in oil has given the Fed the ability to take a wait-and-see approach consistent with their dual mandate. Recent manufacturing data has surprised to the downside, and there is little doubt that the global economy is slowing. Tax cuts and fiscal stimulus will be waning on the margin, and it is prudent policy to allow the economy (not the market) to digest recent rate hikes.

A pause should have implications for the yield curve, and the dollar. We expect near-term curve steepening and dollar weakness due to a Fed pause. Whether it ultimately morphs into a "pivot" and reversal of policy will be a function of macro-data. We do not see enough weakness in the consumer and employment to merit a reversal in policy currently and expect no recession in 2019. If anything, the recent plunge in oil and gasoline prices has added additional time to this late-cycle expansion. 126 Million households in America are spending $700 less per year on gasoline annually than they were in the Summer of 2018. In the end, this is not a tax cut. It is a tax credit for the consumer. The Fed can afford to move more slowly, and this gives us more conviction in a continued expansion.

The bad news for investors is that the Fed's QT program is on auto-pilot, and this, combined with treasury issuance, will continue to suck liquidity from financial markets. Volatility in asset markets will continue, and it is very likely that the recent bottom in equity prices is temporary. They will likely be tested, and much will be garnered regarding the health of the stock-market when they do. My feeling is that multiples, in an environment where liquidity is being crowded out by treasury issuance will be much lower than many expect. Multiple expansion will probably not occur until Quantitative Tightening and treasury issuance are pared back. And I do not see either of those happening in 2019.

In terms of the U.S. yield curve. The last three months have done nothing to sway my opinion that yields (especially on the long-end) will be significantly higher. Supply will continue to overwhelm any risk-off bid that may occur in response to market volatility. The largest holders of treasuries, the Fed and China, are now net-sellers of treasuries. On a relative basis, currency hedged treasuries are still not attractive to their global counterparts. And finally, the extreme bearish positioning in treasuries has been quickly cured. The necessary conditions for higher yields are in place, and I suspect we see a 4% ten-year yield at some point in 2019 which will provide a very difficult environment for risk-parity funds and asset allocators that depend on negative correlation between asset classes.

CONCLUSION

Our major theme for 2019 is the dichotomous relationship between the real economy and asset prices. It is our opinion that this will garner increased attention from market pundits and investors alike. And although the Federal Reserve will pause and continue to be data dependent, unlike some of his predecessors, Jay Powell will continue to formulate policy based on the goings-on of Main Street. The liquidity flow from Wall Street to Main Street will continue, and as a result, the Fed will continue with QT and be more hawkish than the market will like.

For a short-term fund this environment should provide many opportunities. Illiquid markets have a way of revealing value, and the ultimate liquidity comes when our holdings mature. As a result, we will hold additional cash (10-15%) to take advantage when opportunities present themselves. We will continue to focus on domestic names that are insulated from a global growth slowdown, and we will heed our market indicators which suggest now is the time to increase credit quality and be a bit more defensive.

Important Risk Information:

Business Development Company ("BDC") Risk. BDCs have little or no operating history and may carry risks similar to those of a private equity or venture capital fund. BDC company securities are not redeemable at the option of the shareholder and they may trade in the market at a discount to their net asset value.

Credit Risk. The risk that the Fund could lose money if the issuer or guarantor of a fixed income security is unwilling or unable to make timely payments to meet its contractual obligations.

Fixed Income Risk. When the Fund invests in fixed income securities or derivatives, the value of your investment in the Fund will fluctuate with changes in interest rates. Typically, a rise in interest rates causes a decline in the value of fixed income securities or derivatives owned by the Fund.

High Yield Risk. Investment in or exposure to high yield (lower rated) debt instruments (also known as "junk bonds") may involve greater levels of interest rate, credit, liquidity and valuation risk than for higher rated instruments. Overall equity market risk may affect the value of individual instruments in which the Fund invests.

Quantitative Investing Risk. The Adviser may use proprietary computer trading modeling systems to implement its investment strategies for the Fund. Investments selected using these models may perform differently than the market as a whole or from their expected performance as a result of the factors used in the models, the weight placed on each factor, changes from the factors' historical trends and technical issues in the construction and implementation of the models. There is no assurance that the models are complete or accurate, or representative of future market cycles, nor will they necessarily be beneficial to the Fund if they are accurate.