



Investment Management Group®

The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

Market Perspective 2018

It's always interesting to reflect back on a calendar year, and try to piece together the events and make sense of it all. There was a lot to digest in 2018, but it doesn't take any special deciphering to recognize that it was a year of **transition**.

Last year, we noted that "Goldilocks" environment was helping to inspire the second longest bull market since World War II. With tongue-in-cheek we also noted that the story of Goldilocks and the Three Bears doesn't exactly end well – although she finds porridge and a bed that is "just right", in the end she has to flee the house! Similarly, the economy in 2017 seemed just right, but by the end of 2018, investors were fleeing the market.

The prior market regime was dominated by the barbell-approach of owning the so-called FANG stocks on one end, and passive on the other. This simplistic strategy was fueled by near-zero interest rates and several rounds of Quantitative Easing. I've been making this case for a while now: coming out of the recession in 2009, central bankers suppressed interest rates in order to stimulate the economy. The suppression of rates leads to the suppression of risk – companies on the verge of failure are bailed out by the additional liquidity or cheaper borrowing costs. The suppression of risk means that fewer companies fail, and ultimately manifests itself as the suppression of volatility.

Markets are very efficient at figuring out how to capitalize on asymmetries. With artificially suppressed volatility, the money gravitated toward "risk-on". It paid to take more risk, because the Fed was suppressing risk – no one was getting burned. Taking the time to invest in quality companies didn't really matter. It was the low quality companies that had the most to gain. A rising tide was lifting all boats, so why not invest in a passive strategy that owns all the boats?

We always believed that rates and monetary policy got us into this situation, and surely they would get us out. The Fed had already made moves to get off the zero-bound in 2017, but the true impact of monetary policy lags. And so, it was *this* year in which the first moves in Fed Funds rates started to show up in the economy. With rising rates, came rising volatility.

As monetary policy became more and more hotly debated, and instead of "Goldilocks" we are starting to use the dreaded "R-word," recession. Economic issues were further complicated by trade wars with China and others. At the same time the FANG stocks lost their luster, as regulatory risks mounted, and investors began to worry about privacy concerns.

While it seemed like so much changed in 2018, the trend toward passive investing didn't seem to show any signs of slowing. Money continued to come out of active managers and flow into passively managed vehicles. As a result, we continued to see signs of an inefficient market and dislocations based on the money flow.

While the fourth quarter of 2018 was characterized by a sharp pull back, our take is that it is part of the healthy transition from a one-sided market exploiting unusual monetary policy, to a more chaotic and uncertain market. It may be too early still, but it might be the beginning of a reminder to investors that there is a reason to hire active managers.

Ryan Edward Crane
Chief Investment Officer

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