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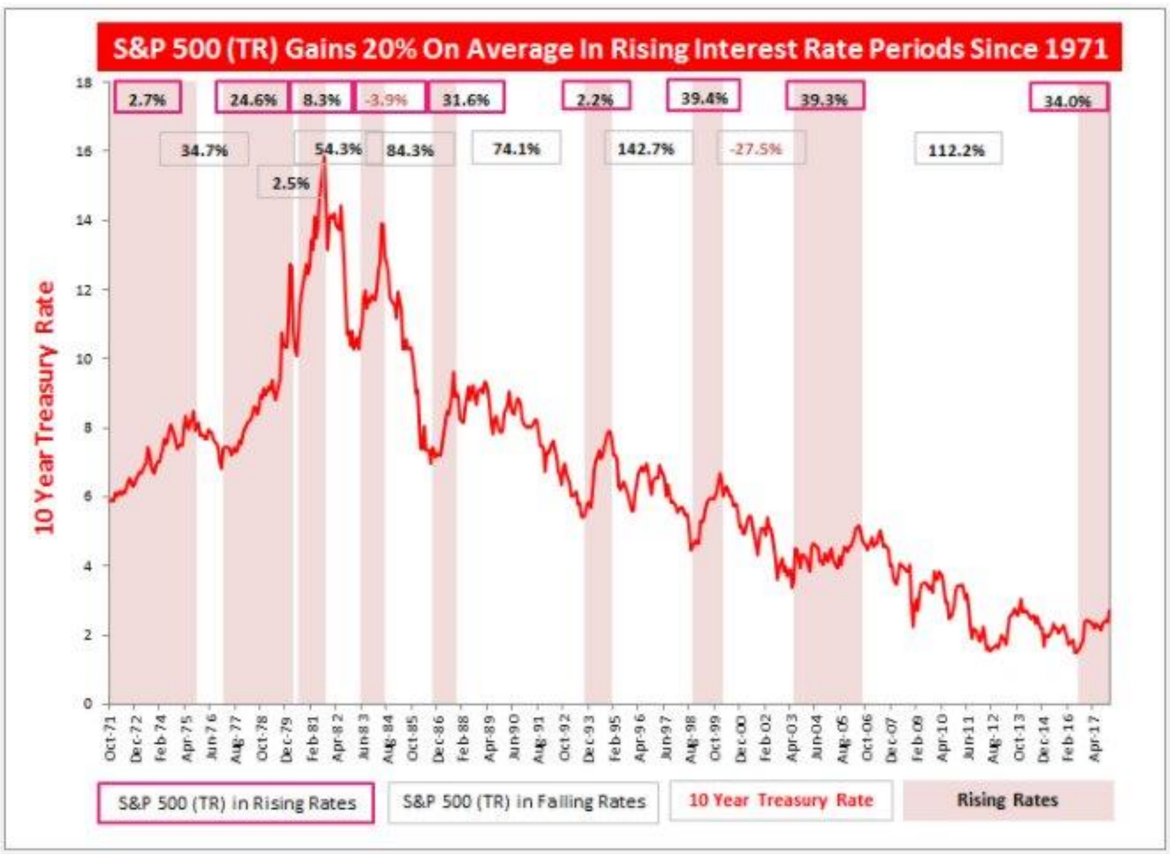
Fear of the Known

On 2nd February, 2018, the Bureau of Labor Statistics (BLS) under the Department of Labor reported that wages of American workers for the month of January 2018 grew by 2.9% from a year ago. It marked the best wage growth since 2009, as the adjoining chart shows. Most economists had expected it to be 2.6%. Unemployment rate, meanwhile, dropped to 4.1%, also at the best level since 2009. Equity market's response to this set of good news was anything but good – Dow Jones Industrial Average (DOW) dropped 666 points or 2.5% on the day and the U.S. 10 Year Treasury Note declined in value to yield 2.84% from 2.79%. Apparently, the equity market sell-off was due to concerns of rising inflation given the stronger than expected wages gains. Curiously, the bond market didn't show the same level of concern as the +5 basis points (bps) action indicates. Over the next four trading days through February 8, the DOW lost another 1660 points or 6.5% even as the 10Y Treasury actually moved lower to 2.83%. Clearly, the anxiety of higher interest rates had more bearing on the equity markets than the reality of muted rates action. While we don't disagree with the premise that higher rates will hurt growth, our confusion centers on the intensity of equity market's reaction. After all, participants had seen robust economic growth numbers for almost a year and even the Federal Reserve, which is known to almost always be behind the curve, had been pretty consistently prepping the markets for higher inflation. So, the stronger wage growth number should not have been a surprise and even if it was a surprise, we think market's reaction was exaggerated. "Fear of the known" is perhaps the best way to describe it.

Source: New York Times

In our last update titled "QE to QT" we had written extensively about the issue of rising rates. In fact, we have been pointing to that expectation for even longer and have been detailing how we are proactively positioning our strategies to not only avoid the negative impact of rising rates but also gain exposures to ideas that would benefit from rising rates. To that end, recall that we had been selling REITs, Utilities, and Consumer Staples while increasing exposure to Banks. What we find really perplexing is the almost universal acceptance of the notion that higher rates are "bad" for equities. The chart below should question that assumption. As can be seen, since 1971, equities, as represented by S&P 500, have gained almost 20% on average during rising rate periods!



Source: S&P Dow Jones Indices and Federal Reserve Economic Data, Economic Research Division, Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org

With the important caveat that no two situations are the same, we wanted to point out these facts because the relationship between rising rates and performance of equity market is counter intuitive in the initial stages of rising rate cycles. Of course, eventually, equities do succumb to the force of higher rates but investors could end up leaving a lot on the table if interest rate movements become the sole guide for asset allocations decisions. During such periods, sector rotation appears to be more important and its execution could be the difference between below par and above par investment returns.

Performance Review

Core strategy

OppoQuest's Core strategy (CORE) continued its 1st half of 2017 momentum and generated a gross return of 6.04 % for the 2nd half of 2017 (2H17) versus 7.17% for the benchmark, S&P Target Risk Growth Index. Gains for the CORE were fairly broad-based with notable contributions from Commodities, Financials, and Energy sectors. Top performing individual positions included FCX, TAN, RDSB, and BAC. These names were also higher weighted in the strategy and indicates that stronger conviction positions performed better. Driving the energy related positions was a remarkable rebound of +26% in West Texas Intermediate (WTI) crude Oil prices which pushed the sector higher and created a halo effect for other commodities as well. Interestingly, the biggest gains for 2H17 came in the month of December with the passage of Tax Cuts and Jobs Act (TCJA). And speaking of the TCJA, we see it as a huge catalyst for economic growth and should disproportionately benefit U.S. based companies in the old economy sectors - Commodities, Energy, and Banks – areas where we have bigger exposures!

With respect to performance detractors, Technology and Industrial sectors negatively impacted returns with NOK and GE positions being the biggest drags. NOK declined after 3Q17 earnings as the company gave a tepid outlook for the remainder of the year but has reversed the entire decline after providing better then expected outlook for 2018 and beyond in their 4Q17 earnings report. We are quite baffled at the swift reversals in investors' assessment of the outlook for a company whose business is fairly matured and well understood. GE, on the other hand, has now become a show-me story and we are hugely disappointed with the new revelations of mismanagement under past CEO, Jeff Immelt. It's of little consolation to us that Mr. Immelt's departure was one of the catalyst for our buying decision. That said, the new CEO, John Flannery, seems to be cleaning house rapidly and we expect him to set a new strategic direction for GE that will eventually lead to a stronger company. Notably, both GE and NOK are only mid-sized position which means that their negative performance was less impactful to CORE.

Also affecting negatively was CORE's defensive positioning, partially reflected in its 10% cash holding. However, that drag should reverse in the first half of 2018 given the big decline in risk assets in early February. We would like to emphasize here that holding cash in an investment strategy is also an active bet and is therefore an equally hard decision to make. In fact, most money managers avoid having cash because of the fear of missing out a strong up day. Others justify not holding cash as a matter of their investing mandate. Even those that do have the flexibility and conviction do not necessarily get it right at times. For example, Ray Dalio of Bridgewater Associates with about $160 billion of assets under management, said recently at the World Economic Forum in Davos that investors with cash holdings would feel "stupid" because risk assets were poised to take off. Two weeks later, global Equities had sold off anywhere between 10 to 15%. This is not a dig at Mr. Dalio. On the contrary, we admire him immensely and one unflattering prediction is not going to change his legendary stature. But it does highlight how difficult market timing is and has boosted our determination to stick to our discipline of not succumbing to external pressures.

Turning to changes in the CORE strategy, we have increased our Technology and Financial sectors exposures while continuing to lower Real Estate Investment Trusts (REITs) weight – just as we had indicated in our previous update. Over the last one year we have brought down CORE's REITs exposure, including Mortgage REITs, to around 5% from almost 15%. We are convinced that conditions favor interest rates heading higher which presents a significant risk to rate sensitive sectors like REITs and Utilities. And conversely, higher rates should benefit Banks, whose weight was increased, as mentioned earlier. Speaking of rates, the yield on 10Y U.S. Treasury Note did move higher by 11 bps to 2.41% over 2H17. Finally, we also did reduce our Energy sector exposure given the strong run-up in many of its holdings. This reduction is more to do with our risk management process than any change in our outlook for Energy.

Conservative Strategy

OppoQuest's Conservative strategy (CONS) also continued its 1H17 performance momentum and generated gross returns of 4.43% for 2H17 versus 5.21% for its tracked benchmark, the S&P Target Risk Moderate Index. CONS's gains were also led by contributions from Commodities, Energy, and Financial sectors. Top performing individual positions were BBL, FCX, RDSB, and BAC. Similar to CORE, these were among the higher weighted positions in the strategy. And, December was extremely strong for CONS as well.

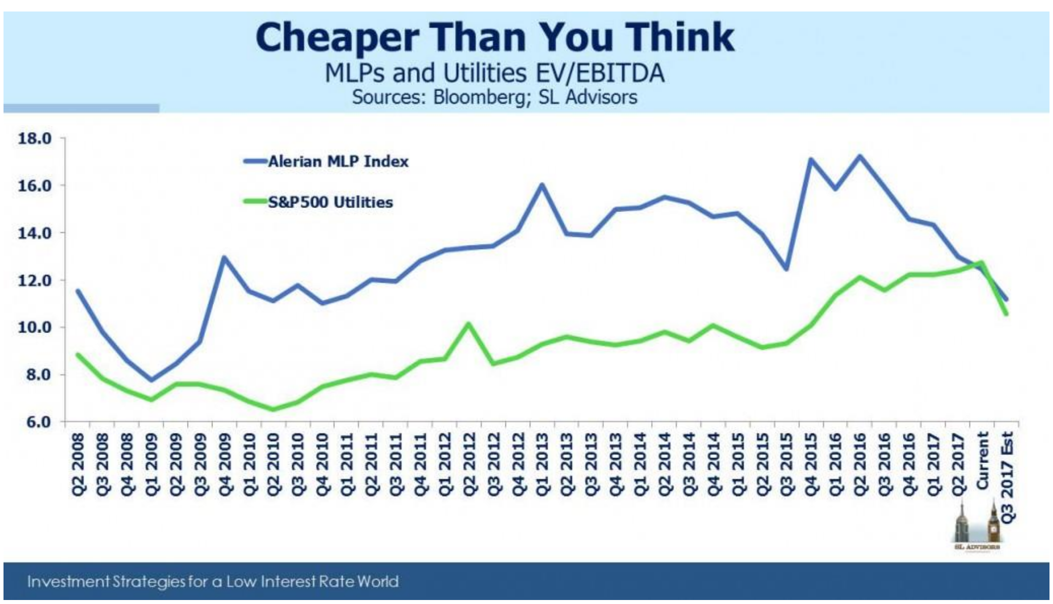
Weighing negatively on the performance were the Technology and Healthcare sectors with NOK and GSK negatively impacting performance. While we have already discussed NOK earlier in this update, GSK is being put under scanner after it announced intentions to bid for Pfizer's consumer business and also indicated willingness to cut dividend if the deal materializes. Market already seems to have passed a verdict, but we think it is important to wait and see how the deal, if consummated, is structured. We find it hard to imagine there would be no plans to quickly delever and restore the dividend if the cuts are in fact made. CONS's cash position of 13% also impacted performance negatively.

Most of the changes in CONS were similar to CORE as Technology and Financials exposures were increased while REITs exposure was reduced substantially. In addition, exposure to Utilities was reduced by 4% points. Recall that CONS had much higher weight in Utilities versus the CORE. Lastly, Energy positions were reduced in CONS as well following our risk management process explained earlier. Given the reduction of exposure to high yielding areas like Energy and REITs, and the subsequent increase in cash position, CONS's yield declined from 3.93% to 3.36%. As we have mentioned many times before, we are content to accept lower yield temporarily if opportunities are limited. We do not see yield as a target in itself, but a byproduct of the opportunities available.

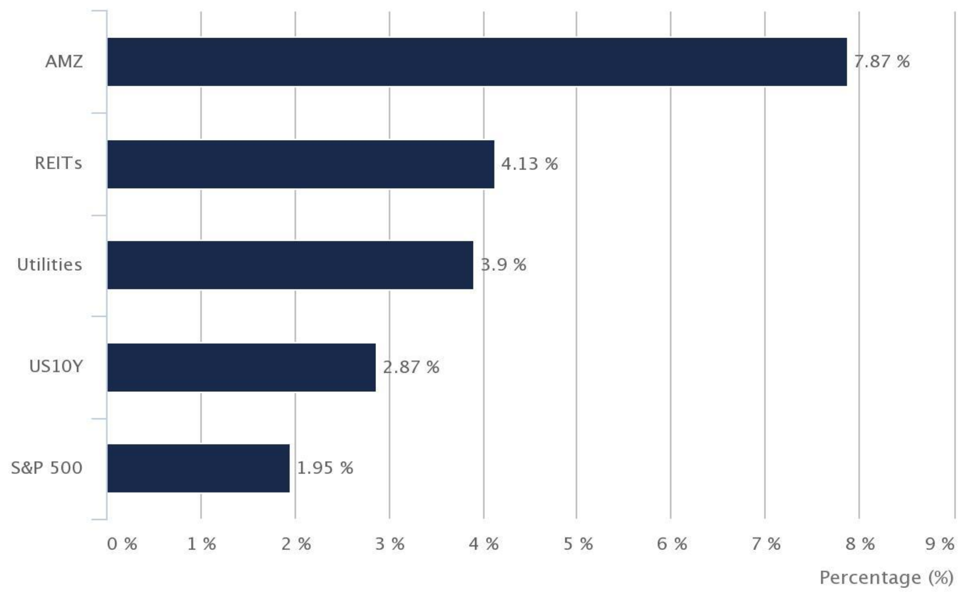
Outlook

Since the passage of the Tax Cut and Jobs Act last Christmas, several companies have announced plans to issue bonuses or increase wages for their employees, initiate capital expenditures, and increase dividends or stock buybacks. These are positive developments and support the strength in risk asset markets we saw in January. However, the sharp pullback in February has put a dampener on that positive sentiment. As we mentioned in our opening remarks, we think risk appetite will return once the economic fundamentals reassert themselves.

We are concerned, though, about the negative phycological impact sustained volatility could have on market participants. Nowhere is that more evident than the energy sector. Crude oil prices, as represented by WTI, in the last few years have been on a wild ride dropping from over $100 a barrel in June 2014 to under $30 in early 2016 and then rising almost +50% from 2016 lows before dropping -19% in the first half of 2017 only to be followed by a rebound of +26% in 2H17. Such gyrations seem to have taken a toll on the energy sector as a whole with the sector trading at 10% discount to its average 5 year EV/EBITDA multiple according to Goldman Sachs. Midstream businesses within the energy sector represented primarily by Master Limited Partnerships (MLPs), have also seen valuations shrink substantially, as the chart above from SL Advisors shows. The Alerian



MLP Index (AMZ) now trades at the same EV/EBITDA multiple as Utilities after having traded at a significant premium since the financial crisis. For sure, other factors have also contributed, not the least of which was the sizeable distribution cuts that many MLPs had to make in 2016 and 2017 in order to fund growth projects after funding costs became prohibitive in public markets. However, a large number of them have announced recently at least partial restoration of those distributions and most of them also now have better leverage ratios than they did in 2014. Meanwhile, volumes have continued to grow as U.S. oil and natural gas production reaches record levels. Further, even on lowered distributions, the Alerian MLP index (AMZ) currently yields close to 8% as the adjoining chart from Alerian shows. In addition, there are other important fundamental catalysts underpinning our constructive stand including rising share of gas-based power generation in the U.S., booming LNG export market, rising exports to Mexico, and higher industrial demand. They all point to sustained growth of natural gas production for years to come that should benefit MLPs meaningfully. Needless to say, we are long the midstream space.



Overall, though, we remain slightly cautious on risk markets, notwithstanding the solid corporate and economic fundamentals, primarily because we expect the process of adjusting to higher interest rates to be bumpy. While we do not see any major decline on the horizon, volatility is on the rise and is likely to present reasonable trading opportunities even for long-term investors. Our defensive positioning and cash holdings have been built precisely to take advantage of such opportunities.

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