as we see it

Fall 2018

THOUGHTS FROM OUR CHAIRMAN

Historically, investors seeking to invest in publicly traded opportunities have focused on owning a "piece of the rock" (stocks/ equities) or some of a company's or the government's debt (bonds). Risk tolerance, growth targets, income objectives and tax issues have influenced commitment to either or both. In our Fall issue of As We See It, our associate Joe Healy provides observations on the changing considerations pertaining to investing in bonds and reminds investors, at least for now, "it may be different this time."

At Van Liew Trust Company, we remain optimistic about investing long-term. Yet, along the way we wouldn't be surprised to see modest market pullbacks (a buying opportunity) and/or sector and capitalization (small cap, mid-cap, large cap) rotations within the equity markets. The US economy is growing and we still see investment opportunity in our equity markets. Likewise, we believe there will be improvement in foreign economies but such improvement may prove to be spotty in nature.

Van Liew takes a team approach to investment and administrative tasks. A recent addition to our team is James M. Powell, CFA, CAIA. For more information about James, please visit our website – vanliewtrust.com. As an experienced investment professional, he adds further depth to our team and investment management process.

Alfred B. Van Liew

Unlike Equities, Bonds are Safe . . . Right?

Joseph J. Healy, CFA

Conventional wisdom says equities are riskier and bonds are safer. If only life were that simple.

Recently, Goldman Sachs senior investment strategist, Abby Joseph Cohen, expressed greater concerns about bond valuations, rather than equities, in the current environment. Her belief is that over the next year bond yields will rise. JPMorgan Chase CEO Jamie Dimon has also expressed expectations for higher bond yields.

Here at Van Liew Trust Company our fixed income (bond) process strives to achieve preservation of principal and high current income through strategies designed to meet those objectives. We have broadened this process beyond traditional fixed income classes to include floating rate debt, high yield debt, preferred stock, convertible bonds, and global and emerging market debt, to name a few, to help meet these goals.

This issue of As We See It touches upon concepts that inform our fixed income thinking and influence bond investing in the current environment.

Know what you own - Some fixed income assets classes may have "equity-like" characteristics and higher correlations to equity asset classes. They may not provide the diversifying hedge versus equities one might expect. For example, convertible bonds often behave like equities, despite the "bond" moniker, when their prices trade at a premium above conversion value. Historically, high yield debt has posted returns closely tied to equities but with lower volatility (standard deviation).

Correlation between bonds and stocks - The correlation (degree in which securities move in relation to one another) between bonds and stocks has been rising which could increase client portfolio volatility and reduce the risk-reduction benefits of fixed income in a portfolio. Historically, this has been the case, too, in periods of restrictive monetary policy. Still, inflation has remained

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tame which has also been the case in past periods of lower correlation. While this correlation relationship is still negative (average correlation since 2000 has been -0.27), over the decades correlations have shifted. Questions about how much rate tightening is coming down the road make this an issue that bears watching.

Stretching for yield - As interest rates declined many investors became more comfortable extending maturities and investing in lower rated bonds to replace lost income or to "chase yield". Investors need to recognize this creep to seek more yield may increase their potential price volatility more than the investment-grade, shorter-duration paper they may have owned in past higher interest rate environments.

Bond liquidity risk - We do not know how bond markets will behave in a dramatic sell-off. In the post-2008 era of better capitalized banks and brokerage firms with their shrunken balance sheets, meaning these firms hold smaller bond inventory, one might ask who will be the other side of the bid in a market where everyone is a seller? Recent years of heavy bond issuance, taking advantage of lower interest rates (some even referring to it as "free money"), has expanded debt levels. Lower coupon issuance won't be as attractive in a higher rate environment too.

Rising equity dividend yields - Equity yields are below their historic averages - but are rising. Reversion to the mean, perhaps? Growth companies with cash heavy balance sheets no longer dismiss paying dividends. Will the rising dividend trend continue as companies enjoy lower corporate tax rates and rising revenues? Some have speculated that rising bond yields could lure investors away from equities. Don't ignore the risk that higher equity yields will continue to be an alternative to investors seeking a proxy for bond income.

Deficit pressures? - Jim Tankersley's New York Times article (7/26/18) points out that the recent tax cut has pushed corporate tax collections, as a share of the economy, to a 75-year low, and our Federal Deficit to $1 trillion. Financing that debt through bond issuance could lead to higher bond yields and lower bond prices. Since the so-called Great Recession of 2008 we've worried about the added pain and expense of financing our Federal debt if interest rates rose – which incidentally didn't happen, as was feared, after the Fed took steps to then stimulate the economy. Is it happening now? We've now seen economic stimulus begin to roll-off the books replaced by a rising Federal deficit. We hope this shift can be offset by rising incomes from U.S. economic growth.

Mounting global woes? - We've grown to rely on global demand for U.S. debt. Many economic pundits previously saw our U.S. economic business cycle as further down the road – closer to the end than to the beginning - than most foreign economies. That may no longer be the case as there are now more question marks about foreign economic strength than our own. Euro zone GDP has risen only 1.5% so far this year and world GDP for 2018 is estimated at 3.1%. If foreign economies falter could such weakness reduce their demand for our debt and exert upward yield pressure? That said, as our yields rise, relative to the rest of the world, our debt will look pretty attractive and that may act to suppress yields.

Flat yield curve - A flattening yield curve, like we are currently experiencing, doesn't mean our economy is on life support. It illustrates the relatively small gap between short and long term yields. Some fear it could be a pre-cursor of an economic slowdown but the argument can be made that we've essentially been in a flat yield curve environment for quite some time and that it is an indication of economic stability.

My intent is not to be "gloom and doom" about the fixed income asset class. In fact, the bond market makes its living off negative thinking. If there was no fear of a downside and no need to hedge, we would live in an equity-only world. For our clients it's the fixed income component of their portfolio which helps allow us to take risks through equities. Equities remain the chief driver of higher annualized growth in client investment portfolios. It may be "gloom and doom" - trying to recognize when circumstances aren't perfect - but this thinking helps reinforce why fixed income is a vital part of our portfolio construction process.