PORTFOLIO UPDATE – DECEMBER 21, 2018

Nature abhors a vacuum and the market abhors uncertainty. Unfortunately, we have found ourselves in a period of uncertainty unlike any we have experienced since the Financial Crisis. Yes, there have been bouts of volatility and some meaningful if temporary retracements of both equity and bond markets. What was different then vs. now is that there were reasonable explanations for price behavior previously. The volatility we have experienced throughout the fourth quarter is something new. When taken in totality, it is easy enough to make a list of challenges that could upset the proverbial apple cart, from trade tensions with China to the Federal Reserve becoming less accommodative. The troubling thing is that all of this was known, in some cases months if not years in advance, and market participants had already priced in these risks. We have been waiting a decade for the Fed to bring short term rates back to a historical neutral. The Fed telegraphed these increases three Chairmen ago. Perhaps the market is disappointed Chairman Powell did not hit the pause button to continue easy money, but clearly the committee did not feel that was necessary based on economic conditions. And therein lies the problem. The Fed moved because, all things considered, conditions are ok. There is plenty of room for criticism, but overall, there is growth, there are jobs, taxes were lowered, inflation is not a problem, innovation industries are still thriving. Growth may be slowing, and our leadership may be throwing up needless barriers, but there is still growth. There was no report that said jobs were destroyed or the economy was shrinking. In other words, nothing has really significantly changed from September.

What we are most concerned about, and we have discussed this several times in our 'Chart of the Week' posts, is that short term volatility has spiked. Daily trading ranges have blown out for major indices, and the direction is uncertain. We have experienced strong opens and then the market rolls over and gives up everything and then some. We have seen steep declines that abruptly reverse based on no discernible news. Hedge funds that thrive on this kind of volatility and irrationality are no doubt doing well, which may be part of the problem. There are clearly forces at work driving prices that have little to do with fundamentals or news. Hedge funds, algorithmic traders, panic sellers and frenzy buyers, and perhaps even participants with less than honorable motives are converging to scramble the market. When markets stop making sense, it is time for concern. When they break loose, it is time to sell.

Across all portfolios we elected to further reduce equity exposure, principally large cap U.S. equity, and raise additional cash. This puts us in an even more guarded stance than after our last action on December 10th. We remain short duration in fixed income, overweight the U.S. dollar and underweight non-U.S. bonds. We are significantly underweight U.S. equities, and went further underweight non-U.S. equities by eliminating our remaining Japan exposure. We are poised to respond when Keynes' animal spirits are satiated and the market gets back to investing instead of trading.

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