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INVESTMENT PERSPECTIVES

>> THIRD QUARTER 2019

The private equity boom: All you need is cash

By Michael A. Tyler, CFA
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The numbers are simply staggering: Investors have plowed more than $2 trillion into private equity (PE) and venture capital (VC) funds in the past ten years; total PE and VC assets have grown by more than 50% in just the past five years to $2.8 trillion. That's an unprecedented stampede of capital, and it may not end well for investors: Too many dollars are chasing too few opportunities, resulting in higher private valuations for weaker companies.

Fund managers have struggled to find good investment opportunities for the money they have raised. Despite holding back more than $450 billion in "dry powder," these managers have still deployed more than $1.3 trillion into technology companies that often don't have established track records or profits. According to figures compiled by Empirical Research Partners, half of all private investments in the past two years targeted money-losing companies, compared with a historical average of only about 25%.

The private fund managers are now exiting their positions by flooding the IPO market. Their pre-IPO investment performance looks good, with returns that have beaten the public equity markets; but Warren Buffet, among others, has argued that these returns are improperly inflated because the uninvested cash isn't included in performance calculations. Including the cash, and adjusting for debt leverage, results in performance that's no better than that of small-cap public equities, according to the CFA Institute.

What's more, many of the recent IPO exits were half-baked: Almost 70% of IPOs in the past two years were money-losing companies, which explains why some recent IPOs have fizzled — see Lyft, Uber, and Sonos, among others; the valuations of their last private financing rounds were inflated by the crush of private money and couldn't be sustained in the public markets where investors care about profitability rather than aspiration. Ouch!

Nevertheless, private equity investors are still living in hope for another day of gains. Capital inflows continue unabated: These funds raised more than $100 billion in the first half of 2019. Anticipated interest rate cuts may prolong the party, but too many bad IPOs may sour investors on the asset class. As the Rutles noted, we may be about to see how the good times roll … away.

>> PERSPECTIVES ON THE ECONOMY

Fewer headwinds in housing?

By Allen Laine, CFA
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In 2018, a soft housing market was one of the only blemishes on the U.S. economy witnessed by investors. While the metrics were not outright bad, they were far from the stellar numbers posted for indicators measuring employment, GDP growth, and confidence. The U.S. housing market has been plagued over the last several years by affordability issues. Home prices consistently rose between 4% and 10% per annum from 2013 to 2018, making the American Dream less attainable to many.

Home demand has outstripped supply, due in large part to lack of desirable locations to build. A precipitous rise in mortgage rates throughout 2018 also had negative repercussions. The 30-year fixed-rate mortgage moved from approximately 4% to 5% over the course of 2018, according to Freddie Mac. Borrowers — especially the younger generations heavily indebted by student loans — have been unable to bear that extra financial burden.

Home price appreciation has slowed in 2019, however, and wage growth is finally giving consumers more purchasing power. Additionally, mortgage rates have fallen this year, triggered by the dovish messaging from the Federal Reserve; the 30-year mortgage rate dropped below 4% heading into the seasonally active summer months. Perhaps these benefits will begin to filter through the data and lead to better housing starts. When the housing sector performs well, it drives a strong multiplier effect to growth, benefiting the entire economy.

MORTGAGE RATES HAVE RECENTLY DECLINED

Freddie Mac US mortgage market survey 30 year homeowner commitment national.

>> FOCUS ON EQUITIES

Keep your seatbelts fastened

By Timothy Garvey
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The U.S. stock market roller coaster has become increasingly more erratic and unpredictable. Equity markets achieved record highs last September, then tumbled 20% into year end, and then roared back to establish new record highs in the first half of 2019. Recent returns have been just as volatile: Stocks gained 4% in April but fell 6% in May before a 7% rebound in June; in all, large-cap U.S. stocks posted a total return year-to-date of nearly 19%.

The year's gains haven't come from just a few big winners but are more broad-based; except for health care and technology, every sector gained between 15% and 22% through June. It has been a market exceedingly driven by macro headlines and conjecture — When will this record-long expansion finally end? How has the U.S.-China trade dispute affected company earnings? When, and by how much, will the Fed cut rates? These issues will likely determine the direction of this bumpy stock market ride through the remainder of the year.

Despite the headlines warning of a potential recession, most economic data remains favorable. Some slowing is evident in consumer spending, housing growth, and business investment. Yet the U.S. economy still grew at 3.1% in the first quarter and leading indicators suggest we can remain in "Goldilocks" slow-growth mode for the foreseeable future.

Still, corporate profits have slowed sharply. Uncertainty regarding tariffs, together with slowing international economies, have affected company strategy and profits. However, investors still anticipate single-digit earnings growth this year and over 10% growth in 2020. Even with that favorable backdrop, investors still expect the Federal Reserve to cut rates at least twice this year; the Fed may not be so obliging.

While it is quite advantageous to be able to pinpoint investors' concerns, these issues can result in perverse market outcomes. What if economic data begins to accelerate again? What if we get a substantial improvement on the trade front? The Fed could deem it unnecessary to cut rates, while the market is evidently convinced rate cuts are warranted. Positive economic developments could foreseeably result in adverse equity performance because of the potential implications for future monetary policy. Good economic news may beget bad market outcomes. We maintain our neutral allocation between stocks and bonds.

>> FOCUS ON FIXED INCOME

U.S. Treasuries offer too much value to be ignored

By Tom Bussone
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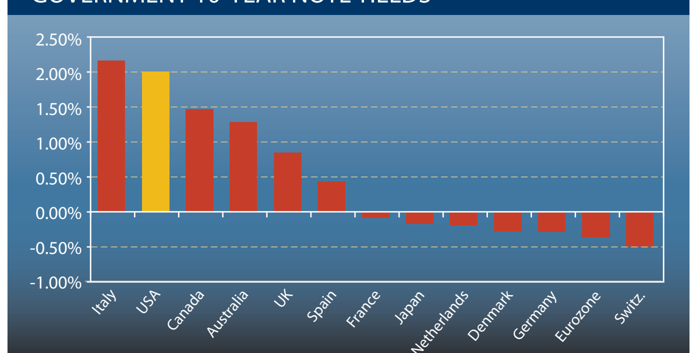
The Federal Reserve reversed course during the second quarter. The Fed, which had previously used the words "patient" with respect to any future monetary policy decisions and "transitory" referring to the lack of inflation, in June acknowledged that growth is slowing, that inflation remains persistently low, and that new downside risks have emerged. Money flowed into Treasury markets, sending the 10-year yield lower by 40 basis points to close June at 2.01%.

In many cases, such a Treasury rally would have sent prices of risk assets lower. This time, however, credit spreads remained tight and the S&P 500 marched toward record levels; corporate bonds and equity investors speculated that the Federal Reserve would slash rates to help extend the decade-long expansion. By the end of June, interest rate futures contracts implicitly reflected three quarter-point cuts this year. If investors are wrong and the Fed is less aggressive with monetary policy, prices of risk assets could struggle.

As countries grapple with slowing growth and a lack of inflation, yields around the globe continue to move lower. Almost $13 trillion of sovereign debt now trades with negative yields; nearly all of it is from European countries, surpassing 2016 levels. Yields are likely to move even more negative as the European Central Bank has indicated it may begin another round of quantitative easing before year-end. It's difficult to see U.S. yields rising, despite approaching record low levels; there is too much value in U.S. Treasuries versus other sovereign debt. Money should continue to flow in from overseas.

GOVERNMENT 10-YEAR NOTE YIELDS



U.S. Treasury notes have both higher quality and better yields than other sovereign debt.