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INVESTMENT PERSPECTIVES

>> FOURTH QUARTER 2019

In the battle between activist investors and management, shareholders win

By Michael A. Tyler, CFA
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Anything you can do, I can do better.
I can do anything better than you.
— No you can't.
Yes I can.

That was Betty Hutton and Howard Keel jousting in *Annie Get Your Gun* in 1950, but it could also happen in a boardroom today:

Any firm you can run, I can run better.
I can run your firm better than you.
— No you can't.
Yes I can.

Activist investors such as Jesse Cohn of Elliott Management have daringly taken on some of America's largest and best-known companies, demanding change and sometimes wholesale restructuring. CEOs like AT&T's Randall Stephenson historically would have responded with contempt and resistance.

In recent years, however, the tune has changed. Just as Hutton and Keel realized by the final reel that they were better together than apart, so too many CEOs today have engaged in dialogue with activist shareholders. Indeed, just a few days after Elliott Management disclosed its stake in AT&T, the two protagonists met face-to-face to discuss the activist firm's proposals. Similarly, Kraft Heinz welcomed investment by the Brazilian private equity firm 3G Capital four years ago.

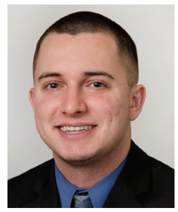
And why not? Activist investors typically don't seek control, nor do they often want heads to roll; they simply have different ideas about capital allocation, strategy, and the future prospects of their targeted companies. They mostly seek board seats to ensure that their ideas are considered and (they hope) implemented.

Recent research by Lucian Bebchuk at Harvard Law School and colleagues suggests that when CEOs and activists negotiate peace, these settlements are accompanied by better operating performance, higher dividends, and higher stock prices. The activists get their coveted board seats, where they then can work collaboratively with management rather than confrontationally. In the process, all of the companies' investors benefit.

It doesn't always work out well, of course. In the case of Kraft Heinz, 3G Capital couldn't help management overcome massive changes in how consumers think about packaged foods, and KHC's stock price plummeted. That's still the exception, however. So when we see activist investors channeling their inner Annie Oakley at management of companies we own on behalf of our clients, we usually smile, get some popcorn, and await a happy ending.

>> PERSPECTIVES ON THE ECONOMY

Monetary policy: data driven or guess and check?



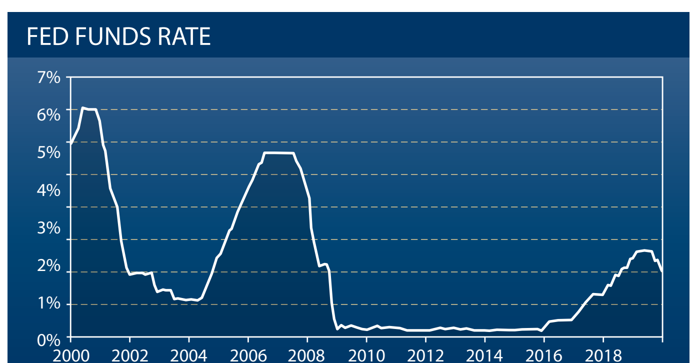
By Timothy Garvey, CFA
Investment Officer,
Wealth Management

Federal Reserve Chair Jerome Powell has often said that the Fed's monetary policy is "data driven," based on actual metrics rather than on hypothetical projections. Over the last few years the U.S. economy has steadily grown more than 2% annually, companies have exhibited strong earnings, and the stock market has achieved record highs. These factors paved the way for the Fed to raise interest rates nine times from 2015 through 2018.

However, this year the Fed has already cut interest rates twice amid slowing global growth, stubbornly low inflation, and mounting geopolitical risks. All the while, the U.S. economy has continued to chug along. With these conflicting inputs, how will the Fed adjust interest rates moving forward? The problem with data-driven policy is that it is inherently backward-looking. Instead, it almost seems as if an acceptable approach to future monetary policy is 'guess and check' — the classic problem-solving technique in which one guesses the answer and then subsequently checks whether that guess was accurate.

Most corners of the U.S. economy are doing just fine. Consumer spending has been strong, the labor market is very tight, housing data is beginning to turn around, and financial conditions remain accommodative. If the Fed were truly data driven, the seemingly non-controversial course would be to keep rates unchanged.

Yet the Fed must also consider unknowable factors like the potential economic fallout from the trade war with China, Brexit, and a potentially looming recession in the Eurozone. Predicting the impact of these events presents a daunting and unenviable challenge. This year, the Fed's rate reversal appears to indicate a shift from data-driven to guess-and-check policy.



After a three-year tightening regime, the Fed starting cutting rates in 2019.

>> FOCUS ON EQUITIES

Despite falling earnings growth, U.S. stocks power higher

By Rose Grant-Brooks
Equity Strategist,
Eastern Bank Wealth Management

The S&P 500 has gained over 20% year-to-date, which is remarkable since the primary reason for an upward movement for the equity markets is usually an increase in companies' earnings — and earnings growth has been scarce this year. Results have slightly beaten expectations, but in reality corporate earnings have still been lower than they were a year ago. Sectors such as energy, technology, and materials have had a difficult time posting positive comparisons.

Even without the benefit of earnings growth, equity markets have performed well this year mainly because of lower interest rates resulting in an expansion of the price-to-earnings (P/E) multiple. As a measure of valuation, the market's P/E ratio has swelled from 14 times year-ahead earnings last December to 17 times at the end of the third quarter.

The slowdown in earnings growth isn't surprising. The U.S. and China have raised tariffs on a number of imported products. Discussions between the countries seem to be ongoing, but a comprehensive agreement in the near term seems unlikely. Corporate managers still worry that new tariffs will be applied to additional imports, or that existing tariffs on other items may be raised further. Understanding all the direct and indirect effects of tariffs is a difficult task. Trade flows are likely to be interrupted, production inputs for certain products may be derailed, and prices for many products from China (especially electronics) may increase. The result has been an erosion of business confidence as company management teams appear to be pausing on implementing any major decisions until more clarity on trade is visible.

Although other worries are also evident, there are still reasons to believe the current bull market can remain intact. U.S. economic growth should persist on a slower but positive path into next year led by consumers, who remain in good economic health. The Federal Reserve has telegraphed that it will be accommodative if necessary. Although the P/E ratio and other valuation metrics are now slightly above long-term averages, the combination of low interest rates and an expected resumption of earnings growth next year provides the equity markets with the required ingredients to move forward.

>> FOCUS ON FIXED INCOME

Corporations take advantage of record low yields

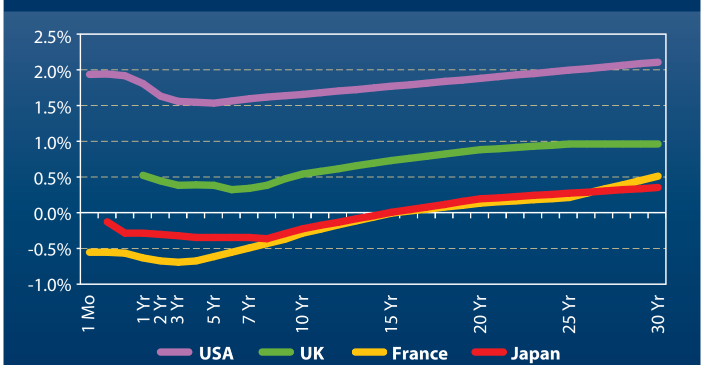
By Tom Bussone
Fixed Income Strategist,
Eastern Bank Wealth Management

Is the bond market in a bubble? Even as stock prices have flirted with new all-time highs, money has continued to flow into U.S. Treasury and corporate debt. The stock market's strength suggests that investors aren't worried about recession; instead, the flood of money into bonds is likely coming from abroad. Global investors are desperate for yield, as over $15 trillion of foreign debt yields below zero. Adding to the demand for U.S. debt has been the uncertainty pertaining to the U.S.-China trade war, Brexit, tensions in the Middle East, and the European Central Bank's (ECB's) recent cut in its deposit rate to -0.50%. Fueled by foreign money, the 30-year Treasury yield closed at an all-time low of 1.95% in August, before ending the third quarter at 2.11%.

U.S. corporations have taken notice of the low yields and issued record amounts of debt, loading up on cheap money. In just one week in September, global bond issuance set a new weekly record of more than $140 billion, fueled by U.S. investment-grade companies that raised $75 billion across 45 deals. Even though an abundance of supply hit the market, credit spreads remained tight as investors seemed desperate for positive-yielding assets.

As investors reach for yield, credit spreads remain below where they began the year. We don't believe investors are being compensated for taking credit risk: Money flowing in from overseas continues to prop up corporate bond prices, resulting in unattractive yields. Therefore, we remain underweight corporate debt in our client portfolios, sacrificing some yield for the safety of owning U.S. Treasuries.

GLOBAL YIELD CURVES



Low yields globally have led foreign investors to pile into better-yielding U.S. debt.