Zevin Asset Management, LLC

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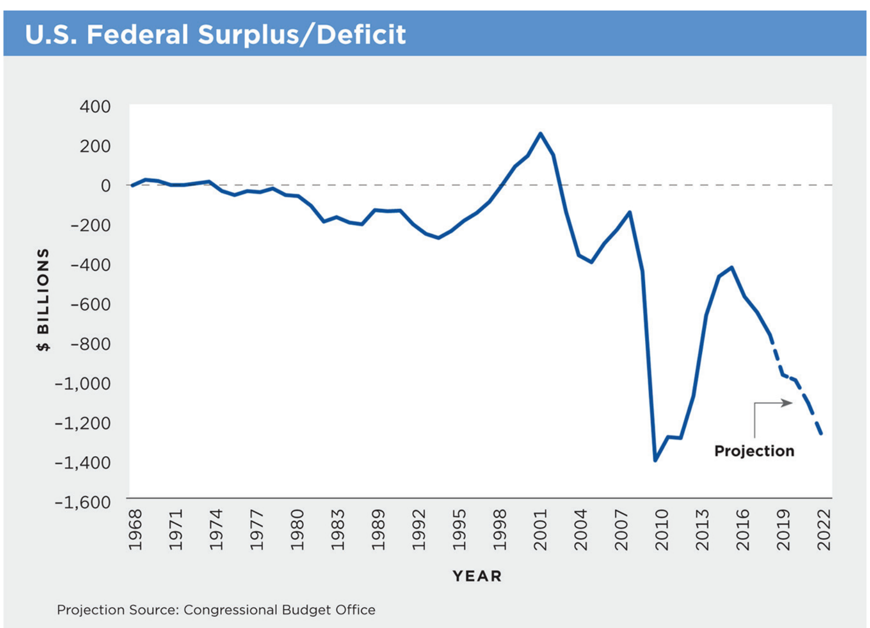
Deficits and Market Churn

Philip Hergel, Senior Quantitative Analyst

As we proceed through the fourth quarter of 2018 we are experiencing one of the most intense periods of equity volatility since this long bull market began in 2009. There are multiple contributing factors at play including geopolitical tensions, expensive stock valuations, rising interest rates, and trade disputes. Regionally, the European Union experiment is starting to crumble with BREXIT scheduled to happen (or maybe not?) on March 29, 2019. The European Central Bank is on the verge of reversing their unprecedented monetary easing policy. Emerging markets are experiencing their worst period of instability since the currency crises of 1997. Chinese growth is decelerating as authorities strive to achieve a consumption-based economy. And in the U.S. economic and political uncertainties abound. As a result, we here at Zevin Asset Management recognize that the outlook for global equity markets has become increasingly risky throughout 2018 and particularly so in the third and fourth quarters of the year.

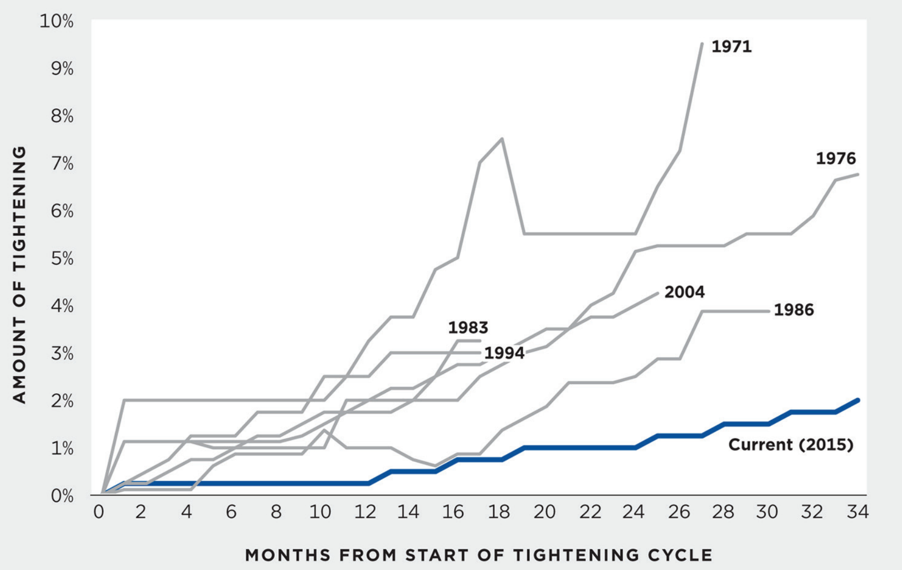
But what does this have to do with U.S. deficit levels? September 30 marked the end of the first full fiscal year of Donald Trump's presidency. It also marked the largest deficit that the U.S. has seen in six years (see chart below). That's not a coincidence. Imprudent and unfunded tax cuts along with increased military spending have led to a ballooning budget deficit. The Department of the Treasury recently announced, for the first time ever, the need to issue 28-week bills. Again, this is no coincidence — the Treasury is finding it increasingly difficult to manage its budgetary shortfalls and is resorting to never-before-seen measures to do so. It's no surprise that the Treasury is on the verge of breaking the record for the highest ever debt refinancing operations. Incidentally, the previous record was set during the Great Recession, which was a time when it made sense to spend to stimulate the economy.



All this to say, the deficit is spinning out of control with no sign of a reversal, considering President Trump's latest suggestion of more tax cuts for middle-income earners. Rising deficits do not directly contribute to short-term market jitters, but in this case President Trump's response to critics of his fiscal irresponsibility has introduced another source of unease. Trump continues to attack the Federal Reserve Bank for raising interest rates "every time we do something great". But what he's really saying is: *higher interest rates make it more expensive to pay off my debts. Stop making me look bad.* Trump would clearly prefer lower rates for longer to help bolster economic performance and also to keep the cost of servicing the debt lower. He even went on to say he might have made a mistake in nominating Jerome Powell as chairman of the Fed. Now that's a cause for concern! Financial markets like stability, and a U.S. President intimating that he may try to fire the head of his central bank is a major source of *in*stability.

The independence of the Fed was established in 1951 so the central bank could pursue its objectives without being influence by political pressures — just as President Trump is doing now. There are two mandates the Fed strives to achieve: stable prices and full employment. That's it; that's all. Both mandates have been achieved and are at risk of exceeding their targets. That is why the Fed is in tightening mode — they're doing their job. They are also trying to provide a cushion for when the next downturn hits. And even still they are conducting what has been dubbed the easiest tightening in history (see chart below). The President is criticizing monetary policy because he's in the hot seat over rising deficits, which is one of many sources of the current market volatility.

Current & Past Tightening Cycles



Note: Dates refer to year in which tightening cycle began.

Bottom Line: budget woes will be a major issue for years to come and will have negative long-term economic effects, as future generations will be forced to divert funds away from productive projects to pay down astronomically high debt levels. In the short-term, however, the Fed's march to normalize rates will put continued upward pressure on bond yields, making government bonds as well as cyclical equity sectors relatively unattractive. The current administration's response to the Fed's tightening cycle has introduced yet another source of volatility. Because of this collection of heightened market risks, since early 2018 we have reduced clients' exposure to equities while simultaneously exploring opportunities to allocate more towards defensive sectors and regions which we believe are more likely to outperform during this period of market churn.