BLUE GRANITE CAPITAL, LLC

INVESTMENT COMMENTARY
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Are you fed up with the Fed? We are.

October was the worst month for stock market performance since February 2008 during the financial crisis, so it’s a good time to take inventory of the current environment and what's looming over the horizon. The perfect storm may have hit global stock markets over the past 5 weeks and in its path left high growth, technology, consumer, energy and industrial stocks to suffer the worst losses. The most impactful issues continue to be Trump & the political atmosphere, trade and tariffs issues with China, mid-term elections and economic vulnerability from Fed monetary policy. These global issues have clearly impacted both domestic and foreign stock prices, caused a major U.S. stock market sell-off and shaken investor confidence. These factors are potentially compounded, as well, by predictions for slowing economic growth and a possible recession in the next 1-2 years.

Let's not forget how far we have come from the financial crisis almost 10 years ago. After getting crushed in late 2008 and 2009, equity markets, especially in the U.S. have rallied more than 300% from their lows. The result has been immense wealth creation in stocks and real estate. We are now witnessing the positive effects of a stronger economy and the lowest unemployment in 5 decades.

This wealth effect is real and substantial but so much of its positive economic impact rides on stock market sentiment. Until 5 weeks ago sentiment was running high and U.S. equity markets hit record levels. What ensued was a quick sell-off in just 5 weeks leaving a trail of stocks that have fallen 10, 20 & up to 30%. The sell-off from record highs has caused the most extreme oversold condition in equities that has ever taken place within 5 weeks of its all-time highs. As we exit October, 75% of all stocks in the S&P 500 Index are in correction territory (-10%) and technology stocks have performed even worse.

There is a silver lining to the impact of the October sell-off. Equity valuations for many equities and in particular the value stocks we crave, have now fallen to extremely compelling levels. As you know, over our 15 year history, we step into buy when equity markets have corrected and take advantage of valuations as an opportunity to enhance portfolio performance. Typically, well established companies with strong earnings, cash flow and solid balance sheets lead the recovery off market lows, not high growth or tech stocks This strategy has been very beneficial for our clients in previous stock market corrections and we see no reason to suggest why this time should be any different.

As we approach the close of third quarter earnings reports, we remain diligently focused on reported earnings, and we view the results positively but notice some market caution in corporate guidance for the fourth quarter and into 2019. No doubt these concerns have crept into recent stock market activity, as some investors have used the opportunity to take profits, raise cash and enter the bond market with the most attractive bond yields in 10 years.

So why are we fed up with the Fed? The Fed has a dual-role mandate with their monetary policy to control employment and inflation by adjusting interest rates. It is not a scientific process but one performed by analyzing volumes of economic data. The decision to manipulate interest rates is based on their assumptions of this data and where they project economic growth and inflation will be in the future. History shows that the Fed typically overshoots on both rate increases and decreases which can have debilitating economic consequences.

The Fed is currently espousing "normalization" in rates to get back to historic levels before putting an end to further rate increases. Very little attention has been given to the impact of rising rates(i.e. the cost of money) and its subsequent impact on housing affordability. Homebuilders, suppliers and the construction labor force will feel the immediate impact of aggressive Fed tightening followed by slowing economic growth. The slowdown of housing activity leads overall economic activity by eighteen months. Housing, being one the most cyclically sensitive sectors of the economy, often feels the impact of higher rates well before other areas. This alone implies a peaking of economic activity right about now, leading to persistently slower growth rates through Q1 2020.

Over the past few weeks there has been mounting criticism of the Fed because they have intimated they are on track for a December rate hike and possibly 3-4 further hikes in 2019 until, as they, say rates are normalized.Our analysis leads us to the conclusion that rates are presently high enough and further increases may likely have a negative impact on corporate profits, economic growth,and stock prices. We believe that “normalization” is a very relative term and that each economic cycle contains varied rates of growth, inflation, employment and stock market performance. The Fed’s decisions on rates in the coming meetings will have a meaningful impact on all parts of the U.S. economy.

In summary, the U.S. economy is still currently growing, employment is high and corporate earnings remain healthy. However, we remain mindful that this doesn’t necessarily correlate with an undisrupted rising stock market! Equities have risen for 10 years and mostly on the back of slow economic growth, high unemployment and hopeful earnings growth. Equity prices are a leading indicator and changes to market multiples could portend a slowing U.S. economy. Changes to the economic landscape are inevitable, and new investment opportunities will always arise.

As we endeavor to bring the plane in for a soft landing, we remain cautiously optimistic but careful in our approach to preserve your hard-earned capital and opportunistically take advantage of this stock market correction.

We hope this finds you well and, as always, thank you for your trust and patronage.
Please call us if there is anything you wish to discuss.

Regards,

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