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# MARKET PERSPECTIVES

## QUARTER TWO 2019

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The investment markets seemed to find their groove during the second quarter after experiencing heightened volatility, both negative (fourth quarter 2018) and positive (first quarter 2019), during the previous two quarters. While the equity markets finished with solidly positive returns, there were some hiccups along the way. The fixed-income markets also performed well, as global interest rates took another leg down. In short, risk assets in general had a strong first half.

Global equity markets produced a second quarter of strong returns; however, these results were not linear. Equity markets declined in May after trade discussions between China and the U.S. suddenly broke off and the Trump administration raised tariffs from 10% to 25% on $200 billion worth of Chinese goods. By early June, President Xi of China and President Trump announced a truce and that trade negotiations were back on after meeting at the G20 Summit in Buenos Aires. This provided investors with hope that a deal was achievable, helping equity markets to recapture previous highs. The S&P 500 finished the first half up 18.5%, its best first-half return since 1997. Stocks outside the U.S. posted strong returns during the first half as well, although they underperformed the U.S. markets, with returns of 14.0% and 10.6% for the MSCI EAFE and MSCI Emerging Markets indices, respectively.

The most meaningful event during the quarter, in our opinion, was the dovish shift by global central banks. The slowdown in economic growth has captured the attention of policy makers, with many of the world's major central banks indicating that they are considering additional monetary stimulus. This pushed bond yields lower, boosting returns for fixed-income investments. The bellwether 10-year Treasury bond ended the quarter yielding 2.00%, down from 2.42% at the end of the first quarter and 2.68% at the end of last year.

In this quarter's newsletter, we discuss two topics that we believe are quite timely. First, we preview a relatively new economic theory known as Modern Monetary Theory, which should gain more attention as the presidential election cycle ramps up. Next, we review the struggles of value investors and attempt to provide some explanations.

# MMT: Modern Monetary Theory as an Answer to Deficit-Spending Concerns?

As the race for the presidential nomination kicks into high gear, some politicians have supported an economic policy known as Modern Monetary Theory (MMT). Despite its support from select politicians, MMT in isolation is not necessarily a political issue. Nevertheless, the controversial economic theory has created a rift amongst economists. To some, MMT can be viewed as a form of socialism. Others, such as Stephanie Kelton, a professor from Stony Brook University and one of the leading advocates for MMT, believe it is a solution to some lingering problems. She argued during a presentation that it is “pretty cruel” not to utilize MMT to solve our country’s problems.

What is MMT? MMT is an economic theory that contends that government spending by a country that controls its own currency should not be constrained by the revenues it collects. Said differently, proponents of MMT believe that a country can outspend its revenues, commonly referred to as deficit spending, without limit. Deficit spending is typically financed through borrowing. Traditional economic theory holds that at some point the means to service this debt will become overly stressed. MMT, on the other hand, argues that such debt can be paid down by “printing” more money, and therefore the ability to take on debt is essentially limitless, bound only by a country’s willingness to endure inflation.

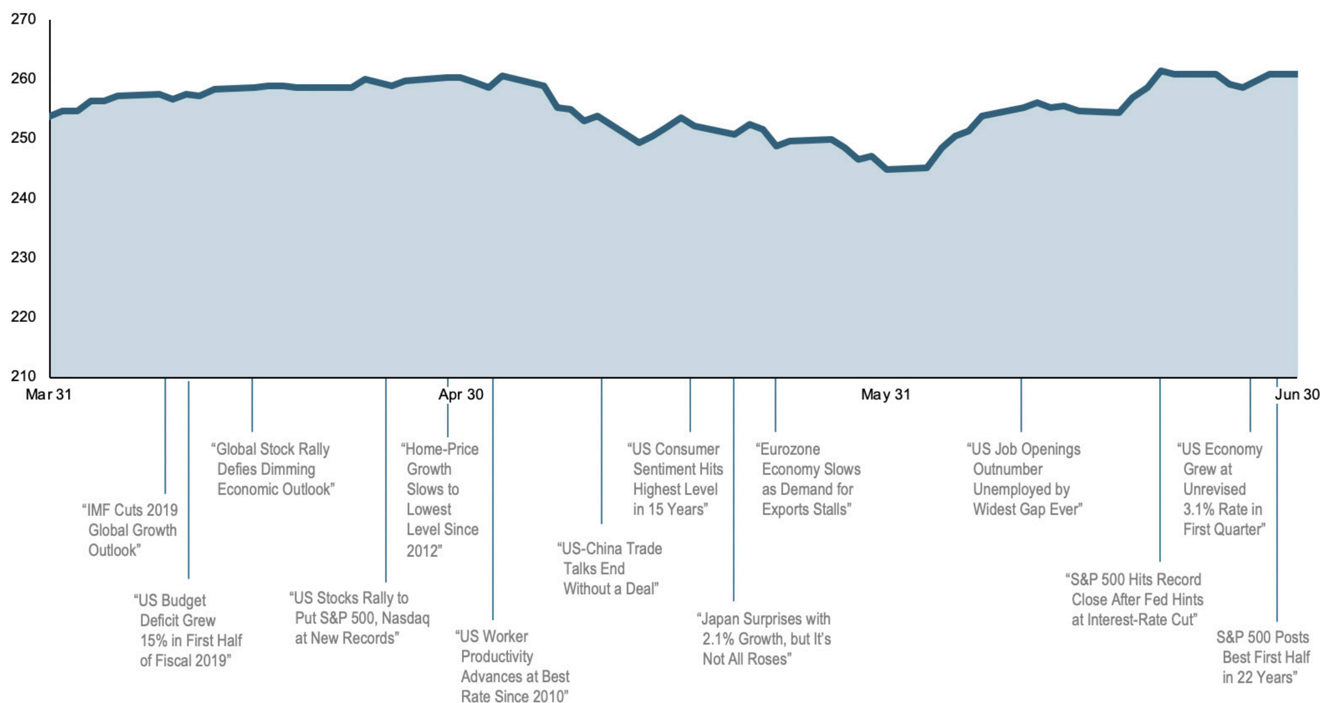
The theory’s name is misleading in a sense. MMT proponents generally believe that *fiscal* policy (controlling government taxes and expenditures) is more effective at regulating the economy than *monetary* policy (controlling the cost or supply of money).

One argument in support of MMT that we hear frequently sheds light on why it is gaining traction. As interest rates have moved nearer to zero over the past several decades, the risk of a liquidity trap, whereby interest rates are so low that investors have no incentive to invest in debt securities over keeping their money in cash, has risen. With a scarcity of buyers, bond yields do not respond to changes to policy rates, rendering monetary policy less effective. MMT backers, therefore, believe that fiscal policy is the better approach in a low-interest-rate environment.

Supporters of MMT also claim that it serves as a counterbalance to the surplus of private-sector savings. Private-sector investment spending has not accelerated to levels hoped for by policy makers, despite relatively accommodative monetary policy. Supporters contend that government spending should fill this void in order to keep the economy running at full capacity.

Opponents of MMT believe that the risks far outweigh the benefits. They argue that prolonged periods of large budget deficits may

## MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q2 2019




**These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.**

Graph Source: MSCIACWI Index [net div.]. MSCI data © MSCI 2019, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

cause a country's debt burden to become unsustainable. Critics also have concerns about government spending crowding out private-sector spending. This can happen as a result of increased government borrowing pushing up interest rates to such a point that they are no longer enticing to the private sector. Lastly, and most importantly, challengers fear that money printing will debase a country's currency, causing inflation to spiral out of control. MMT devotees understand this risk and acknowledge that the only constraint on the issuance of debt is an economy's tolerance for inflation.

### WHAT THIS MEANS

MMT is sure to get more exposure as the election cycle heats up. We've endeavored to eschew analyzing it through a political lens. While it remains uncertain whether the theory ever becomes widely adopted, we feel it is a worthy exercise to evaluate its possible impact on the investment markets.

The current environment of low interest rates and excess capacity might be ideal for MMT economic policy, at least initially. All else being equal, we believe that MMT initially would stimulate economic growth, which would likely be greeted warmly by investors – at least at first.

However, MMT, if left unchecked and exercised to its maximum fruition, could eventually cause an acceleration in inflation. We should point out that it typically takes years of strong growth to produce inflation. When it does come, we would expect to see bond prices fall and interest rates rise, leading to negative returns on fixed-income securities. At this point, equity prices would likely drop too, as higher rates would be a headwind to earnings growth and put downward pressure on price-earnings multiples.

MMT remains largely untested, and its effectiveness and impact on the investment markets are largely unknown. Until there is more certainty on who the presidential candidates will be, we cannot predict the likelihood that this theory becomes policy. As such, we do not expect any MMT-related changes to our investment strategy for the time being.

## Reports of Value Investing's Death Are Greatly Exaggerated

It has been a difficult stretch for value investing over the past 10+ years, causing many investors to question the merits of this investment style. U.S. value stocks have underperformed both the overall benchmark and their counterparts, growth stocks, for most of the past 12 years according to asset manager GMO. This phenomenon is not unique to the U.S., as value stocks have underperformed across most countries and regions. We offer several reasons for the streak of underperformance and share our expectations of what the future may hold for this style of investing.

Historically, buying cheap stocks, the primary objective of value investing, has delivered a premium over benchmark returns. GMO estimates this so-called "value premium" to be approximately 2.0% per annum for the period 1979 through 2006, deliberately leaving off the recent period of underperformance. Including the last twelve years, the premium falls to 1.1%. This premium has persisted even though value stocks generally exhibit slower earnings growth than their peers. The value premium is the result of higher dividend yields, price-to-earnings multiple expansion, and a host of technical factors, which all have contributed to the factor's outperformance over time.

Several characteristics unique to the current market cycle have conspired against value investing. First, low dividend yields have compressed the absolute spread advantage that value stocks have had relative to growth stocks. Historically, value stocks had enjoyed a consistent 50% yield advantage over growth stocks. Today, the dividend yield for the S&P 500 is a little below 2% versus a historical average of greater than 4%. A 50% advantage represents a pickup of only 1% today compared to the 2% historical average.

While this explains why the value premium has been less competitive in a low-yield environment, it does not shed light on why it has turned negative. For an explanation of that we need to look at a core tenet of value investing. Value investors philosophically believe that stocks generally become cheap as a result of some form of controversy. As the company's management team works through these controversial issues, the stock's valuation is expected to recalibrate higher. On the other hand, value disciples believe that growth companies, in general, are unable to sustain extraordinarily high growth rates for long periods of time because such growth attracts competition. As growth begins to slow, these stocks experience a contraction in their valuations. The recent period has been exceptional in this regard, as several large growth companies have been able to sustain above average growth rates and profit margins for longer periods than usual.

Lastly, mergers and acquisitions have had an effect on the value premium. Low interest rates and accommodative debt markets have allowed strategic and financial buyers to afford higher priced growth companies. As the cost of financing these deals has come down, so too has the return on investment thresholds, making deals for growth more accessible and causing buyers to overlook value companies.

### WHAT THIS MEANS

Valuation spreads between growth stocks and value stocks have been pushed to historically wide levels. Indeed, the last time spreads were this wide was during the late 1990s, just before the dot.com bubble burst. According to GMO, value stocks' price-earnings multiples are currently at a 30-35% discount to the market, compared to a historical average discount of around 24%.

We do not believe that the value premium is dead. The past 10 years have been abnormal, to say the least. While the recovery has persisted for longer than many would have thought possible, it is one of the slowest expansions in history. Moreover, investment markets have been distorted by the Federal Reserve's easy-money policy, which has forced investors to take on more risk in order to earn an acceptable return on their investments.

We have strived to maintain a healthy balance between growth and value stocks in client portfolios to the extent that it is suitable. This is consistent with our philosophy, which emphasizes diversification.

Over time, we expect interest rates to normalize and nominal growth to improve. This would enable the value premium to move back toward its historical average. In addition, more robust growth would provide a tailwind that helps value companies improve their operating performance and help close the gap relative to growth companies. We also believe this could level the playing field between active and passive managers, but this is a discussion for another day.

## Conclusion

It is easy to become complacent as a result of the strong returns recorded thus far this year. We remain vigilant, however, as there are numerous risks for the markets to contend with. We are also mindful that the last leg of the market cycle (if that is even where we find ourselves today), often is the most beneficial for investors. This thought pattern highlights why we are committed to a long-term investing approach and prefer to manage risks at the margin.

*See Colony Spotlight on page 5.*

## COLONY SPOTLIGHT

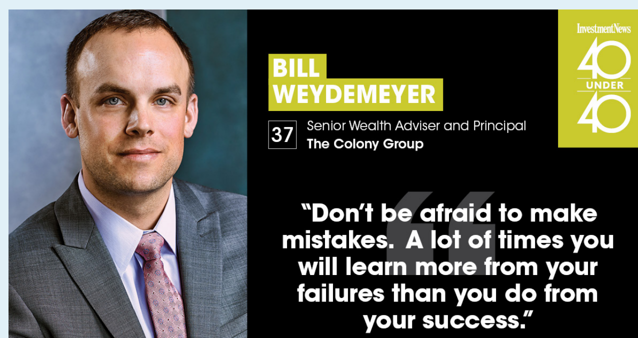
### ▸ Welcome to Our New Boca Raton Colleagues and Their Clients Across the Country

We are delighted to welcome to The Colony Group family our new colleagues from Steinberg Global Asset Management in Boca Raton as well as their clients across the country. Richard Steinberg, CFA, co-founder of SGAM, now serves as Colony's Chief Market Strategist, Co-Chair of our investment division and a member of our Executive Team and Investment Committee. Look for his economic and market commentary on CNBC and Bloomberg News in the months to come! Rich brings with him a talented and caring team of professionals that share our passion for serving our clients! We look forward to continuing this legacy together for many years to come.

### ▸ Bill Weydemeyer Named as One of Investment News' 40 Under 40

InvestmentNews has recognized Bill Weydemeyer, MBA, CFP®, Senior Wealth Advisor and Principal at The Colony Group as a 2019 40 Under 40 Honoree. Bill was chosen from a pool of about 1,000 nominees to make the list of 40 talented individuals.

Bill's passion for promoting financial literacy to clients as well as those who don't have access to a financial advisor, along with his leadership are some of the reasons he was selected for this honor. We are very proud of Bill as he is "dedicated to his clients, his colleagues, his friends and family, his company, his partners, and his community – and he devotes his unbounded energy to every one of his relationships," said Michael Nathanson, Chairman and CEO of The Colony Group.



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