Dear Friends,

In a recent Friday portfolio discussion, our conversation turned to lessons learned and reflections in 2019. We briefly discussed some of the things that have made the last 18 months *interesting*, for lack of a better word. I asked my fellow investors to give some thought to the events of this year, the things that grabbed their attention or provided a learning experience. Attached you'll find their comments.

2019 has proven to be the challenging year we expected. I feel very fortunate to be surrounded by such great investment talent. The team's ability to move among the different segments of the market as well as to dig into the events that are driving market volatility speaks to the collaborative investment process as well as the passion around investing - not to mention wanting to produce great results for our investors.

I am reminded daily of the importance of risk-adjusted returns, preservation of capital and sticking to a process that focuses on delivering consistent results. As I reflect on 2019, I am ever more convinced of the importance of active management - an active process that focuses not just on the risks being taken in the portfolios but the overall risks in the Capital Markets. "Flexibility" and "Fortitude" are two words that come to mind. The flexibility to alter portfolios based on different points in the cycle. The fortitude to deviate from the broad-based indices, saying "no" to index weightings and consensus thinking (the power of zero). As my teammates highlight in their comments, we are entering a new frontier in markets that we believe creates an even greater need for fixed income portfolios to provide a ballast for investors seeking returns when risk is priced right and avoiding drawdowns and preserving capital when volatility arises. There is little doubt that both high risk and complacency seem to be holding hands these days. While friendly at times, they are strange bedfellows.

We appreciate your support and trust in our team. We are building this business around investing, people and culture with a heavy emphasis on service and relationships. Please let us know what we can do to help make your job easier. Thank you for the opportunity to share our thoughts. It's time to kiss 2019 good-bye and commit to making 2020 the best year of our lives.

Let's talk.

Gibson

2019
Reflections from 2019

1. The Seasoned Economic Recovery
2. The New Fed Frontier
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4. The Tweet is Mightier than the Sword
5. When Consensus is Wrong
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Welcome to the Smith Capital Investors 2019 Reflections
(Use the links above to jump to a section)

Reflections from 2019

Introduction

2019 was a year for the record books! We expected volatility but we were even surprised not only by the events that unfolded throughout the year but also the outcomes. There were many "firsts" including a Fed Pivot, a change in direction on trade, an all-time low yield on the 30-yr U.S. Treasury and the strength of performance from both equities and the fixed income markets. To follow is a summary from our team members as we reflect on the wild ride that was 2019.

1. The Seasoned Economic Recovery

From the Strategy Lens – Steve Zamsky, Senior Advisor

One thing that strikes me as we reflect on 2019 is just what an extended cycle this has been. Many pundits and market participants have been calling for the end of the cycle for five years (or more!), and likely missed an enormous upside in risk markets - and bonds for that matter!

The economists largely got this right. The debt overhang that had been created in the run up to the Global Financial Crisis (GFC) led the more astute analysts to observe that we should expect a period of prolonged sluggish growth, as balance sheets were rebuilt, regulations kicked-in, and scar tissue kept animal spirits contained. For much of 2019, it felt like perhaps we would break out on the upside, but we were reminded we have a fragile (and rate-sensitive) U.S. economy, not to mention an overhang from global uncertainty.

It is hard not to be sympathetic to the gloomier forecasts. The ever-tighter "coiled spring" analogy is appealing, and many attributes of the equity and financing markets have gotten more extreme (narrow stock market leadership, LBO financing multiples, corporate leverage, growth in BBB-rated corporate debt, etc.).

This leads to the question for the 2020 outlook, does the economy break-out one way or the other, or will we see an extension of the slow steady grind that is now ten-years in? There are appealing aspects on both sides of the breakout argument.

BOTTOM LINE

My view is that we muddle along down the middle, with consequently divergent and highly idiosyncratic outcomes across industries and companies in credit markets, while interest rate markets are choppier, sitting in the direct crosshairs of the highly unusual monetary experiment now ten-years old.

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Souce: Smith Capital Investors, Bloomberg Economics 9/30/2019

2. The New Fed Frontier

From the Portfolio Lens – Eric Bernum, Investor

2019 was a turning point for the markets. For the last 106 years, the Federal Reserve has been an independent entity that operated within a straightforward theoretical Central Bank policy environment (depending on how you view the early 1980s under Volcker) to achieve its dual mandate of maxim employment and price stability. This year, however, our assumptions around the Fed we know have been turned on its head.

We learned that the Fed's "independence" has vanished in a world of Presidential tweets regarding monetary policy, and a late blooming understanding that the U.S. Central Bank can no longer work autonomously from the rest of the globe. Global liquidity now clearly resides in U.S. Dollars and with growth and investment return opportunities in scarce supply; the United States Central Bank Policy has a magnified impact across the globe. In 2019, the difference between U.S. interest rates and nearly any other developed economy spurred foreign investment to flow into the U.S. impacting fixed income (and equity) markets in a fairly dramatic fashion.

Also, new to this millennial version of the Fed, we learned there was an undiscovered third mandate to "sustain the economic expansion". Three "insurance" rate cuts later, softening but still expansionary economic data, gave Fed watchers a new variable to add to their equation for future Fed decisions. Unemployment is currently running near cycle lows and inflation while slightly below Fed committee expectations, seems to be in a "goldilocks" zone, neither too hot nor too cold. In this environment, the case for a single interest rate cut could be argued as a stretch, but that is not the brave new world of this Fed.

Finally, 2019 was the year we realized that this trip down the unmarked and undiscovered path of Quantitative Easing has implications that centuries of economic theory are unable to guide us through. From negative interest rates throughout Europe and Japan to Greek government bonds trading with a lower yield than U.S. Treasuries - or the ongoing repo market turmoil - it is clear we are in unchartered waters.

BOTTOM LINE

While we don't expect 2020 to contain the sheer scale of shock we underwent in 2019 regarding the reality of the "New Fed," it is clear that the rules of the game have changed and with the new frontier comes a new set of rules yet to be discovered.

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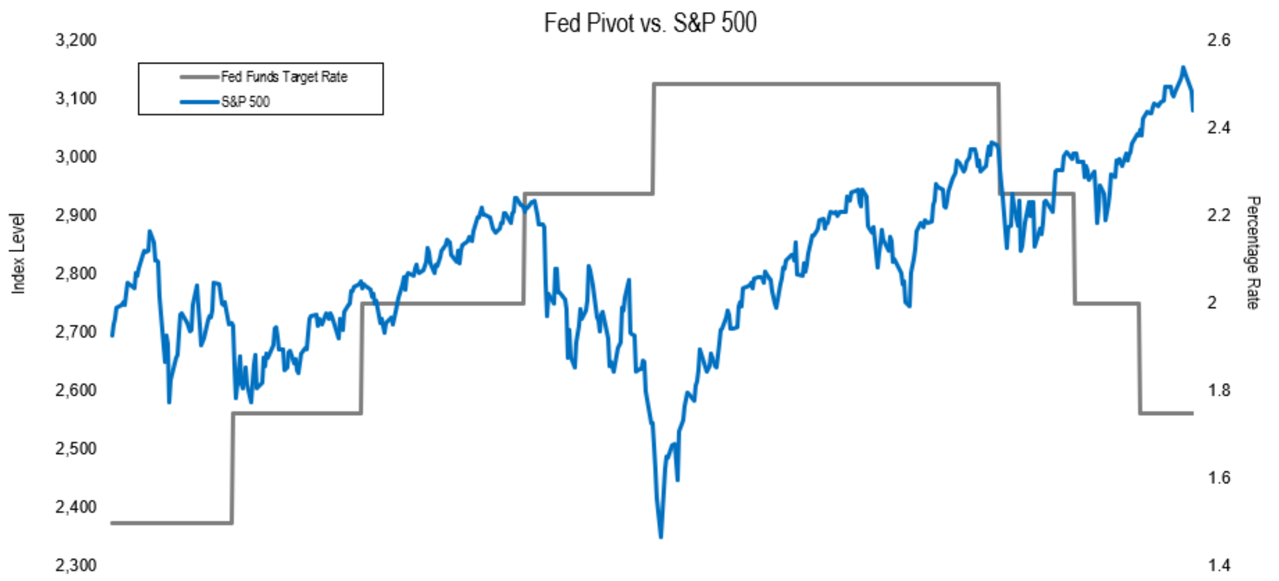

Source: Smith Capital Investors, Federal Reserve, S&P 500 Index 12/3/2019

3. There Are Only So Many (Positive Yielding) Bonds to *KISS*

From the Credit Lens – Jonathan Aal, Investor

Early in my career a wise, experienced bond investor told me that when considering the drivers of current and future valuation, which can ultimately be boiled up to drivers of supply and demand, four central items must be examined: Fundamental, Relative, Structural and Technical.

I don't care much for acronyms because they seem to defeat their purpose—in trying to make something simpler it just gets more complicated. Plain, straight talk works for me.

This said, there is an old military acronym that I was reminded of when thinking about the returns of U.S. Fixed Income this year and the previously mentioned drivers of the very simple concept of supply and demand. *KISS* stands for "Keep It Simple Stupid" and very simply, flows (a technical factor) had a very pronounced impact on the fixed income supply and demand curve this year.

Often when risk-free rates are going lower, it is not necessarily accompanied by a tightening in spreads—fundamentally, such simultaneous moves would more than likely be signaling contradictory messages. This year though we have witnessed both rates rallying and spreads tightening, to momentous degrees! U.S. credit spreads are 45bps tighter YTD (through 12/3/19) and the 10-yr U.S. Treasury is over 92bps lower (YTD through 12/3/19). Combined, these factors are largely responsible for the Bloomberg Barclays U.S. Credit Index posting a year to date total return of >13% (YTD through 12/3/19).

Through strictly a fundamental lens it is difficult to rationalize the co-existence of these moves; let alone see them coming a year ago. This brings us back to flows. Flows into U.S. fixed income have by far been the biggest driver of valuation change YTD.

As the amount of negative yielding debt across the globe increases the desire to "lock-in" a stream of positive yielding cash flows has grown. That has driven a mountain of money into U.S. fixed income markets, particularly those segments of the market that have no, or less perceived, credit risk (U.S. Treasuries and Investment Grade Credit).

BOTTOM LINE

Like what a wise and experienced bond investor told me early in my career; a true, well-rounded investment process includes a close examination of fundamental, relative, structural, *AND* technical factors. At Smith Capital Investors we like to keep those at the forefront of our research process while believing in keeping it simple.

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Investment Grade Credit vs. 10-year U.S. Treasury

Source: Smith Capital Investors, Bloomberg Barclays U.S. Credit Index, U.S. Department of the Treasury, 12/3/2019
OAS = Option Adjusted Spread

4. The Tweet Is Mightier Than The Sword

From the Macro Lens – Lindsay Bernum, Investor

The new communication landscape (the Fed, the President, companies, individuals, social media) is completely untested. I have been shocked and frustrated by the unintended consequences associated with instant access to information (correct or incorrect) and the market reaction via animal spirits, also known as momentum.

We published our views on the economic environment for 2019 last December and looking at the environment today, many of our predictions were in line with the outcome. The economy was adjusting from a 3% pace of growth to a 2% pace of growth. We called it being down but not out. Employment continued, inflation was stirring in the background and the foundation was strong enough to weather the ensuing storm. The starting point and ending point, however, tell a much different story than the data points in between would suggest.

The storm "in between" has been strong and unnecessary in the form of a trade war with headlines running the spectrum from real and unfortunate, to bogus, and leaning to irrational. This has created an environment where the market now moves - in both directions - on "tweets" as opposed to fundamentals. Unfortunately, this new form of communication has also caused decision making paralysis, specifically for businesses. This has been felt throughout not only manufacturing but the entire economy. The result has been much shorter and more intense cycles, creating massive bouts of volatility.

The examples throughout the last twelve months include:

*The ~20% decline from the S&P 500 Index between October 2018 and year-end saw the 30-yr U.S. Treasury rally ~55 bps.

*The ~7% decline from the S&P 500 Index in May 2019 saw the 30-yr U.S. Treasury rally ~46 bps.

*The ~6% decline from the S&P 500 Index over one-week at the end of July on the heels of the negative trade war headlines saw the 30-yr U.S. Treasury rally ~66 bps and **hit an all-time low yield of 1.95%.**

BOTTOM LINE

We fully welcomed volatility this year, but the extreme nature has been even more intense than previously expected. Looking ahead to 2020, we believe there will be even shorter cycles with more extreme outcomes and unintended consequences.

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Source: Smith Capital Investors, S&P 500 Index, US Department of the Treasury, 12/3/2019

5. When Consensus Is Wrong

From the Trading Desk – Zach Tucker, Investor

This year taught me a lesson in crosscurrents, that an explanatory variable may not always lead to an expected market outcome. The main example was reconciling the direction of U.S. equity and bond markets given classic data on supply-demand characteristics, such as fund flows, net issuance, and asset yields.

If an investor saw the chart below at the beginning of the year, what would be the conclusion on where to invest?

It would seem reasonable for that investor to conclude that the rotation from equities and into bonds would be the smart trade, perhaps even shunning equities altogether. As of 11/26, YTD total returns for the Bloomberg Barclays U.S. Aggregate Bond Index (Agg) is 8.74% and the S&P 500 Index is 27.5%. While the Agg makes sense, pairing it with the equity market returns makes less sense.

The point is, being armed with perhaps very important supply-demand data still does not explain some of the results we've seen in 2019. That perplexes me, especially with many market participants wary of the end of the equity rally.

I believe the fear points more toward the fixed income market; if the asset allocation and fund flow mix is this skewed to bonds, what happens when the dynamic reverses? One of the largest drivers of U.S. fixed income returns has been both foreign and domestic fund flows. It has absorbed the robust supply. I underestimated this dynamic (especially thinking back to one of the historically largest months of supply in September).

BOTTOM LINE

Conflicting technicals would have argued for a cautious approach to both bonds and equities…and it would have been wrong.

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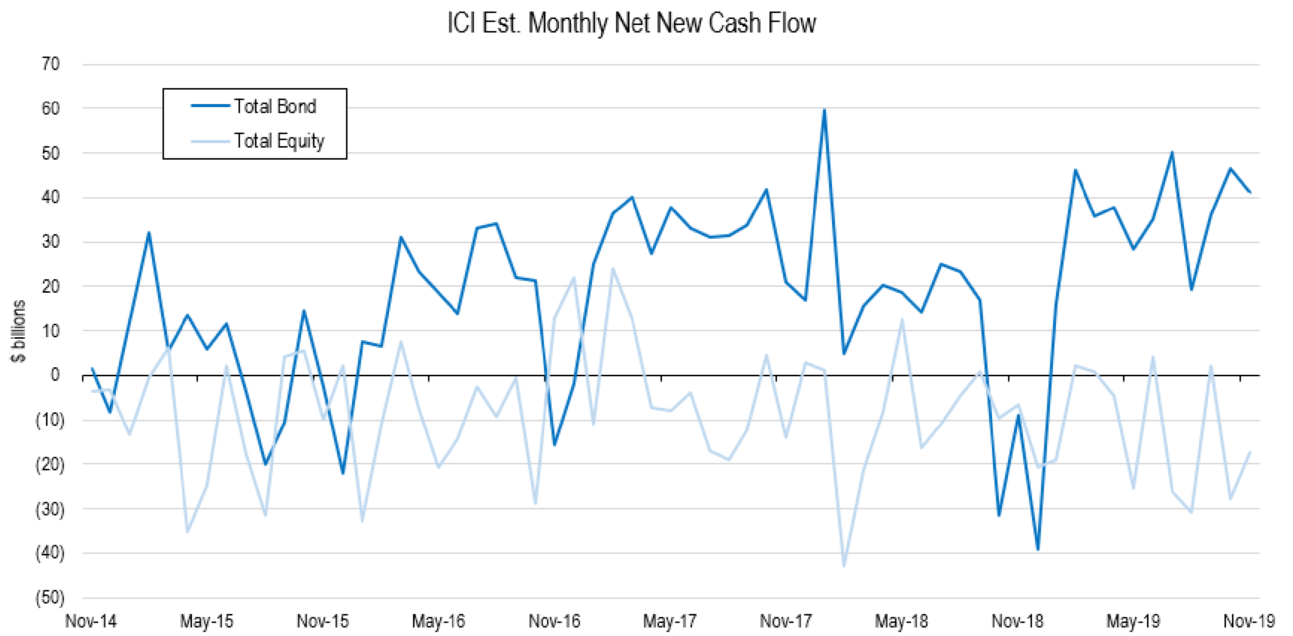

Source: Smith Capital Investors, ICI Investment Company Institute

6. When Money Is Cheap, Every Deal Looks Like A Good Deal

From the Equity Lens – Brinton Johns, Senior Advisor

In 2019 we saw the knock-on effects of cheap money. Companies are doing the rational thing. In the face of slower growth, high operating margins, and cheap debt, companies are turning to M&A. Private equity is doing more and ever-larger deals. Venture capital companies are staying private longer. Leverage is the great magnifier, but for some time now, magnification has been going one way.

The environment has been the inverse of the Buffettism, "Only when the tide goes out, do you discover who's been swimming naked." Put simply, the tide remains high and shows no signs of going down.

Environments like today's are where in-depth research seemingly matters the least but matters the most. Not every deal will stand the test of time. Established companies are facing an increasing risk of disruption (remember Toys-R-Us?). Disruptors, such as We-Work are often given more latitude than fiscally responsible in an environment of easy money.

BOTTOM LINE

In times like these, we constantly remind ourselves to stay disciplined, stick to our philosophy and research every deal with the same rigor we might during the bad times.

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Source: Smith Capital Investors, Bloomberg Barclays U.S. Corporate Index

Conclusion:

We realize that 2019 was a doozy and just as you are catching your breath, 2020 is fast approaching and bringing along its idiosyncrasies. Expect another year of volatility (oh boy!) and with even more extreme outcomes (even better!). Our recovery is rather seasoned as we mentioned above and this is at a point when we are heading into an election year and on the heels of impressive returns with equities marking all-time highs, the 30-yr U.S. Treasury marking an all-time low in yields and credit spreads at year to date tights (2019). What could go wrong?!? The market has a good deal of information to digest, a new landscape ahead with even shorter cycles, more extreme outcomes, and unintended consequences. If 2019 taught us anything, it is to expect the unexpected!

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