Independence Asset Advisors

Independence Asset Advisors, LLC

Year-End Commentary

December 18, 2018

Dear Clients and Friends,

Since our last investment update, stocks have attempted to rebound several times only to stall and fall back down on a persistent stream of negative news stories. While not quite a perfect storm, it has been a challenging period and investor sentiment has turned increasingly negative. With markets once again returning to the lows reached in late October, retail investors continue to withdraw money from both the stock and bond markets (including mutual fund and ETF redemptions). Some of this selling is tax loss harvesting, which we have also done this year for the advantage of several clients. While cash building on the sidelines can be considered good from a contrarian perspective, a positive trigger will be required to halt outflows and reverse them to inflows, which would move markets higher.

Oil has weakened further (to below $50 a barrel for WTI) and credit spreads have widened. We believe the story with oil is more a function of heightened supply than a function of reduced demand (which could indicate a significant slowdown in global growth). While we are slightly surprised by the sudden year-end volatility, we are not overly concerned. We are always wary of broad credit spreads widening materially, and over the past month we have witnessed this trend in investment grade and high yield corporate bonds, as well as leveraged loans. However, these wider spreads remain below their medians, and default rates for lower-rated credits remain below historical averages- a comforting affirmation. More concerning to us at this time is the recent (albeit temporary) inversion of the yield curve. The shape of the yield curve has been a reliable indicator of future economic conditions, and when yields for intermediate-maturity U.S. Treasuries fall below yields for short-maturity Treasuries, it can signal a downturn in the future.

We remain cautiously optimistic and view current equity levels as a moderately attractive entry point for long-term investors. The correction in U.S. and global equities has brought valuations to or below historic averages. That being said, patience is required to take advantage of our current situation, as we don't expect a sudden sharp rebound. In the U.S. we believe that a recession is largely avoidable, but if it were to occur, it would likely be self-inflicted (e.g. due to trade wars, government shutdown and/or an overly tight monetary policy). We continue to slowly invest excess cash on weakness, rebalance as appropriate and harvest tax losses where appropriate. However, we do not believe that this is an opportunity for clients to go overweight risk assets versus their strategic long-term targets. There is too much uncertainty and too much fat tail risk (significant downside risk) to make big bets.

A few key things to keep in mind:

1. The global stock index is down 6-7% thus far in 2018. In 2017 it delivered a positive 24% total return. Combined, the last two years have delivered above average returns for investors.

2. While stocks turned negative in October, if you remove a handful of technology related stocks from the index, 2018 had been a mediocre year for investments even before October. In fact, most asset classes had been flat to down most of this year including value stocks, emerging markets, domestic bonds, international bonds, REITs, MLPs, commodities and more.

3. Given a modest slowdown in growth expectations, tame inflation and weaker capital markets, the US Federal Reserve is likely to slow down its pace of interest rate hikes. If they raise one last time this week and then slow future hikes, it would go a long way to improve investor sentiment. If they continue with their original guidance, with quarterly increases to a 3% Fed Funds rate, markets may struggle for a few more quarters.

4. Related to Fed actions, we are watching for 2 to 20-year yield curve inversion. The yield curve is 10 for 10 in foreshadowing the last ten recessions, so we consider it a reliable predictor. It is also a leading indicator, with inversions occurring from 6 months to two years before recession. That said, this time might be different, with the extraordinary bond purchases by the Fed, ECB and BOJ affecting long rates. An inversion at 3% may be a flashing yellow warning. Markets have risen in the past after inversions, so we must be cautious not to overreact.

5. It is in everyone's interest to avoid a deepening trade war with China. Moreover, ending tariffs on our allies in Canada, Mexico and Europe and reaffirming open global supply chains would be highly positive. As such, we continue to believe that constructive efforts to tackle the issues between the US and China should proceed. This uncertainty is part of the reason we are not currently buying risk assets more aggressively.

As always, do not hesitate to contact me or anyone on the Independence Asset Advisors team with questions or if you would like to discuss these issues further. All of us at IAA wish you happy holidays and a healthy and prosperous 2019.

Kind regards,

Scott D. Renninger