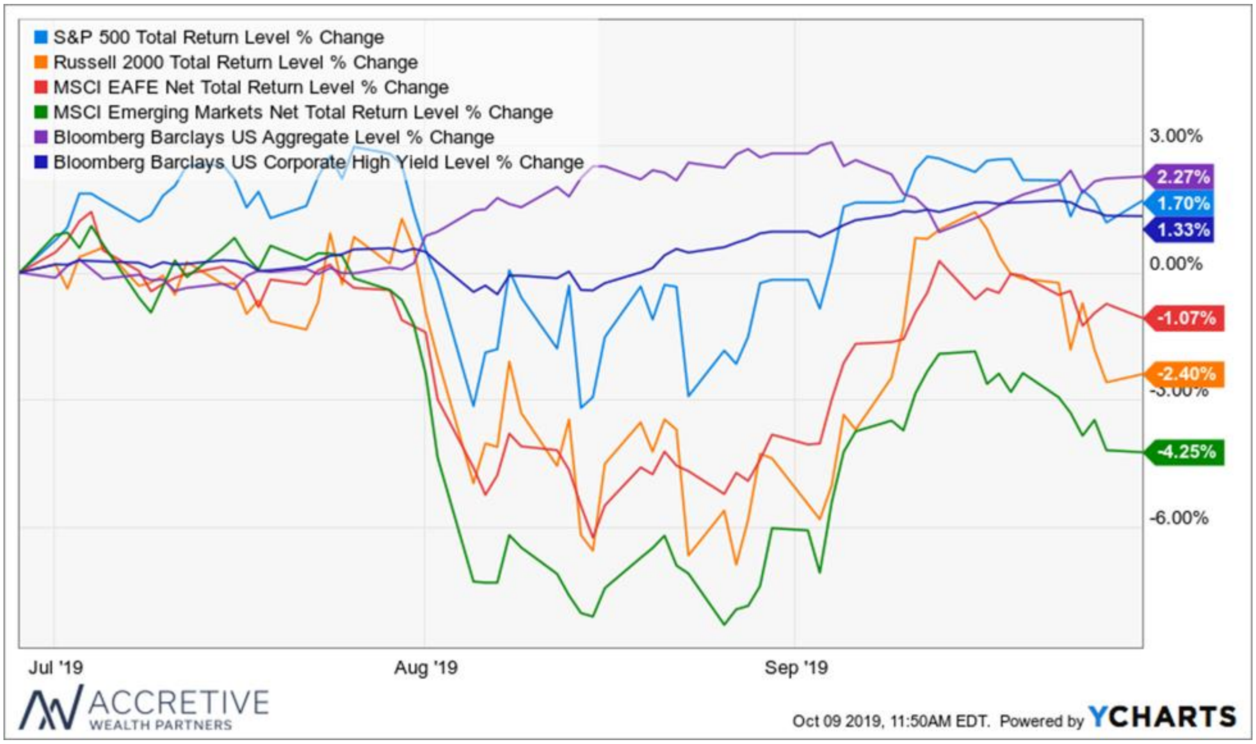
Third Quarter 2019 Client Letter

Dear Clients and Friends of Accretive,

The third quarter is in the books and markets were mixed. US markets for both large company stocks and bonds were higher, while US small company and non-US equities were lower.



Markets responded to various headlines, which included recent positive or negative developments in the US/China trade war, the latest strong or weak economic data, and the most recent dovish or hawkish comments from various Federal Reserve governors. Taken in its totality, outside the outlook for interest rates, things have been kind of directionless.

As markets fluctuated, the Federal Reserve lowered its benchmark interest rate twice, going from 2.50% to 2.00%, with expectations of more easing the next time the Fed meets. This brings us to our quarterly topic, where we delve a little deeper into the topic of interest rates.

Accretive On: Interest Rates

One of the common topics of conversation with clients is the global interest rate environment, both in the United States and outside of it.

Many clients are of a demographic that remembers interest rates in the mid to high-teen percentages, and inflation rates of a similar magnitude. Many also observe the quantity of debt taken on by governments and conclude that inflation and interest rates should be heading higher, not lower.

If that was not confusing enough, currently there are over $15 trillion worth of bonds that are priced to have a negative yield. Most of these bonds are concentrated in Japan and mainland Europe. Even Greece, which has had several debt crises that resulted in several bailouts in the past decade, recently issued short-term bonds at a negative yield. [1] Put another way, one of the least creditworthy nations in the world as of a couple of years ago is currently getting paid to borrow money. The current state of things is a little confounding, to say the least.

We think the rate environment is inextricably linked to the global growth environment, for which the outlook is generally low. We believe there a few additional factors that have created the environment for low/negative interest rates and disinflation/deflation: debt, technology, and demographics.

Let's start with demographics. Most of the countries in which low or negative rates are an issue have challenging demographics. The most notable country is Japan, which has a shrinking population. Most of Europe struggles to keep its population from shrinking and would be unsuccessful without immigration. In the US, we are fortunate that our population is still growing naturally, but it is worth noting that it is at a declining rate. As countries age, they save more and spend less, which is disinflationary. As countries shrink, there are fewer people spending money, which is deflationary.

Technological advances also put pressure on inflation and interest rates. We would define technology broadly, not just computing power and the internet. Technology allows people to do more with less, but also allows them to do it less expensively. A good example is in energy, where the fracking revolution has upended the "Old Oil Order". Technological advances have changed the market structure and OPEC, once widely feared, is now much less powerful in the setting of oil prices. The Saudis, once the swing producer, now take a backseat to a wildcatter in the American mid-west. The marginal cost of production keeps falling as technology improves. The example is instructive, not just in energy but in many industries. A bet on inflation is, in some ways, a bet against technology, innovation, and human ingenuity.

We think the sheer quantity of debt is a hinderance to higher rates. When talking about debt, it is important to distinguish between developed, where most of the debt is issued, and developing economies. In the developing world, debt tends to get linked to US dollars and too much of it tends to lead to hyperinflation. In the developed world, countries borrow in their own currency and too much debt tends to create a deflationary overhang.

We believe the process by which the overhang happens is mechanical. This is perhaps counter-intuitive, so some numbers may be helpful. Earlier in the year, the Institute of International Finance reported that global debt was near $244 trillion, or roughly 318% of global GDP.[2] The interest rate environment we are in has persisted for some time, so most of the global economy has financed itself at very low rates. Leverage has a way of magnifying outcomes, given the global economy is levered >3 times, a 1% increase in borrowing costs creates a 3% headwind. Meaningful upticks slow growth significantly, and lead to conditions that warrant lower rates. In economic parlance, it's a liquidity trap.

How do you break the trap? It is hard to say. Historically, money centers of the world's most developed economies have experienced long periods of low rates. Generally, prior to the 1970's, inflation happened as a result of wars. The 1970's were an outlier and it could be argued they were the result of the US abandoning the gold standard, and thus one time in nature. A big question is whether negative rates can or will come to the United States?

We think they can but are not sure they will. It might be helpful to compare the US and Germany for context. Germany can issue bunds and get paid for the privilege of borrowing for a very long time; almost 30 years. It also currently runs a budget surplus, which means the supply of bunds should be shrinking. There is not a lot our political parties can agree on, but we think that if borrowing costs got so low in the United States our politicians would figure out ways to spend money.

Year End Outlook

As we head into year end, there is more uncertainty in the outlook because 2020 will feature an event with a binary outcome. 2020 will be an election year and we expect the market to move its attention from the Fed to the latest polls. The election outcome has the potential to reshape economics in several industries, with the most notable of which is probably healthcare. We expect the Fed to continue what it has been doing, which we think has been letting the market influence monetary policy to a large degree albeit with a modest lag in timing.

There is a lot of talk about whether the expansion will continue or if it is running out of steam. While no one knows the future, and there appears to be some slowing, we think the economy can grow at a modest pace for quite some time. If the growth is modest and large excesses are not building in the markets, we think a downturn is less likely to be a result of the business cycle turning and more likely the result of some exogenous shock. By that we mean an event that changes things from outside the economy rather than a wash out of previous excesses within it.

Our Portfolios

In this quarter our portfolios performed in line with our expectations, given what transpired in the market. As a reminder, our portfolios tend to be positioned to handle a more difficult market than outperform a robust one.

We have made a few changes to the portfolios throughout the year and our activity level is in line with our expectations generally. One theme in the activity has been a reduction in exposure to investments we view as being implicit wagers on stable and/or rising short-term interest rates. To that end, there were a few changes in the quarter that you may see in your transaction log. Feel free to ask us any questions you may have on the specific changes.

Closing Remarks

We are three full quarters in, and things are going well for us at Accretive. We hit a key milestone in the third quarter, as our assets under management topped $100 million and we expect the momentum to continue into year end. As we grow, Eric, Steve, and I are focused on building a different kind of wealth management firm. We mean that in a positive sense. As we make our way towards 2020, we expect to have some exciting new announcements to share to that end.

As always, if you have any questions, please feel free to call or email us. We welcome the opportunity to speak with you.

Thank you,

Gary C. Ribe, CFA, CFP®
Chief Investment Officer, Managing Member

[1] https://www.washingtonpost.com/world/europe/in-historic-sale-greek-debt-carries-negative-interest-rate/2019/10/09/11686a52-eac6-11e9-a329-7378fbfa1b63_story.html
[2] https://markets.businessinsider.com/news/stocks/debt-around-the-world-hits-244-trillion-near-record-2019-1-1027872023