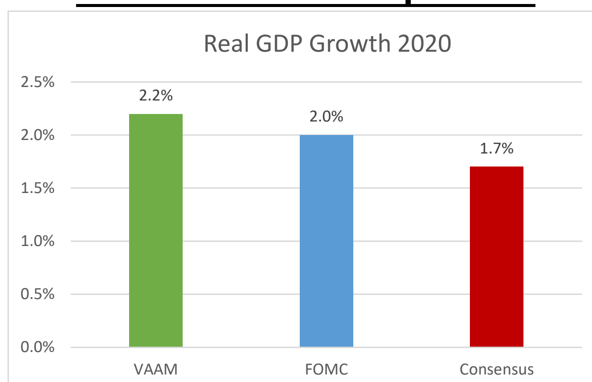
VANDERBILT Ave.
ASSET MANAGEMENT

4th Quarter 2019

Vanderbilt Avenue Asset Management forecasts 2020 **economic growth** at 2.2% which is above consensus estimates. The chart below compares VAAM's forecast with both the Fed's outlook as well as the consensus forecast. The economy grew at 2.6% for the first half of 2019 and 2.1% in the third quarter. The consumer (70% of GDP) has continued to provide the growth momentum whereas capex/business investment has lagged. There are few signs that shoppers are overextended. Household debt as a share of income is lower than it was in 2008 and the savings rate remains high at approximately 8%. Online shopping set the pace for a strong holiday season. Contrary to the consumer sector, low interest rates and reduced business taxes have not yielded the anticipated capital expenditures by the business sector. A slowdown in global growth combined with trade policy uncertainties have held back capex with cash flow instead being deployed for share buybacks and larger dividends. It is possible that recent tentative trade policy agreements will lead to improved business confidence and provide a stimulus to business investment. Recession warnings from earlier in the year have eased up: the unemployment rate at 3.5% is at a 50-year low, the yield curve has become more positively sloped and housing construction has picked up.

GDP Forecast Comparison

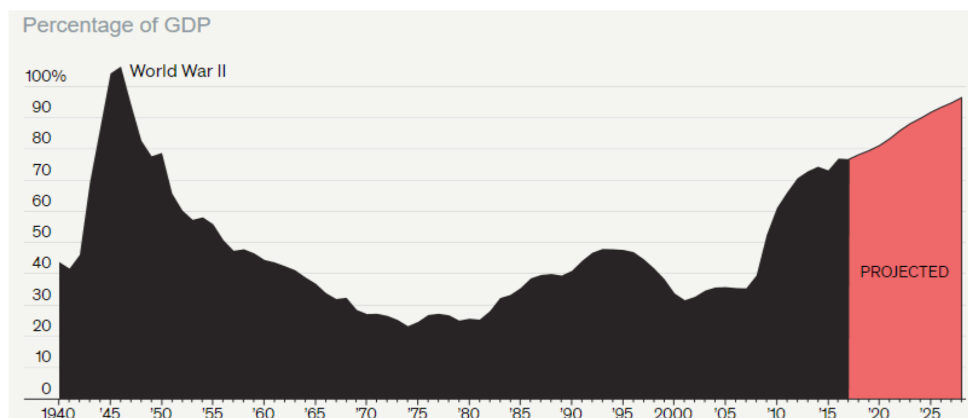


VAAM's **inflation** forecast for 2020 of 2.5% is also above consensus estimates. The core CPI is already at 2.3% and we believe inflation could surprise on the upside. The consensus outlook is that inflation is not a problem despite a full employment environment. Two key drivers appear to have kept inflation relatively low: technological innovations and global supply chains. Technological innovation provides constant downward pressure on prices. Global supply chains have grown rapidly complex the past 20 years. Competition has brought down the cost of moving raw materials from one country and having them assembled in another country. This lower production cost to a certain degree has been passed on to consumers. In addition, inflation has been impacted by online retailers. However, inflationary pressures will eventually, in our opinion, be felt from the extraordinarily strong labor market and resultant cost push pressures. Job growth is the longest on record and the labor market continues to drive wage gains. Nominal wages are up 2.9% year-over-year, there is no slack in the labor market and the Phillips Curve (when the unemployment rate falls, inflation goes up, and vice versa) is starting to respond. Wages for rank-and-file workers are rising at the quickest pace in more than a decade, even faster than for supervisors. Pay for the bottom 25% of wage earners rose 4.5% in November from a year earlier. Average hourly earnings for production and nonsupervisory workers in the private sector were up 3.7% in November from a year earlier.

There are clear signs that the **Federal Reserve** is now more open minded to letting the economy run and seeing just how many people can be put to work and how much wages can rise before it causes inflation. There is an expectation that the central bank will adopt an average inflation target. By raising the target above the current threshold of 2% during periods of expansion, it would offset low inflation during periods of recession. By adopting average inflation targeting, it would be less likely that rate hikes would occur during economic expansions until inflation reached a higher level.

There should be major concerns revolving around the **deficits** and resultant rising national **debt** levels that are being created. In just two years the national debt has increased by $2 trillion to now $22 trillion. This does not include contingent liabilities like social security, Medicare or student loans. While some politicians are downplaying the size of the national debt, it is an alarming growth pattern that does not seem to have any fiscal reins in Washington. The 2017 tax cut increased the budget deficit from 3.5% of GDP in 2017 to 4.5% in 2019. Total national debt now equivalent to 76% of GDP will rise to 96% of GDP in 10 years (as depicted in the graph below). Studies have shown that when debt exceeds 90% of GDP the median growth rate of the economy falls by 1%. A decade from now, interest expense will total $900 billion (versus $363 billion today) and represent 13% of the Federal budget. This will surpass spending on both Medicaid and defense.

Publicly Held US Government Debt

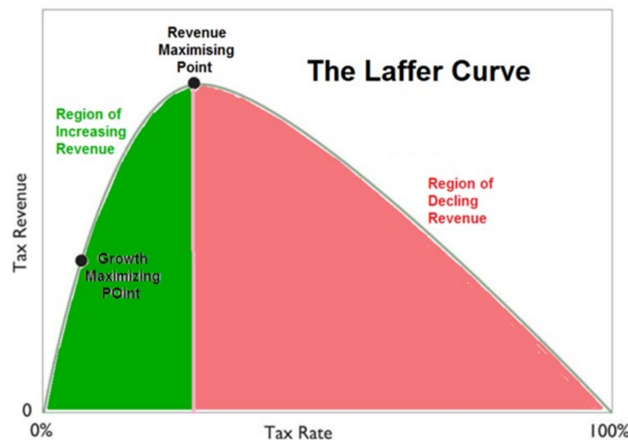


Source: CBO

Annual budget deficits have now increased for four consecutive years. This is the first time for such a run since the early 1980's. Big budget deficits usually widen in times of recession; this time deficits are growing while the economy is expanding. The current levels of debt are unprecedented in peacetime during a growing economy and the consequences of this irresponsible spending are unknown. A potential risk is that higher debt levels could force restraints on officials responding to an economic downturn. Countries with higher debt/GDP levels heading into a recession have smaller fiscal responses and diminished growth outcomes. This is in conjunction with the Fed's lower flexibility to adjust monetary policy when required- the fed funds rate is currently at 1.5%-1.75% versus 5.25% before the last recession.

Republicans point to the Laffer curve to justify their tax cuts and minimize concerns about deficits. They argue that lower taxes will increase economic activity and government revenues thus keeping deficits under control. However, the 1964 and 1980's tax cuts did not increase government revenue. It was the tax rate increase in 1993 that led to increased government revenues. Tax revenues for the last two years

have fallen more than $400 billion short of what the CBO projected in 2017 six months before the new tax law was passed.



For their part, Democrats argue that widening deficits are justified by modern monetary theory (MMT). MMT promulgates that countries that issue debt in their own currency can finance growth through deficit spending if rates and prices remain low. MMT teaches that under such circumstances a country cannot go bankrupt. If revenues are down, deficits can always be funded by the central bank. MMT has come in for a fair amount of criticism. The Federal Reserve has warned of widening deficits. Former Treasury Secretary Larry Summers has called MMT "… a recipe for disaster." While countries usually finance themselves through taxes and the central bank prevents inflation, MMT has the central bank taking on the role of lender. It would finance the government and create capital when money is needed. Countries should worry about inflationary consequences of paying off those debts by abusing its money. Summers says MMT is very much misguided given the premise that somehow you can always print enough money to cover all of your debts.

A preliminary phase one **trade agreement** between the US-China holds the promise of lowering global trade uncertainties and restoring confidence potentially leading to investment spending firming and global growth finding renewed momentum. However, there remain many uncertainties. Although agricultural exports to China will double from a previous high of $20 billion to $35 billion, tariffs on about $370 billion of Chinese goods (equal to approximately 75% of American imports from China) will remain in place. U.S. farmers must demonstrate the ability to produce enough goods to double previous export levels. The trade war has hurt the manufacturing sector and capex. The Federal Reserve recently completed a study on Trump's tariffs that concluded that the higher costs from tariffs swamped benefits to specific industries from import protection. We are in the process of moving from globalization to bilateral trade negotiations between countries. This moves trade policy away from promoting free markets and back toward an earlier era of managed trade. Previous Republican and Democratic administrations worked to lower global tariffs and build an international system that promoted freer trade. Many trade experts fear the U.S. approach could backfire by degrading the international trading system and raising the cost of manufacturing resulting in lower productivity.

During the fourth quarter, the level and shape of the **yield curve** changed in a manner consistent with a lessening possibility of a recession. The yield curve moved in a "bear steepener" manner. Two-year U.S. Treasury levels declined five basis points while the longer end of the yield curve rose to higher interest rate levels. Yields on U.S. government bonds have rebounded from near-historic lows hit just several

months ago, sending one of the clearest signals yet that investors' earlier recession fears have waned. This resulted in a steeper slope for the curve (2-year vs. 10-year) from four basis points to 35 basis points. This reflects the tentative trade agreement, the continued strength of the labor market and the decision by the Fed to halt any further interest rate reductions at this time.

	9/30/19	12/31/19	Change
1-month Treasury Bills	1.86	1.43	-0.43
3-monthTreasury Bills	1.81	1.54	-0.27
2-year Treasury Note	1.62	1.57	-0.05
5-year Treasury Note	1.54	1.69	0.15
7-year Treasury Note	1.61	1.83	0.22
10-year Treasury Note	1.66	1.92	0.26
30-year Treasury Bond	2.11	2.39	0.28
10-year vs. 2-year	4	35	31

For the full year 2019, the yield curve also steepened; however, the curve moved in a bull steepener manner where interest rates declined across the curve. Interest rates declined more in the short end of the curve versus longer maturities. The two-year U.S. Treasury declined 92 basis points for the year whereas the 10-year declined 76 basis points.

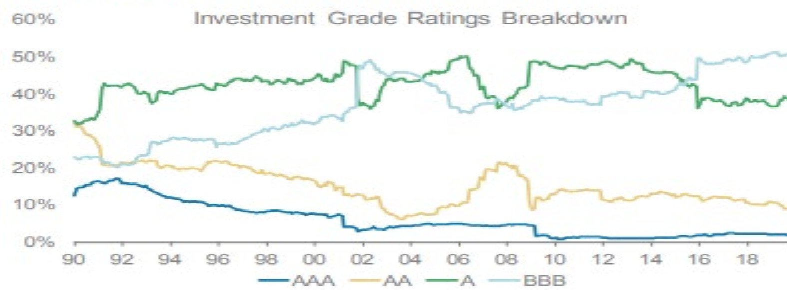
Corporate securities
The Corporate sector provided strong relative performance for both the fourth quarter and full year. Fourth quarter results were driven by the Federal Reserve's additional lowering of short-term interest rates, an improved outlook for the China/U.S. trade dispute, and a continuation of solid U.S. economic fundamentals. The combination of tighter risk spreads over comparable U.S. Treasury and the higher income of the sector provided an excess return of 1.22% as measured by the ICE BofA 1-10 Year US Corporate Index and 0.38% for the shorter ICE BofA 1-3 Year US Corporate Index for the fourth quarter.

We reduced exposure to the sector during the year as the spreads over U.S. Treasuries moved from fair value to overvalued. The tightening trend is shown in the table below:

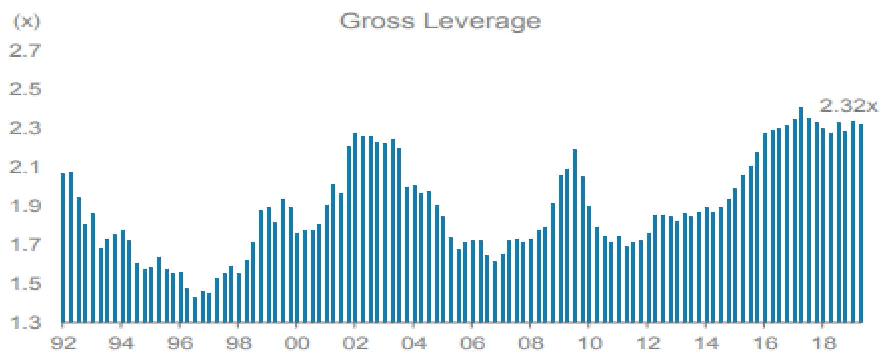
Corporate Index	Corporate Spread 12/31/2019	Corporate Spread 9/30/2019	Corporate Spread 6/30/2019	Corporate Spread 3/31/2019	Corporate Spread 12/31/2018	Corporate Spread Historical Median
ICE BofAML 1-10 Year	0.78%	0.96%	1.00%	1.03%	1.39%	1.17%
ICE BofAML 1-3 Year	0.49%	.59%	0.66%	0.64%	0.93%	0.88%

Median Spread based on the period from 12/31/1996 through 12/31/2019

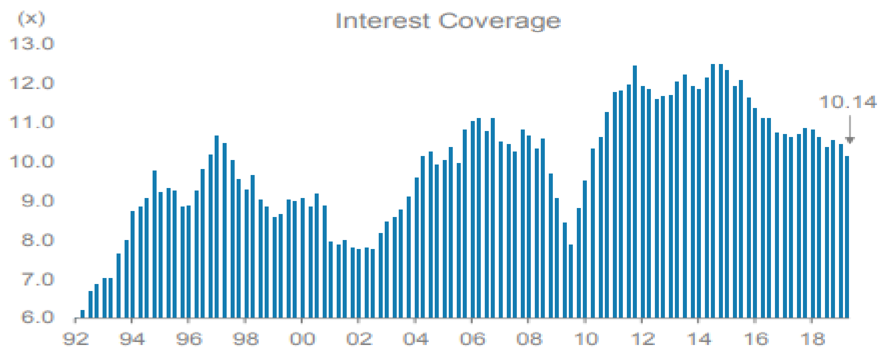
Spreads in the sector are actually tighter than what appears in the above chart, since the sector's credit quality as measured by credit ratings and financial fundamentals are weaker over the past several years than in the earlier years. For instance, the Corporate Index is now 50% "BBB", the lowest investment grade rating.



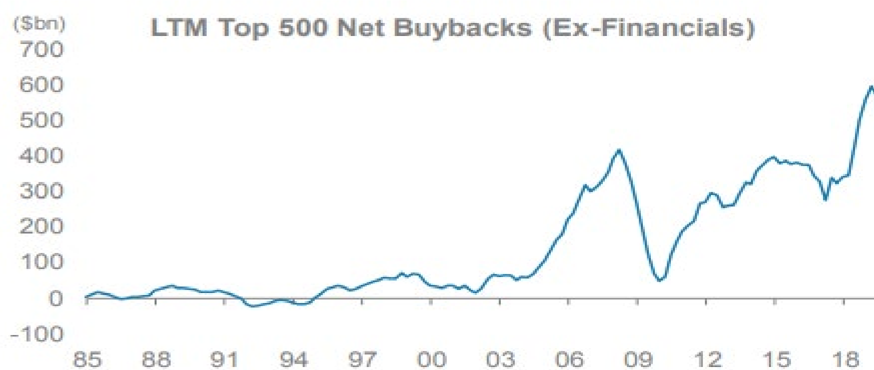
Corporate leverage is also at elevated levels as compared to earlier economic cycles. Leverage remains higher than levels reached in the aftermath of prior recessions and significantly higher than prior recoveries.



The overall Interest Coverage is strong based on historical levels but has deteriorated significantly since its peak due to debt, and interest costs rising faster than the growth rate of cash flow ("EBITDA") during the years 2012 through 2017. Any deterioration in corporate cash flow will place rating pressure on securities in the sector, especially lower rated "BBB" companies as leverage could move significantly higher from already elevated levels. In addition, Interest Coverage would move lower placing additional pressure on the credit quality of the sector.



If the above debt issuance had been used primarily for capital expenditures, the higher debt levels would be better supported in any future economic slowdown. Unfortunately, a significant use of this issuance as well as existing cash balances have been used for stock buy backs and M&A activity which may support current equity prices but not future cash flow generation.



The combination of relatively tight spreads, that reduces the potential for significant outperformance of the sector, and financial fundamentals at elevated risk levels has led us to structure our portfolios at a much higher level than the overall index. For instance, lower rated "BBB" securities are underweighted. A downgrade to non-investment grade would result in prices gaping lower as the buying power of investors permitted to own these lower rated securities is significantly smaller than the larger pool of investment grade buyers.

Illustrations of the issuers currently held by our portfolios are Honeywell, NVIDIA, Microsoft, and UnitedHealth. Honeywell is a diversified technology & manufacturing company with operations in aerospace, performance materials, building technologies and performance materials. NVIDIA designs and develops 3d graphics processor and related software. These GPUs are used to generate computer game images and are usable in applications for autonomous vehicles and AI applications. Microsoft develops software products and is the second largest cloud service provider. UnitedHealth is the leading U.S. health insurer offering plans and services to group and individuals nationwide. The table below shows several of the key financial fundamentals of these companies.

Honeywell	A2/A	2.44x	22.3x	Significant Positive
MICROSOFT	Aaa/AAA	1.44x	22.4x	Significant Positive
NVIDIA	A3/A-	0.99x	48.8x	Significant Positive
UnitedHealth	A3/A+	1.76x	13.6x	Significant Positive

Within the Financial Sector our portfolios hold a number of the largest, diversified U.S. banks, such as JPMorgan Chase and Morgan Stanley. JPMorgan Chase is the largest bank holding company in the U.S. with operations in mortgage lending, credit cards, commercial lending, investment banking, and asset management. The company is rated A2/A-. Their Tier I Risk Based Capital Ratio is 14.1%, a Return on Assets of 1.37%, and Return on Equity of 13.9%. Morgan Stanley is a diversified financial services company, rated A3/BBB+ that operates a global securities business and asset management business. They have a strong equity position with a 16.3% Tier 1 Common Capital, a Return on Assets of 0.94%, and a 10.8% Return on Equity. Both companies had a Significant Positive Earnings Surprise for the fourth quarter earnings report.