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CMG Managed High Yield Bond Program
2019 Q1 Quarterly Update

The strategy began the quarter in a defensive position before quickly moving back into high yield bonds in early January. The strategy had moved to a defensive positon in early October and was able to avoid the large drawdown during the fourth quarter. The timing of our move back into high yields could not have been better and speaks to the efficacy of the strategy during volatile market environments. For most of the past two years high yield bonds have been range bound, creating few trading opportunities. The blow out in high yield spreads late last year was the best trading opportunity in high yields in close to five years. The sell-off took less than two months and set up the strong first quarter for high yields.

The strategy was well positioned over the past six months, avoiding almost all of the decline in the fourth quarter and capturing most of the upside in the first quarter, all with much less risk than a long only high yield strategy. As we wrote in our last update, we believed that the outlook for high yields in 2019 was going to be much brighter due primarily to the Fed's guidance suggesting an additional rate hike was off the table for 2019. Additionally, valuations looked attractive after the blow out in spreads. Although high yields have rallied off their lows, the environment for the foreseeable remains accommodative. Barring any change of direction from the Fed, we believe the environment this year will be conducive to solid returns from high yields; albeit with most of the total return coming from yield and not price.

Market Commentary

If there is one word that I could choose to describe the past six months of market activity, it is "absurd". The panicked decline and irresolute recovery was absurd, illogical and wildly unreasonable. There is really no other way to describe it although adolescent comes close. The sell-off last year was purportedly triggered by concerns that the Fed had hiked rates too far thereby creating headwinds for growth. After the Fed offered guidance in December suggesting no rate hikes were on the table for 2019, investors were exuberant and have since pushed equity markets back to all-time highs. Now, after a solid first quarter, the debate is not about when or whether the Fed should increase rates at all, but rather about whether they should cut rates. While there is at least a plausible case to be made for slowing the pace of rate hikes or the withdrawal of other accommodative policies, the argument for cutting interest rates is nothing less than absurd.

The Dueling Mandates of the Dual Mandate

What is known today as the Fed's "dual mandate" has an interesting history. Its origins reside in the Employment Act of 1946, a policy passed by Congress that was meant to address the challenge of finding jobs for American soldiers returning from war and inspiring confidence in the economy. The specter of the Great Depression still loomed large for the country and the original act declared that "All Americans able to work and seeking work have the **right** (this word was ultimately removed from the final bill) to useful, remunerative, regular and full-time employment…". Clearly, jobs were the priority and inflation was only a modest concern against the deflationary period of the Depression. At the time, some economists felt the legislation ignored price stability and its impact on standards of living. The two decades following the act saw stable employment and inflation in a healthy range of 1 to 5 percent (stable by the standards of those times). Stagflation in the 70s led policymakers, and indeed the executive branch, to a renewed focus on inflation. Starting with President Ford's WIN (Whip Inflation Now) speech in 1974, Congress set about refining the Fed's mandate to include stable prices, culminating in Resolution 133 in 1975. The key and now familiar statement from the resolution instructed the Fed to: "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment,

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stable prices, and moderate long-term interest rates". In 1977, Congress formally amended the Federal Reserve Act to include this mandate and it was signed into law by President Carter in 1978 as the Full Employment and Balanced Growth Act, more commonly known today as the Humphrey-Hawkins Act. Some of the more radical proposals left on the cutting room floor included explicit employment targets and government action to reach those targets and a greater role for the executive branch in monetary policy in the form of the President's recommendations on monetary policy submitted for the Fed's consideration.

By the late 70s the monetary policy pendulum had completely swung to the side of price stability as Fed Chairman Paul Volcker sought to fight inflation at all costs. The cost was higher unemployment and Volcker was pressured to do more on jobs. Despite pressure from Congress and the President, Volcker saw inflation as the more important battle, and more significantly, a battle that he could win. Volcker would be proven right as unemployment levels fell alongside stable inflation in the late 80s and 90s. Scrutiny of the dual mandate was scarce during this period although calls for an explicit inflation target were discussed amongst members of the FOMC. Fed Board Vice Chairman Alan Blinder, poured cold water on these proposals, arguing instead that that dual mandate provided the flexibility for the Fed to do its job more effectively than other proposals, suggesting there was little evidence supporting a fundamental change.

Fast forward through two major domestic crises and the pendulum once again swung back to the side of employment. In the wake of the worst financial crisis since the Depression, jobs were the focus and the political loadstar. Never mind that loose monetary policy fed the credit bubble that would bring the economy down. Over the past decade, not only did we get low interest rates, the Fed used several unorthodox policies, most notably QE, to stimulate the economy and drive unemployment to the current low level. What is notable about the current cries for help from the Fed is that neither employment nor inflation are a problem. So why the anxiety about the economy and the wishful thinking about a rate cut?

The answer may lie in a paper Alan Blinder published in 1982, titled "Issues in the Coordination of Monetary Policy". Blinder examined issues concerning the coordination between fiscal and monetary policies and stressed that his findings are not meant to be answers to the questions at hand but was meant to stimulate discussion. It is an interesting read (please contact me if you would like a copy of the paper) with several insightful sections that include a game theory approach to determine what coordination would look like, ranging from perfect coordination to complete lack of coordination. Utilizing the Nash equilibrium, Blinder suggests why "uncoordinated behavior will result in tight money and loose fiscal policy" despite the fact that both the Fed and the fiscal authority would prefer "easy money plus tight fiscal policy". Clearly, the optimal situation of easy money and tight fiscal policy cannot exist. There is no political will (and no support from voters) to raise taxes or cut spending on Social Security or healthcare. Policies from the current administration are mixed and, as a result, the response from the Fed is mixed. Corporate tax cuts meant to stimulate the economy have been offset by negative trade policies that create uncertainty and potential inflation if the situation does not de-escalate. The Fed has had to react to these policies, at times increasing interest rates in response to expansionary policy (tax cuts, lower tax revenues and higher deficits and a desire for a cushion before the next crisis) and more recently pausing rate hikes as the benefits of tax cuts wane and the trade war escalates (something akin to tighter fiscal policy without the explicit tax hike). How these interactions play out over the next several years will determine what path the Fed takes, raising rates to historical norms or keeping rates subdued for longer.

While it is always dangerous to make predictions, I would venture to say that the pressure on the Fed will overwhelm good policy making and make it that much more difficult for the Fed to keep policy stable. This is likely to lead to higher debt levels, lower interest rates for longer periods followed by bouts of volatility and ultimately debt crises in the long-term (that's how these episodes always end). It is like two parents, one permissive and one who disciplines: at some point even the disciplined parent throws in the towel and lets the kids have what they want. The fiscal authorities (in my example, both Congress and executive branch with the markets as cheerleader) want expansion at all cost to achieve growth rates that are not realistic. How the Fed faces down these challenges will, in no small part, be determined by the personalities (and physical stature) of the board and the chairman. In this light it is a relief that the kibosh has been put on the rumored nominations of Herman Cane and Stephen Moore, two of the worst nominations ever and noted sycophants to Trump. No matter whether a president is a Republican or a Democrat, an independent central bank is a worthy aim and investors, market commentators and policymakers would do well to look at other solutions to generating growth: education, infrastructure and investment, increasing productivity, healthcare and tackling growing monopolies or the opioid crisis to name a few. That said, what's the big problem with the economy we have: 3% growth, sub 4% unemployment and sub 2% inflation. You can't always get what you want, but if you try, sometimes you might find, you get what you need.

Kindest regards,

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President

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