Perkins
—JANUS HENDERSON—

CIO OUTLOOK

UNCOMMON VALUE℠

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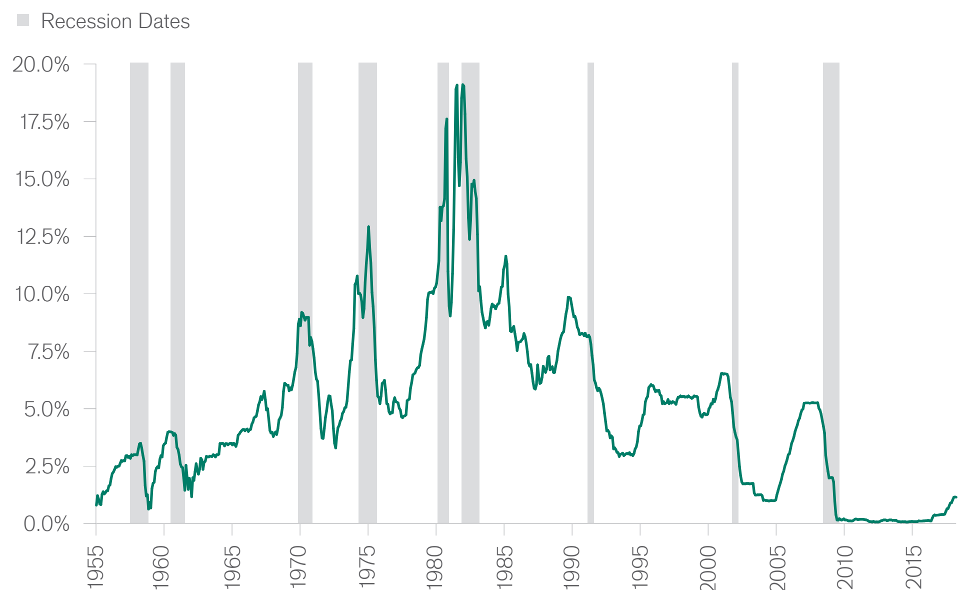
YOU DON'T KNOW HOW IT FEELS

Rock legend Tom Petty – a favorite in our household – passed away this fall and we've since found ourselves listening to his music a bit more often. His 1994 hit "You Don't Know How It Feels" (the one with the harmonica solo) seems to me to be about the role of people in our lives. Evoking a particularly low feeling after being dumped, Petty sings, "And turn the radio loud, I'm too alone to be proud." Especially when disappointment is new in nature – think breaking up with your first "true" love – the ensuing emotional low can be very low indeed. This is true in investing as well. When you've grown to count on something and then eventually it is no longer there, well, the downside can be dramatic, as anyone who experienced the 2000s housing bust can attest.

One thing financial markets have grown to count on over the years is the so-called "central bank put." Originally it was the "Greenspan put," often dated to the U.S. stock market crash in October 1987. But really, the maestro's approach – to cut rates and provide liquidity in the event of a market crisis – has been the way of Federal Reserve monetary policy for quite a long time. It is a global phenomenon, too, and one which is worrisome today. In a recent paper, Harvard economics professor Kenneth Rogoff writes that "with today's ultra-low policy interest rates – inching up in the United States and still slightly negative in the eurozone and Japan – it is sobering to ask what major central banks will do should another major prolonged global recession come anytime soon. During nine recessions since the mid-1950s, the U.S. Federal Reserve has cut its policy interest rate by an average of 5.5 percentage points (emphasis added). There is hardly room for that now, or into the foreseeable future."[1] In other words, when the next recession comes the world's central bankers' previous go-to policy may not be an option. Do they know how it will feel? Do investors?

U.S. EFFECTIVE FEDERAL FUNDS RATE
07/01/1955 - 09/01/2017



Source: Board of Governors of the Federal Reserve System (U.S.). fred.stlouisfed.org

"Our analysis generally suggests cyclical areas of the market are rapidly becoming less attractive ... with gaping downside scenarios."

All of this is particularly relevant when considering the prospects of the most economically sensitive sectors, which have been surging of late. The MSCI World Index has gained 19% over the past year, and many cyclical sectors have led the way: financials (+34%), technology (+28%), materials (+24%) and industrials (+22%). There are reasons for the excitement, naturally, including improved GDP readings across much of the world, potential corporate tax rate cuts in the U.S., and that little blip higher in the chart showing the Federal Funds Rate, among others. The economic sensitivity of these companies works both ways, though. What would happen to earnings in the event of a downturn? Is the balance sheet strong enough to endure weak end markets? To what extent would (now elevated) valuation multiples compress? These questions are old standbys, especially for the most cyclical fare. But to the list we should now add: What will happen to earnings, balance sheets and valuation multiples for cyclical companies *in the event central banks cannot jolt the economy out of a downturn*? How will it *feel* to own those stocks if the central bank support we've all grown accustomed to is no longer (as) effective? Not good, in all likelihood. Our analysis generally suggests cyclical areas of the market are rapidly becoming less attractive from a reward/risk perspective, with gaping downside scenarios.

Perkins' analysts and portfolio managers continue our search for bargains – generally defined as stocks with limited downside potential but attractive long-term upside potential – even though such asymmetric reward/risk ratios have become very rare amid the strong bull market. We're finding interesting ideas in both stable companies (often favoring their pricing power, persistent demand, reasonable valuations and downside scenarios, which we believe are relatively undramatic) and, yes, even some of those cyclical companies (typically predicated on competitive positions and balance sheets that we think can endure current headwinds). In addition, we increasingly favor a third category: the eclectic. Being less mainstream may also mean being less exposed to general bullishness and the potential reversal of that bullishness. Eclectic also holds the potential to strengthen a portfolio's diversification. As the market becomes increasingly unattractive from a reward/risk standpoint we want our portfolios to look less like the market/benchmarks.

So much of investing is in the feelings. Today's high stock and bond prices sit uncomfortably with the seeming inability of monetary policy to be much more supportive than it already is. Stated differently, the central bank put looks increasingly overpriced. Investors would do well to consider this developing weakness, and take action within their equity portfolios prior to any economic or other wobbles in the financial markets. Should the market ever reconsider its bullishness, we believe defensive positioning will be well rewarded.

Thank you for your investment with Perkins Investment Management.

Gregory Kolb
Chief Investment Officer,
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1. Rogoff, Kenneth S. 2017. "Dealing with Monetary Paralysis at the Zero Bound." Journal of

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No investment strategy can ensure a profit or eliminate the risk of loss.

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MSCI World Index^{SM} reflects the equity market performance of global developed markets.

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