ARX
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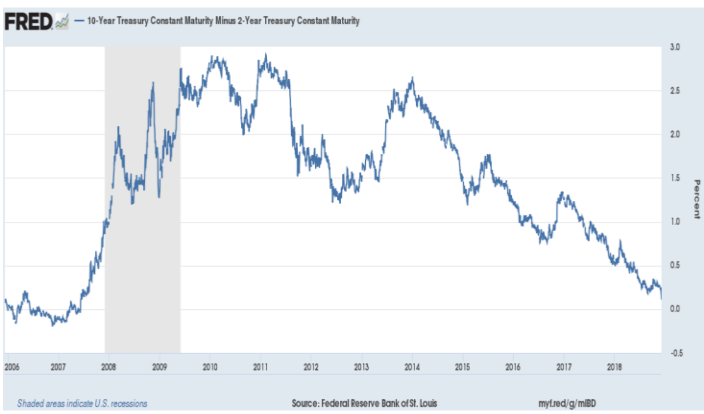
NOVEMBER 2018 MARKET COMMENTARY *"The High Road"*

After experiencing their worst month since the Financial Crisis, US equities posted modest gains in November. It didn't feel good, however, as elevated levels of volatility persisted throughout the month as investors finally seemed to acknowledge the bull market wouldn't last forever. Key to this market action is something we've been writing about all year – the Federal Reserve's program of removing historical levels of accommodation by raising interest rates and reversing its massive Quantitative Easing program implemented during the crisis.

Federal Reserve Chairman Powell finds himself more and more in the spotlight, as President Trump and market pundits have vocally pushed back against the Fed's program of rate hikes. A key goal of the Fed is to raise rates to a level that fosters full employment while keeping inflation in check – an elusive level known as "neutral". Bonds sold off early in the month as Powell indicated several more rate hikes were in store, but rallied late in the month as he seemed to cave to pressure and softened his stance by suggesting that rates are now "just below neutral". While ARX still believes the Fed will ultimately raise rates to around 3% before pausing next summer, the ride there should now be more interesting.



The yield curve is at its flattest since just before the Financial Crisis

After a parallel push higher in rates during October, US Government bond yields drifted lower and the yield curve resumed flattening in November. The front end of the curve remained anchored, reflecting expectations for another rate hike December 19th, but longer maturities rallied significantly as yields declined 10 to 15 basis points. Yield curve flattening is a theme we are keenly focusing on as an inversion of the yield curve, where short-term bonds offer higher yields than their longer counterparts, has historically been an almost perfect predictor of recession. As I write this in the first week of December, the yield spread between 2 and 5 year US Treasuries has inverted, and the spread between the 2 and 10-year is at its narrowest level since just before the Financial Crisis…and stocks have gotten hammered.

Outlook:

We are really at the crossroads of a battle between the removal of Fed-driven liquidity vs. a currently robust economy. Markets are forward looking and investors are rightfully concerned that the bull market can't continue as the Fed is pulling the punch bowl away. The Fed historically wins and the amount of stimulus being unwound this time is of historic proportions, so we believe this equity selloff has much further to go. What's more, nobody really knows how the massive shift toward passive index products and ETFs will impact markets once investor "fear" starts to take hold in earnest. Our worst-case scenario is that no natural buyer will emerge once the algorithms all start selling - remember, the big banks are no longer the liquidity provider of last resort – meaning the door will slam shut just as most investors rush toward the exit.

You know what's safe in that type of environment? Bonds – especially shorter maturities which now offer very attractive yields with virtually no interest rate risk.

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Market Snapshot:

	10/31/18	11/30/18	Change
Fed Funds Target Rate	2.00-2.25%	2.00-2.25%	UNCH
3-month US Treasury	2.34	2.36	+2
2-year US Treasury	2.88	2.80	-8
10-year US Treasury	3.15	3.00	-15
30-year US Treasury	3.39	3.30	-9
S&P 500	2,712	2,760	+1.8%
Stock Mkt Volatility (VIX)	21.23	18.07	-3.16
US Dollar (DXY)	97.08	97.22	UNCH
Oil	64.95	50.70	-21.9%
Gold	1,217	1,228	+0.9%
Bitcoin	6,300	3,934	-37.6%

ARX Spotify Playlist: **"The High Road" by Broken Bells**

In this month when we celebrate veterans, the passing of President George H.W. Bush reminds us that it is still possible to take the high road and serve with honor, regardless of political orientation.

About ARX Management:

Established in 2011 by professionals with direct experience in complex litigation and institutional investment management, ARX offers an unmatched mix of capabilities relevant to managing 1.468B Qualified Settlement Funds. Our expertise investing conservative capital preservation products is directly related to the management of institutional QSFs. Contact us today at arxadmin@arxmgmt.com to discuss a customized QSF for your settlement.