April 3, 2018

After a year of historically subdued stock price volatility and an uninterrupted stock market uptrend, the first quarter of 2018 provided a change of pace. Racing upward in January, the stock market advance ran head on into concerns about higher interest rates as the 10-year U.S. Treasury bond yield broke out of a four-year trading range. The result was minor negative returns for New West Investment clients and for all the indices I use for comparison on quarterly reports, except for cash, which provided a positive return and out performed the stock market for the first time in nine quarters.

There are four major factors that contributed to the increase in interest rates. First is the continuation of the Federal Reserve Board's normalization of rates, lifting fed funds 0.25% in March after three similar moves last year and forecasting two or three more hikes this year, with more expected in 2019. Second, the Fed is reducing its reinvestment in U.S. Treasury bonds and federally backed mortgages as it reverses crisis era monetary policy, reducing demand for bonds and mortgages. Third, the U.S. Treasury is issuing an increasing amount of debt to finance the burgeoning budget deficit, having to pay higher rates to attract buyers. Lastly, unemployment seems to have finally decreased to a level that requires an increase in wages, adding to inflation expectations and the premium built into interest rate structure.

Why does a tick up in interest rates depress all asset prices? Let's start with a 10-year U.S. Treasury bond. When the interest rate on the 10-year increased from 2.4% at year-end to 2.9% a month and a half later, the price of the bond declined 4.3%. This adjusts for a 2.4% interest rate being less attractive in a 2.9% world over the next nine and three quarters years. The utility stock index, which is a bond surrogate for investors, dropped 5.7% over the same time frame.

Looking at real estate, the move from 4.0% to 4.5% on a 30 year fixed mortgage during the quarter increased the monthly payment for a $300,000 home loan from $1,432 to $1,520, or by 6.1%. Consider this in an environment where wages are only advancing 2% annually for those that are employed. The real estate stock index weakened 7.5% over the same period.

Finally a review of stock prices suggests the higher discount rate (increased interest rate) would decrease the value of a company, as the stream of income and dividends is relatively less appealing, all thing being equal. Of course, the earnings and dividends of companies are always changing so the connection is not perfect, which explains why the S&P 500 stock index declined only 0.8% in the first quarter.

Since investors are forward looking and interest rates and inflation are projected to rise over the next couple of years according to forecasts published by the Federal Reserve Board, a headwind has been created for asset prices. The good news is higher interest rates are largely beneficial to New West Investment clients as savers and investors. I have been purchasing 1-year U.S. Treasury bonds in accounts and getting over 2.0% return, a vast improvement over the 0.1% rate available in 2012. The Federal Reserve Board indicates rates could approach 3.0% by 2019.

As mentioned above, there was also a large surge in stock price volatility during the first quarter. Low interest rates, elevated valuations, automated computer trading, new financial products and evolving media probably means that periodic sharp, rapid price declines will likely be a feature of the stock market for the near future at least. This has been a disturbing aspect of investing for New West Investment clients and myself.

In order to have the potential for reasonable returns over the long term, participation in the stock market is a must. Reducing the emotional costs requires the use of balanced, diversified portfolios, adjusting expectations, distancing oneself from the constant news cycle and sticking to a pre-established investment plan. In fact, we may be able to benefit from the volatility as opposed to reacting and selling into low stock prices.

As for the current market climate, with robust employment, few signs of impending recession and growing corporate earnings, stocks will still likely provide a positive return over the next year or two. However the positives are challenged by the drag of higher interest rates mentioned above and the increased uncertainty from the controversial policy and approach emanating from the current administration.

As always, I appreciate your allowing New West Investment to manage your investments. Enclosed please find your first quarter portfolio report. As required by regulatory authorities, New West Investment Management, Inc. has updated Form ADV Parts 1 and 2, A & B for year-end 2017; there are no material changes to report. You can review the complete current version at www.adviserinfo.sec.gov or contact our office, if you prefer that we send you a copy.

Best regards,

Peter V. Hedberg