Morris Capital Advisors, LLC

Investment Commentary
September 30, 2019

What, Me Worry?

Those of us "of a certain age" will immediately recognize that phrase. It is the tag line for Alfred E. Neumann, the gapped tooth mascot of MAD Magazine. He graced the cover of almost every issue, often superimposed on celebrities or targets of the satire magazine's articles. MAD Magazine ceased publication of new issues recently, a victim of online media, changing demographics, and rising production costs. The magazine survived for 67 years, published more than 550 issues, and didn't accept advertising until 2001. Circulation peaked at 2.1 million copies in 1974, but was down to 150,000 by the end. It was a good run, and they left a legacy of great satire.

A satirical "What, me worry?" might be an appropriate analytical basis for the financial markets these days. While returns were modestly positive for both the stock and bond markets this quarter, stocks pushed to new highs in July and interest rates pushed towards new lows. From January through September 2019, stocks, as measured by the S&P 500 index, are up more that 20%, while bonds, as measured by the Bloomberg Barclay Intermediate Treasury index, were up 5.2%. That is impressive considering just nine months ago we were at the end of a disastrous quarter that pushed stock returns into negative territory for 2018. The move by stocks towards new highs this year is concerning, however, given valuation premiums and external risk factors.

In addition to valuation measures in the upper range of historical norms, domestic investors worried about the direction of Fed policy and slowing economic growth in the US. After roiling the markets last year with talk about "Quantitative Tightening on autopilot" the Fed seemed to become more sensitive to market sentiment. Responding to anecdotal indications of a slowdown in economic growth, and the inversion of the Treasury yield curve, the Fed moved to cut rates and end its Quantitative Tightening at the FOMC meeting in August. But in comments afterward, Chairman Powell raised uncertainty about further Fed action, contributing to a stock pullback. Stocks rebounded when the Fed cut rates again in September and clearly signaled its intent to remain in an accommodative mode. The need for accommodation became apparent as rates on overnight repurchase agreements ("repos") spiked late in the quarter. While initially blamed on heightened liquidity needs for quarterly tax payments, the dislocation in repo rates persisted, indicating unusual stress for liquidity to facilitate bank funding needs. By quarter-end the Fed was forced to inject significant liquidity into the system in what some commentators are referring to as another round of "quantitative easing".

On the global front, slowing growth in China and the European Union created additional uncertainty. Growth in China clearly slowed over the past few years, compounded by trade tensions and recent decisions by several US companies to actively shift production capacity from China to the US or more favorable nations. Growth in the European Union remains anemic, even in Germany, once the driver of EU growth. The European Central Bank reinitiated quantitative easing as the term of Mario Draghi came to an end, but there are mounting concerns that the EU has limited options to expand its monetary stimulus. With interest rates already in negative territory further interest rate reductions may prove to be counter-productive.

Market moves such as we have seen this year often contribute to complacency. Investors, relying on the Fed as a market backstop, assume additional risk in pursuit of higher yields and stock market returns. That risk translates to higher volatility as markets become overextended at the top. Successive rounds of liquidity injections over the past several years have contributed to concerns about the capacity and effectiveness of ongoing Fed market interventions, while the recent liquidity crisis in the repo bank funding markets underscores the potential that continued market interventions may have unintended consequences. Over-reliance on the Fed may prove disappointing if the Fed is not ready, or able, to provide stability when markets falter.

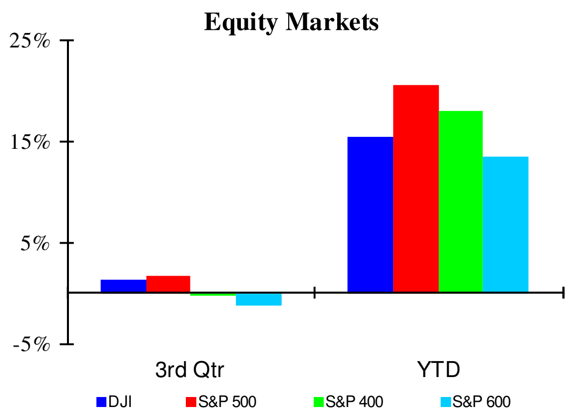
As the stock market rebounded late in the quarter we observed a shift in market leadership . Since the financial crisis, a period corresponding to repeated Fed market interventions, stocks with growth characteristics have outperformed stocks with value characteristics on a consistent basis. That relationship reversed in September, indicating the possibility that the impact of additional Fed liquidity injections may be limited. We have always believed that valuation matters in stock selection, and sense that the markets may be turning in our direction. We have confidence that our focus on companies with strong fundamental valuations, solid balance sheets, reasonable debt levels, and the ability to remain profitable in difficult times will be rewarded. While we worry about the ability of the markets to continue their upward move, we believe that the consistent application of our valuation-based process provides the best guidance for investing in these uncertain markets.

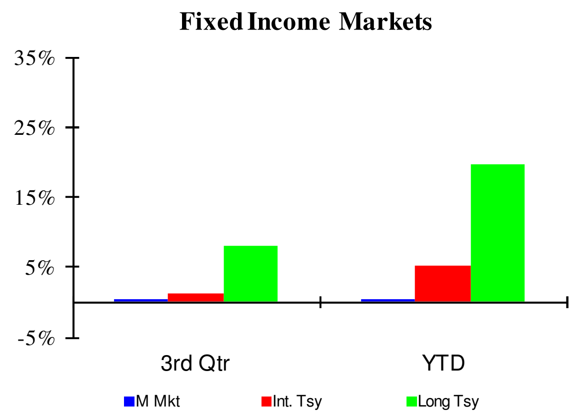
Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
September 30, 2019





Stock markets traded in a fairly narrow range during July 2019, as earnings reports were fairly uneventful. Markets began to sell off in early August, in reaction to sharp moves in the US Treasury market. The Federal Reserve in its August meeting supplied what investors were looking for by cutting rates 25 basis points and announcing an early end to its Quantitative Tightening policy. However, the press conference given by Chairman Powell was viewed as insufficiently dovish, driving long-dated treasury yields down and punishing economically sensitive stocks. Investors apparently feared that Fed officials did not fully appreciate the risks presented by a continued slowdown in global manufacturing that was being exacerbated by an intensifying trade war.

By the middle of September this market action had completely reversed itself, owing to better-than-expected retail sales data, hopes for renewed progress in trade negotiations, and a technical policy change made by the European Central Bank that had the effect of making interest rates less negative on the continent. By quarter's end, however, equity markets began to trade off again as economic anxiety levels increased.

For the quarter, large cap stocks posted very modest gains, and small cap stocks declined slightly. Beneath the surface, however, momentum and value-oriented securities showed showed unusually sharp relative performance swings, with value factors outperforming sharply in the second half of the quarter for the first time in many months.

The U.S. Treasury yield curve began 2019's third quarter by trading quietly for the month of July. That changed dramatically in early August, when the Fed delivered on anticipated rate cuts and announced an early end to its policy of slowly reducing the size of its balance sheet. However, at his post-meeting press conference, gave the impression that the Fed was almost finished with interest rate cutting program. Moreover, he seemed unresponsive to apparent liquidity problems in the market for very short-term borrowing.

Investors reacted very strongly, driving yields on long-dated paper to near-record lows by month end. Investors feared that the Fed was slow in reacting to mounting weakness internationally, and did not sufficiently understand the implications of its policy of removing bank reserves from the system.

In early September these dramatic moves in yields sharply reversed, as data on domestic consumer spending suggested that perhaps fears of near-term recession were overblown. At the same time, the European Central Bank introduced technical changes to its bank reserve system that appeared to indicate that the lower bound on negative yields had been reached, which in turn caused U.S. Treasury investors to also reassess how low rates might go. By late September the Fed finally responded to mounting pressure in the repurchase agreement by engaging in open market operations for the first time in a decade, and longer yields resumed their decline. On balance long-term paper delivered strongly positive total returns, far outpacing short maturities.