Monthly Update **August 2017**

The QT Quandary

Mark R. Hoffman
CEO, Principal

Since 2008, we have all had to familiarize ourselves with various forms of Quantitative Easing (QE). Following the financial crisis of 2008-09, the Federal Reserve first dropped the Federal Funds Rate from ~5% to ~0% over an 18-month stretch. Then, to keep rates low, inject liquidity into the financial system and remove toxic assets from balance sheets, the Fed began purchasing trillions of dollars of Treasuries and mortgage-backed securities. The buying stopped in 2014, but left the Fed with a $4.5 trillion balance sheet. Whether QE did anything constructive for the economy is a topic for another article. But what we can say is A) the world did not end, B) at some point, the Fed knew it had to reverse course, and C) no one knows exactly what will happen when they do, as this much and this form of QE is a completely new experiment.

Now we have to familiarize ourselves with Quantitative Tightening (QT). Theoretically, the Fed would tighten when the economy was overheated, we had full employment and inflation was high. That's where we are, right? The Q2 2017 GDP growth rate has "rocketed up" to 2.6%, the Bureau of Labor Statistics tells us that unemployment is ~4.5% (which would be a low number if we believed it) and inflation is hovering at ~1.5%. Ugh. But at some point the Fed has to tighten – it simply needs bullets in the chamber when the next recession hits (and it will hit). Enter QT.

In December 2015, the Fed hiked rates for the first time in a decade and has done it three more times since. Now there is serious talk of shrinking the balance sheet. In theory, great! But how will they do it and what are the implications? The current thought is that it will be very slow and (hopefully) uneventful. Philadelphia Fed President Patrick Harker described the planned approach as "the policy equivalent of watching paint dry." Indications are that the plan will start with a drawdown of ~$10 billion/month by allowing older bonds to mature and not replacing them with newer ones. (Why the paint drying analogy? At that rate, the balance sheet would be worked off in 37.5 years!) The drawdown rate would then be increased gradually to ~$50 billion/month "as conditions warrant," by selling bonds off the balance sheet back into the market. What happens then? I may not remember everything from my ECON 101 class in undergrad, but I do remember that increasing supply will make bond prices fall (and yields rise) to attract buyers. How much? We've seen estimates ranging from 5-10 basis points for every $100 billion released back into the open market. At $10 billion/month, the numbers aren't large, but at $50 billion/month, that's 30-60 bps/year.

All of this is likely to occur when the Fed has been directly raising rates ~50 bps/year (4 rate hikes in 2 years) and Federal deficits are estimated to be $700-800 billion/year (meaning that the Fed will be selling $700-800 billion/year of Treasuries to finance the deficit). And the $700-800 billion deficits do not include any potential tax cuts, spending increases or recessions! Can a US economy limping along at 2-2.5% absorb all of that? Hence the QT Quandary. If a recession hits, you need ammunition. But does the cost of acquiring that ammunition trigger a recession?

Equity-heavy portfolios have loved the QE phase of ultra-low interest rates. Our guess is that those same portfolios will be significantly less enamored with the QT phase or the recession that the QT phase is trying to prepare for. Difficult investment climates demand that portfolios carry a very different risk posture – one that includes asset classes beyond traditional stocks and bonds. Our investment philosophy (and the philosophies of the largest, most successful university endowments) relentlessly stresses diversifying strategies to better balance portfolio risk.

Mark is a co-founder of Lanier Asset Management and serves as its Chief Executive Officer. Prior to founding Lanier, he was a partner at The Boston Consulting Group. Mark is an honors graduate of The University of North Carolina at Chapel Hill with a BA in Economics, and holds an MBA from The Harvard Business School.

Key Points From Our Investment Meeting – 8/10/17

Macro Viewpoint

- Geopolitical risk rises as North Korea continues to threaten the US and others of further nuclear actions.
- Fed raises rates again and considers a more gradual approach. Going forward, they are also considering reducing the balance sheet ($4.5 Trillion) by $10-50 Billion per month as securities mature.
- We are entering the 9th year in this economic cycle without a bear market. Be careful and consider low to negatively correlated assets.

Asset Class Comments

- Momentum continues to push the US equity markets higher. We guess the Gundlach, Dalio, Gartman, etc. models are also wrong.
- The 10-year treasury yield is back to 2.2%. Consider shortening duration and reducing credit risk. Either the treasury market or the stock market is wrong. We'll bet on the treasury market.
- Developed foreign and emerging equity markets have found their footing as investors look outside the US for gains.

Performance Update

	Investment Vehicle	Total Return (%)							
						Annualized			
		July	QTD	YTD	1-Year	3-Year	5-Year	7-Year	10-Year
TRADITIONAL ASSETS									
Cash									
Vanguard Reserve Prime Money Market		0.0%	0.0%	0.1%	0.4%	0.3%	0.2%	0.2%	0.7%
Fixed Income									
Domestic (Barclays US Agg)		0.4%	0.4%	2.8%	-0.7%	2.7%	1.9%	3.0%	4.4%
Vanguard Total Bond Market	VBMFX	0.4%	0.4%	2.7%	-0.8%	2.5%	1.8%	2.9%	4.3%
Eaton Vance Floating Rate	EIBLX	0.6%	0.6%	3.0%	7.5%	3.8%	4.1%	4.7%	4.1%
US Preferred Stock ETF	PFF	0.7%	0.7%	8.0%	2.6%	5.6%	5.9%	6.2%	4.8%
High Yield (Barclays US Corp HY)		1.0%	1.0%	5.6%	10.1%	4.8%	3.2%	4.4%	5.8%
Short Term High Yield	SJNK	0.7%	0.7%	4.8%	10.1%	-	-	-	-
Equities									
Domestic Large Cap (S&P 500 TR)		2.1%	2.1%	11.5%	16.0%	10.8%	14.7%	14.6%	7.7%
S&P Equal Weight	RSP	1.6%	1.6%	9.5%	14.0%	9.5%	15.4%	14.5%	8.4%
Domestic Mid Cap (S&P 400 TR)		0.9%	0.9%	6.9%	14.7%	10.2%	15.0%	14.3%	9.1%
Vanguard Mid-Cap ETF	VO	1.8%	1.8%	11.0%	14.0%	9.6%	15.2%	14.3%	8.2%
Domestic Small Cap (S&P 600 TR)		1.0%	1.0%	3.8%	17.6%	11.5%	15.7%	15.2%	9.0%
Vanguard Small-Cap ETF	VB	1.2%	1.2%	6.9%	14.7%	9.1%	14.6%	14.1%	8.6%
Developed Intl. (MSCI EAFE)		2.9%	2.9%	17.1%	17.7%	2.7%	9.0%	6.9%	1.4%
MSCI EAFE	EFA	2.7%	2.7%	17.8%	18.4%	2.9%	9.1%	6.8%	1.5%
Emerging Intl. (MSCI EM)		6.0%	6.0%	25.5%	24.9%	2.4%	4.7%	3.5%	2.0%
Vanguard FTSE Emerging Markets ETF	VWO	5.3%	5.3%	21.2%	19.1%	2.1%	4.4%	3.0%	1.7%
Real Assets									
Real Estate (FTSE NAREIT US REIT)		1.2%	1.2%	6.0%	-1.9%	8.4%	9.2%	11.7%	6.8%
Mortgage Real Estate	REM	0.3%	0.3%	15.5%	20.0%	9.3%	7.4%	8.6%	-
REIT ETF	VNQ	1.2%	1.2%	3.8%	-4.7%	8.5%	9.2%	11.8%	7.2%
Commodities (Thomson Reuters/Jefferies CRB Index)		6.5%	6.5%	-4.8%	10.2%	-17.5%	-11.2%	-7.0%	-6.5%
DBC	DBC	4.1%	4.1%	-5.1%	5.3%	-17.2%	-13.2%	-6.2%	-5.4%
Gold	GLD	2.3%	2.3%	10.2%	-6.4%	1.9%	-4.4%	1.0%	7.0%
DIVERSIFYING STRATEGIES									
Hedge Funds									
HFRI WCI		1.2%	1.2%	5.1%	7.4%	3.3%	5.0%	4.4%	3.1%
INFINITY*	OCEAN	0.9%	0.8%	2.2%	6.3%	4.9%	7.5%	7.3%	6.3%
Boston Partners Long/Short Equity	BPLEX	2.0%	2.0%	-2.2%	7.6%	3.6%	6.8%	9.2%	10.7%
QIM Tactical Aggressive*	QIM TA	-7.4%	-7.4%	34.3%	20.6%	21.0%	14.8%	16.3%	19.5%
Citadel*	CITADEL	2.3%	2.3%	6.8%	14.0%	10.7%	14.2%	15.3%	10.6%
Millennium*	MILLENN	0.9%	0.9%	3.3%	6.8%	8.6%	9.1%	9.2%	8.2%
Hedge Fund Plus*	HF+	-0.6%	-0.6%	7.5%	10.0%	8.4%	9.3%	10.0%	10.2%
Boston Partners Global Long/Short	BGLSX	0.9%	0.9%	3.2%	4.9%	3.3%	5.6%	4.8%	3.4%
Managed Futures									
Barclays CTA Index		-1.5%	-1.5%	-1.0%	1.2%	3.1%	1.0%	1.6%	3.0%
WINTON*	WINTON	-0.5%	-0.5%	-4.3%	-10.6%	-1.2%	-1.8%	-0.5%	1.5%
QIM*	QIM	-0.2%	-0.2%	2.8%	8.3%	7.5%	0.3%	1.5%	3.3%
AQR Managed Futures Strategy	AQMNX	0.1%	0.1%	-5.5%	-15.7%	0.6%	1.0%	1.4%	2.7%
Natixis ASG Managed Futures Strategy	ASFYX	2.9%	2.9%	0.3%	-11.5%	2.8%	4.0%	3.4%	4.3%

= Benchmarks
= Lanier Selections

* For Accredited Investors

Our Team

Mark R. Hoffman
CEO, Principal

Junius V. (Trip) Beaver, III
Co-Chief Investment Officer, Principal

Carl W. Hafele, CFA, CPA
Co-Chief Investment Officer, Principal

John E. Thompson
Director, Private Client Group

Dr. Daniel L. Bauer
Financial Consultant

Sara B. Thomas, JD, CPA
Financial Consultant

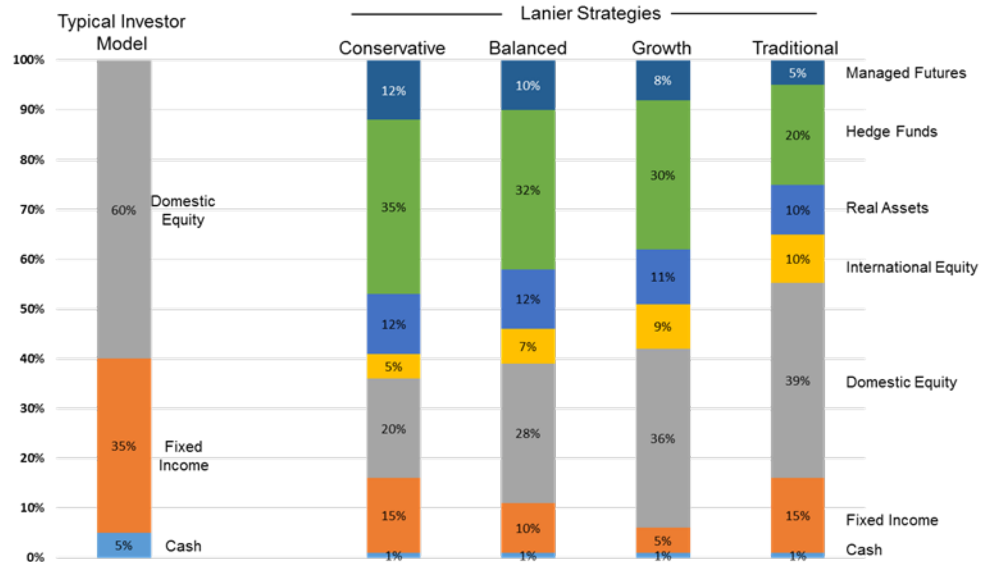
Deidre M. Durbin
Chief Compliance Officer

Stephanie E. Milby
Investment Associate

Building Confidence and Security in Your Financial Future

Our Approach

At Lanier, we believe that portfolios designed to deliver superior performance and lower correlation with the overall markets must decrease reliance on stocks and bonds and be complemented with a set of diversifying strategies and alternatives



Each of our clients has a unique set of needs (based on age, risk tolerance, income need, etc.) and an asset allocation model designed specifically to meet those needs. Consequently, actual client investment models can and do vary from the allocation percentages listed above.

Lanier Asset Management is an independent Registered Investment Advisory firm. Our mission: ***To Build Confidence and Security in our Clients' Financial Future***. We use an open architecture investment structure to combine the best of proprietary and independent investment strategies. At Lanier, we deliver superior service and performance to our clients as a result of four distinguishing elements:

- **People**: we are an independent firm, providing objective advice from experienced investment professionals working in your best interests
- **Investment Philosophy**: we seek to smooth investment returns, providing superior investment performance and a significantly lower correlation to the overall market
  - Focus on projected returns rather than historic for all asset classes
  - Similar to the largest U.S. endowments
- **Investment Process**: combine active and passive management in traditional asset classes; complement with diversifying strategies/ alternatives
- **Conviction**: we believe in our approach – this is how we invest our own money

Past performance is no guarantee of future results. Investing entails risk, including possible loss of some or all principal. Historical performance results for investment indices and/or categories have been provided for general comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges. It should not be assumed that your account holdings correspond directly to any comparative indices.

Lanier Asset Management, LLC ("Lanier") is an SEC registered investment adviser located in Louisville, Kentucky. The firm's CRD number is 150888. Certain Representatives of Lanier hold Series 7, 31, 63, and 65 Securities Licenses. Securities offered through Comprehensive Asset Management and Servicing, Inc., Member FINRA/SIPC/MSRB. 2001 Route 46, Ste. 506, Parsippany, NJ 07054.