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Disciplina Capital Management
September 2017 Quarterly Update

"If a tree falls in the forest and no one is around. Does it make a sound?"– George Berkeley

Third Quarter 2017 Update

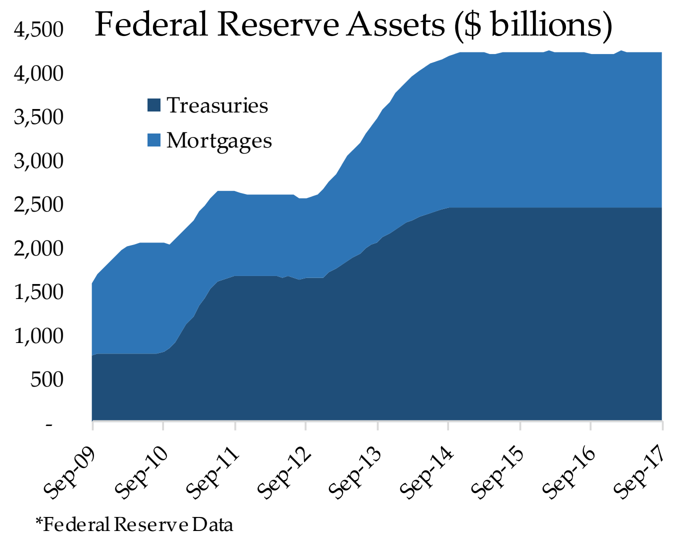
Berkeley, an Anglican bishop and philosopher, posed this question that anchored his immaterialism philosophy - denial that material things exist. With three quarters of the year behind us, 2017 is setting up to post very impressive returns across the spectrum in global equity markets. U.S., European and Asian indices are up over 10% and emerging markets are lapping the U.S. with a return of 28%. Credit markets in the U.S. and Europe have also managed to generate respectable mid to high single digit returns. While we maintain a generally favorable view on the global macro outlook, it makes sense to ask ourselves what risks might be on the horizon with valuations in many asset classes approaching or breaching fair value.

The twenty-four hour news cycle provides investors with an overwhelming amount of noise. While each story is important, they tend to muddy the waters when it comes to deciding what is likely to impact an investment portfolio. Coverage of North Korean missile launches, a Catalonian separatist vote, healthcare law votes (or lack thereof), tax reform, Trump tweets, hurricanes, floods, earthquakes, wildfires, and Russia allegedly meddling in everything but last night's lotto drawing can seem to leave investors on anything but solid ground. These news stories distract investor's attention from what may have a meaningful impact on their portfolio.

Cutting through the noise and focusing on what matters is something we believe Disciplina has excelled at as a team over the years. As has been the case for the last several years, much of what matters still relates to central banks. Specifically, the U.S. Federal Reserve, which has now started gradually moving towards a more restrictive monetary policy and may have significant changes in the composition of its board in the upcoming year.

Getting Back to "Normal"

In addition to raising rates, the Fed has now finally started the process of its balance sheet normalization program. From 2009 to 2014, the Fed dramatically increased the size of its balance sheet through large scale asset purchases of treasury and mortgage backed securities (MBS). These extreme measures were deemed necessary as short-term rates approached zero and financial markets suffered from the aftermath of the global financial crisis.



So enough with the macro mumbo jumbo, what exactly is going to happen here? Starting this month, the Fed will no longer reinvest the full amount of Treasury Notes and mortgages as they mature. Since the Fed is taking a very slow and gradual approach, most economists estimate that their balance sheet will not "normalize" until late 2020 to 2021. The definition of "normal" is subjective with the Fed stating that the size of the balance sheet will "reflect the banking system's demand for reserve balances and the Committee's decisions about how to implement monetary policy most efficiently and effectively in the future". In short,

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we'll stop when it feels about right. We estimate a 10% reduction by the end of 2018, and possibly a 50% reduction into 2021. Even at a 50% reduction, the Fed's balance sheet would be about three times its December 2007 level.

Changing of the Guard?

The changing composition of the Federal Reserve board next year may be another source of central banking volatility. Of the voting members of the FOMC, three spots remain to be filled, four if we include Chair Yellen. The remaining members with voting responsibilities in 2018 are fairly balanced amongst doves and hawks. Fed Chair Yellen holds a dovish view and may or may not return after her tenure expires in early 2018.

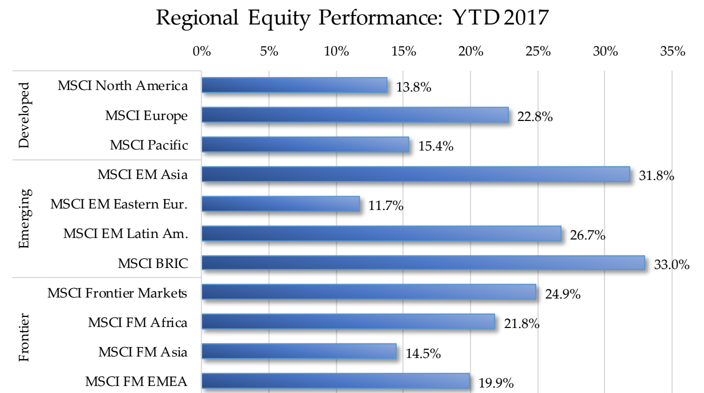
Nominations for open seats will be made by a President who, on the campaign trail, accused the central bank of "doing political things" by keeping interest rates low for too long. As we write, the leading candidate appears to be current Fed governor Jerome Powell from the dovish camp and is seen as unlikely to shake up the markets.

From the hawkish camp are Stanford economist John Taylor and former Fed governor, Kevin Warsh. Despite Powell leading the charge, the President has been known to act unpredictably, and thus Warsh could be a front-runner for the nomination. This is based upon President Trump's tendency to go with the "friends & family" program when making major appointments. Mr. Warsh's father-in-law is Ronald Lauder, the President's close friend for decades. Nevertheless, Mr. Warsh does have legitimate experience on the Fed board, so his candidacy is not as much of a wild card. Warsh's comments have tilted towards the more hawkish side of monetary policy in the past, so his nomination and appointment may put upward pressure on U.S. rates. This would be offset by the fact that many international banks remain in easing mode and have rates much lower than the U.S.

Outside the U.S. market awaits the ECB's views on the size of their balance sheets and the prospects for rate hikes in the upcoming years. While our base case is for a benign market environment heading into 2018, the direction of centrals will continue to be a key area of focus for us as we look where the next pocket of volatility may come from.

Market Update

International and emerging market equities have propelled global equity markets to a 17.3% gain thus far in 2017. China's markets have almost doubled other emerging markets' gains, rising 42% while several other major emerging market country's markets are up over 24%. European markets have performed very well, with an overwhelming majority of developed and emerging European country markets up over 25% year-to-date.



As equity markets have led the charge, fixed income markets have fared well despite rising Fed Funds rates as the yield curve has flattened with short rates rising and long rates falling. The Bloomberg Barclays U.S. Aggregate has increased 3.1% thus far while long-treasury bonds have increased 6.0%.

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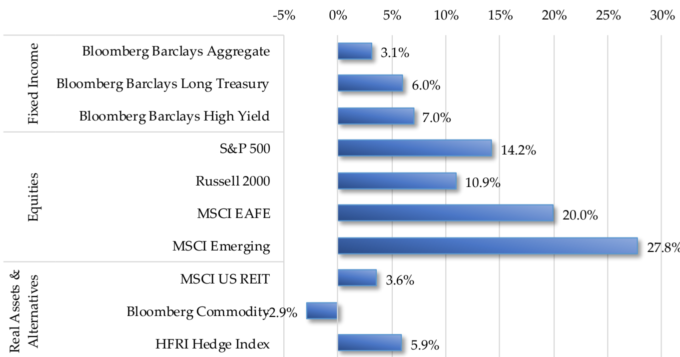
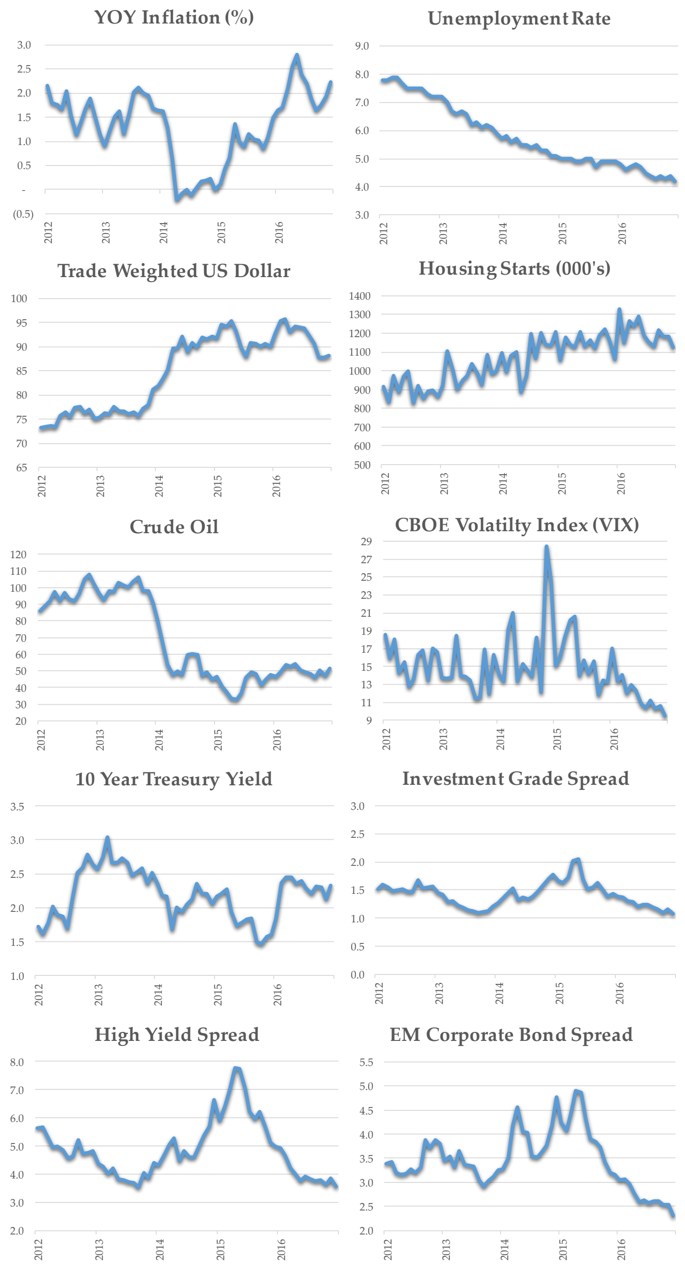


Real estate assets have had mixed results as returns on retail operations have fallen -11% to -15% YTD while other sectors have experienced double-digit returns such as Industrial (+18%), Infrastructure (+24%) and Data Centers (+28%). Commodities remain in negative territory as the energy complex fell -12.2% and most agricultural commodities fell. Ex-energy, the commodity market rose 1.7% year to date given both industrial and precious metals gaining ground and rising 13.1%.

Firm Update

As we continue to grow as a firm by deepening our existing client relationships and developing new prospects, we are pleased to announce the addition of Andrew Farmer with Pratt and Company, a third-party placement agency. Our team has known Andrew for over a decade. He previously worked at Earnest Partners and Integre Asset Management.



* Sources: BofA Merrill Lynch; US Departments of Labor, Commerce & Energy; CBOE; Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System

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