
John D. Gillespie
Portfolio Manager


Kevin R. O'Brien
Portfolio Manager


Jason A. Kish
Portfolio Manager

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Prospector Partners Quarterly Commentary

Current Market Environment

What a difference a year can make . . .

A year ago the stock market outlook was rather sanguine, which is not surprising after the S&P 500 posted a strong 21.8% gain for 2017. The consensus was for the record-setting bull market to continue notching gains on the heels of healthy economic growth, strong corporate earnings, a prolongation of the low interest rate environment relative to history, and the continuation of near-pristine credit quality. Looking back, these were cheery consensus conditions. The dramatic price appreciation of Bitcoin and related cryptocurrencies at the end of 2017 accurately reflected the market sentiment at the time.

Fast forward twelve months and conditions are different. The stock market bulls are quiet and a tone of elevated caution has taken hold of the market (not to mention that the Bitcoin bubble has 'popped' and sold off 80%). In Q1 2018, we outlined our case for a flattening yield curve going forward and the possibility of an inversion in the not so distant future. In Q4, we did see a brief inversion in certain portions of the curve and the 10-year / 2-year treasury rate spread ended the year at a meager 21bps (the spread started the year at 54bps). In our view the bond market has historically been a more reliable predictor of the future than the stock market. As such, concern about a recession appearing sometime in the next 18 months has increased markedly.

It's easy to arrive at a more guarded outlook on the market when one considers these factors: the negative impact from tariffs, deteriorating trade relations with China, a possible slowdown in global economic growth, concerns over peak margins, worries over future credit quality, a weakening Chinese economy, the uncertainty surrounding Brexit, a Fed perceived as not dovish enough, and concerns over the health of the housing sector. Yikes! In December 2018, we did briefly breach the

20% sell off threshold in the S&P 500 which most often technically defines a bear market. Revered ex-Fed Chairman Alan Greenspan declared the bull market over and that investors should prepare for the worst (though to our benefit his track record on these predictions is rather poor).

All this said, we are not sounding the recession horn just yet, nor are we necessarily expecting bear market conditions to persist for the full year 2019. Actually, we remain cautiously optimistic on the year ahead, however, we strive to position portfolios in a way to capture upside potential in the market, yet heavily protect the downside should a bear market scenario come to pass. In fact, should we be entering a period of market turmoil, this is a time where we believe the Prospector Partners approach to investing will especially shine.

Bank Sector Update

In 2018, the market had disdain for financial services stocks in general. Within the sector, bank stocks were the weakest sub group by far. S&P 500 banks finished the year down 16% while the S&P financials index finished down 13%. There were a few key reasons for this and all of which are perceived as potential headwinds for the sector going into 2019.

First off, while rate hikes are traditionally a good thing for banks (and we saw four in 2018), they were certainly not viewed as such last year. Typically, a rate hike allows banks to reprice loans in the short term and lag on deposit rates over the long term, thus capturing a higher net interest margin spread between what it receives on interest from loans versus what it pays out as interest to deposit holders. However, this year, banks experienced a meaningful ramp in deposit costs as both corporate and retail customers demanded higher deposit rates and refused to sit idle and accept a low rate relative to Fed Funds. As a result, banks have 'given up' a greater portion of the benefit from higher rates in the form of paying higher deposit rates to customers which has constrained earnings growth. These deposit pricing pressures remain a constant topic of focus with investors.

Additional rate hikes have also put pressure on the yield curve which flattened over the course of the year. In short, this puts more pressure on the net interest margin of banks which is another headwind to earnings. Recall that banks typically borrow on the short end of the curve and loan out at the long end, making a steeper curve preferable. Also, with an inversion realized in parts of the curve during the fourth quarter, some investors viewed this as a canary in a coal mine, i.e. a warning sign that a recession is just around the corner. For banks, a recession squeezes profits as credit quality deteriorates and loans turn sour. If this all seems bad enough, loan growth disappointed investors' expectations in 2018. Despite some encouraging data that loan growth is rebounding, investors are still concerned that deteriorating U.S.-China trade relations, global political uncertainty, recession fears, and slowing economic growth will temper loan growth expectations.

While the consensus outlook for the bank sector seems dire, we believe these fears are heavily discounted in current bank stock valuations. First off, while deposit costs have accelerated, there is still room for net interest margins to expand further albeit at a more modest pace. Second, even though a few portions of the yield curve have inverted, this data point alone is not nearly enough evidence to support the argument that a recession is imminent and that credit quality will soon turn adversely. Despite all the talk about a recession, credit quality in the U.S. remains strong and bank management teams enter this period of uncertainty with much more fortified balance sheets than prior to the last downturn a decade ago. Finally, banks still have multiple tailwinds in place in the form of an improved regulatory environment, a strong domestic economic backdrop, the potential for higher capital return, and an improving loan growth outlook per recent Fed data. In our view, the market has essentially priced in much of the downside risk and is largely ignoring the positive tailwinds. As a result, we still see plenty of high-quality opportunities in the sector that also exhibit 'defensive' attributes should credit turn and / or deposit costs rip higher.

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WWW.PROSPECTORPARTNERS.COM

370 Church Street, Guilford, CT 06437
info@prospector.net