February 26th, 2018

Patience is the undervalued asset today…

It didn't take long for the U.S. equity market to get its groove back following what was one of the quickest 10% corrections in history. The S&P 500 declined more than 340 points (nearly 12%) from its January 26th high of 2,872 to its recent low of 2,532 on February 9th, and as of this morning's rally the index is back within 100 points (roughly 3.5%) of its all-time high. For those keeping track, that is a 12% correction over 11 days followed by a 9% rally over 9 days. Was this all "much ado about nothing" or a "warning shot of what's to come"? To be frank, it's not an easy call as there is plenty of substantive evidence to support either claim over the near-term, however I'm of the view that from a longer-term perspective, this episode was a warning that highlighted the expanding imbalances that have been built up in the system over the last four years.

Yes, I identify the break-down between fundamentals and asset prices as having started in 2014 because prior to that (even though QE and interest rate suppression was coming to an end in Q3 2014) the economy, corporate profits, and valuations still retained an explanatory relationship that was in step with academic theory and market history. While this current economic expansion is anything but textbook, from 2009 – 2014 fundamentals and price action were both moving up in tandem with fundamental improvements moving in sync to validate the increase in asset prices. It's been over the last 3+ years that this relationship between fundamentals and asset values began to break-down whereby irrespective of the fundamentals, asset prices became one directional (up).

This isn't to say that the fundamentals haven't improved over the last three years, but it's been in fits and starts where the 'fits' would be conveniently downplayed as immaterial and fleeting and the 'starts' were celebrated as though the economy was in the midst of a sustainable, robust expansion. Two examples come to mind on this front:

1. Corporate Earnings: According to data from S&P Senior Index Analyst Howard Silverblatt, from Q3 2014 through Q1 2016 S&P 500 "as reported profits" went through a six-quarter earnings recession with S&P 500 earnings declining -18% while the S&P 500 gained 4.4%. Over this six-quarter period the P/E multiple on the S&P 500 expanded from 18.6x to 24x.

   With hindsight being 20/20 one could look back at this point and claim that since Q2 2016, S&P 500 "as reported profits" have increased by 23%, so those who had the foresight to look beyond what ended up being a fleeting profits decline have been rewarded for this view. However, while profits have increased 23% since Q2 2016 through Q4 2017 (latest results include 92% of companies that have reported Q4 results), the S&P 500 has rallied an additional 34% (from 2,059 at end of Q2 2016 to the current quote of 2,765 on my screen). So, while earnings are now back to moving in the same direction of stock prices, the increase in earnings has not kept pace which has pushed the valuation multiple up to 26x.

2. Economic Growth: It's becoming amusing to me how the stock market has become the go-to fundamental data point to explain what is going on in the economy. It's my opinion that because the stock market is where it is that everyone automatically concludes that the economy is strong, but that conclusion couldn't be further from the truth. Last year the U.S. economy expanded by 2.3% which is the same rate of real GDP growth that the U.S. economy has averaged throughout the duration of this expansion. I'm sorry, say what you will – that's not bad for the eighth year of an expansion, the new administration's policies haven't moved into full swing yet, or whatever other plausible explanation one can come up with – but don't suggest that by the same GDP accounting that has been used for eons to measure the health of the U.S. economy, that at 2.3% the U.S. economy is anywhere in the vicinity of a robust expansion. To be blunt, when peeling back the onion on the U.S. economy in 2017 it looks to me like an economy that was aided and abetted by an array of low quality factors: a weak dollar, a consumer debt binge, a drawdown in household savings rates, one-time hurricane rebuild efforts, and increased consumer spending on the back of stock market gains that doubled the pace of reported profits.

   I'm sure that doesn't fit conveniently into the bullish narrative that so many people are espousing, but it's the reality and the sooner investors can come to terms with it the better because the build in for Q1 GDP growth given the data reported so far in 2018 indicates that the U.S. economy might be lucky to reach a 2% growth rate in the opening 3 months of this year. The Citigroup economic surprise index is back flirting with 4-month lows and nearly 60% of incoming economic data has come in shy of consensus expectations this year versus the 30% that has surprised on the upside.

   And this recent bout of economic data disappointments isn't just a U.S. based issue with data out of Europe softening of late, as both the ZEW and Ifo diffusion indices fell in February and this is following the decline in the HIS Markit Flash PMI which fell to 57.5 from 58.8.

Look, all I'm getting at is that the gap between fundamentals and prices remains pervasive and has been a characteristic of this market for over three years now. No one knows with any certainty when or if this gap will close – history suggests it inevitably will, but that is why investment analysis is both an art and a science. The other item worth pointing out is that with the White House and Congress giving up all pretense of fiscal prudence by pushing forward on a fiscal spending binge that would make FDR blush, it's unlikely that investors need to be fearful of an economic recession commencing anytime in the near future.

I want to come back to the price action in the capital markets for a moment as I think it's important for investors to be open minded to a potential change of character that is taking shape at the current time. While the economic backdrop appears to be solid, as is the case for the corporate earnings profile, one must respect the message Mr. Market is telling us. There is no shortage of possible explanations for why markets experienced such a sharp and severe correction after what was an exuberant run to start off the year. It could just be as simple as suggesting we were long overdue after such a steady, tranquil rise last year, but once again the speed and severity of the sell-off suggests otherwise. Sure, one could look at how the market has bounced back and conclude that nothing has changed, but this rally so far has much more in common with short covering panic buying than it does with new long-term money being committed.

What stands out to me more than anything in this most recent correction and makes me think we are transitioning to a new investing regime is the complete lack of a flight to safety, which wasn't the case in other corrections during this cycle. Unlike prior pullbacks which were driven by exogenous events (government shut-downs, a Greek default, Brexit, or the unexpected Trump Presidential victory…) this correction was very much driven by endogenous forces via the future interplay between Fed policy, fiscal policy, interest rates, foreign exchange and trade policy. When you think through the expected future path of each of these on a stand-alone or even a collective basis, they all point in a similar direction: higher interest rates.

- Fed policy: The Fed has hiked rates five times since December 2015 and market expectations are pricing in an additional 3 – 4 rate hikes this year.
- Fiscal policy: Government spending is aggressively increasing this year with estimates suggesting trillion-dollar deficits starting as early as FY 2019. This guarantees increased Treasury bond issuance which puts additional upward pressure on interest rates.
- Foreign exchange: It's no secret that this administration welcomes a weaker dollar in that it will support both the manufacturing and export side of our economy. However, a weak dollar increases inflationary pressure on the economy via increased import prices and this is a meaningful variable considering our large trade deficit.
- Trade policy: This administration has taken a hard line on existing trade agreements and has started down the path of imposing tariffs on items such as steel, aluminum, washing machines, solar panels… it's safe to presume that the rest of the world will not forever stand idly by without eventually stepping up to protect their local industries. Remove the opinion part of this equation on whether one views these policies as good or bad – trade wars are inflationary, full stop! Yet another item in this list that puts upward pressure on interest rates.

Juxtapose this environment with what has been commonplace since this expansion began in that the Fed was the only game in town, and as a result it was able to move slowly and methodically in gradually increasing interest rates since it ended QE in the fall of 2014. As such, when the economy was weakening in the fall of 2015 / early 2016 the Fed walked back the four interest rate hikes it was guiding markets to expect and eventually only ended up hiking the Fed Funds rate once in 2016.

Now here we are with a new administration and a new fiscal policy that is very much pro-growth and pro-spending which puts the Fed back on its heels in perhaps no longer having the luxury of slowly removing the punchbowl of low rates. It's worthwhile taking a stroll down memory lane in understanding the logic and evolution of the Fed's thinking with the experimental monetary policy tools used this cycle.

Ben Bernanke was very clear in the op-ed article he penned in the Washington Post back in 2010 that the reason he implemented QE was to raise asset prices (stocks, bonds, real estate…):

> *"Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*

Janet Yellen eventually took the reins from Bernanke in 2014, but before doing so she had this to say during the December 2012 FOMC meeting:

> *"…We also face the serious risk that inflation, which we currently forecast to run below our target, could decline further over time, raising real interest rates and thereby making it yet more difficult for monetary policy to provide meaningful stimulus. Under such circumstances, there is an important*

benefit from conveying that we do not intend to take the punch bowl away just as the party is getting going. Frankly, I worried at the time of our September meeting that our open-ended purchase program would be interpreted by markets as tepid support for accommodation. Instead, just the opposite occurred. By linking our purchases to significant improvements in the outlook for the labor market, and coupling this commitment with the statement that we intend to keep rates low as the economic recovery strengthens, we communicated that we will at least keep refilling the punch bowl until the guests have all arrived, and will not remove it prematurely before the party is well under way…"

Now enter Jerome Powell, the newly appointed Fed Chair taking over the post from Mrs. Yellen. First here is what he had to say at the October 2012 FOMC meeting, just prior to Yellen's remarks above:

> *"I think we are actually at a point of encouraging risk-taking, and that should give us pause. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but they have every incentive to take more risk, and they are doing so."*

Nearly two-and-a-half years later in a speech at the C. Peter McCologh Series in April 2015, Chairman Powell made these comments:

> *"Overly accommodative monetary policy also poses risks. First, the economy could overheat, and rising inflation could require the Committee to raise rates faster, which – if overdone – could produce a damaging recession. For now, I would be more concerned with a second risk, which is that more accommodative policy could lead to frothy financial conditions and eventually undermine financial stability. While I do not see a troubling buildup of these risks today, tighter monetary policy might eventually be necessary if such risks do appear."*

So, to summarize – in addition to slashing interest rates, which is a common action by central banks to counteract economic recessions, the Fed implemented QE to target an increase in asset prices that would transmit itself through a wealth effect. The Fed governors continued to monitor the progress towards this objective over the years, being sure to not pullback too soon, and over the last couple years started to speak openly about the risks this type of policy could create.

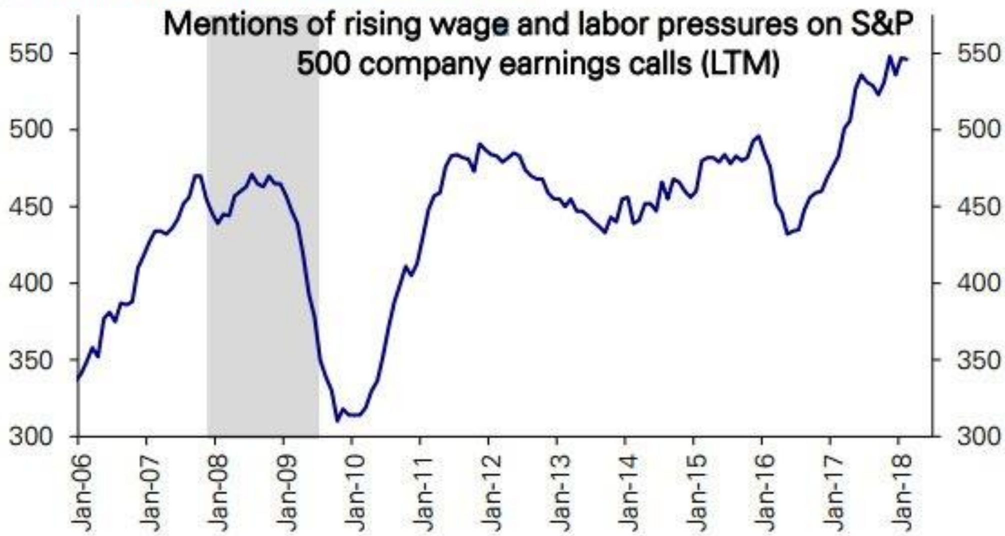
There are plenty of ways to measure the progress of said policy, but I'm going to take a stab at one way to look at the numbers. This has now become the second longest economic expansion on record, and should this expansion make it into the summer of 2019, this will be the longest expansion in history. Alright, now that's saying something. However, this is also the weakest economic expansion in the post-WWII era and looking at things in totality one could surmise that all we've really done is replace one debt-led credit bubble with another. Since the peak in debt in 2007, the U.S economy has added an additional $14 trillion in debt to the system which matches the increase in debt over the 2002 – '07 cycle. In all fairness, the debt at least appears to be in steadier hands this cycle with mortgage debt no longer being a major fault line (auto loans, student debt, and credit cards top the leaderboard in the household sector this cycle) with the biggest increase in debt levels taking place in the government and corporate sector.

However, it's rather ironic looking back that we chose to fight a debt crisis with more debt, but kudos to the powers that be for at least trying. While we'll never know, but one might think that we would be better off today had we actually taken our medicine and embarked on a cycle of organic balance sheet repair rather than papering it over with easy money. It's a hard reality to swallow, but it's the reality that is today where we have had this unusual situation in which the S&P 500 has appreciated at over a 17% annual growth rate while nominal GDP growth averaged just over 3.5% average annual gains. To put this in perspective, this is a 5:1 pace of gains in stocks relative to the economy where the average ratio in all post-WWII expansions has been closer to 2.5:1.

Here we are with central banks having pounded into investors' DNA that asset prices have become perhaps their third mandate (the other two being explicitly identified by Congress as full employment and price stability) and they have gone out of their way to achieve success on this objective. However, now we're at a juncture where the economy is operating at full employment and inflationary pressures are building which puts this implicit third mandate (asset prices) in a bit of a bind and investors in a dangerous position.

Anyone not taking inflationary pressures seriously should revisit what companies were talking about during their Q4 earnings calls where the mentions of labor pressures are the highest they've been all cycle.

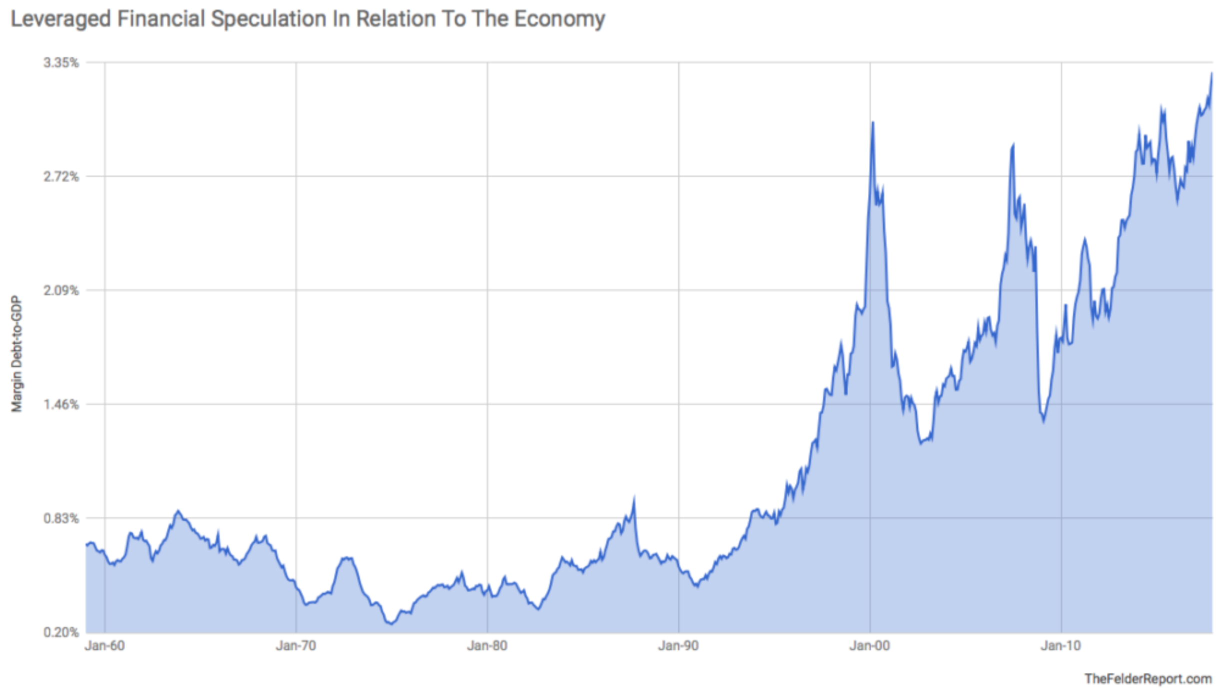
Figure 7: Companies have increasingly been mentioning rising wage costs and tight labor markets over the last year



Source: Company earnings calls, Deutsche Bank

Investing is more than just simply looking at the fundamentals – one has to always take into account market positioning, sentiment, technicals, valuation, and liquidity. It's the sentiment and valuation metrics I want to call some attention to today.

First on sentiment: Jesse Felder (the author of the Felder Report and a great financial mind) put out a post this weekend pulling together a financial metric that incorporates investor sentiment not just by measuring how someone replies to a survey about whether they're bullish or bearish, but rather focusing more on what they are actually doing with their money. Margin Debt on the NYSE is one way of measuring this view and it's not by coincidence that margin debt just hit the highest level in history that he is calling attention to this data point at the current time. Moreover, margin debt hitting an all-time high doesn't really tell you much given the U.S. economy is larger than it's ever been and the stock market is near all-time highs. The below chart Mr. Felder pulled together measures margin debt in relation to GDP, which is a way of scaling it for the current environment. Note that on this basis, margin debt to GDP is also at an all-time high – taking out the levels reached at the peak of Tech Bubble in 2000.



Two things come to mind when seeing this data: 1) Investor moods remain exuberant and the recent sell-off has done little to alter this optimism, and 2) Should the stock market sell-off in a more sustained fashion, this level of outstanding margin debt brings with it a lot of forced selling via margin calls.

The valuation metric that is catching my attention is household net worth as a percentage of disposable income which has been plumbing new highs since 2017. This metric pulls together the entire balance sheet of household assets relative to income levels and has a strong history of identifying when valuations move well out of balance with incomes. At the height of the Tech Bubble in 2000 this metric peaked at 612%, it reached 652% at the height of the Housing Bubble, and as of Q3 2017 (last recorded data) has reached 673%. The orange line on the chart below is the savings rate as a % of disposable income which declined to 2.4% at the end of last year and this was the 2nd lowest level in history (only behind the 1.9% level in reached in July 2005).

I'll sign off with a take away from comments made by Warren Buffet who just hosted his annual shareholder meeting over the weekend. After all, this man is the most successful investor in history and his personality is infectious to the point you just can't fight the jolliness emanating from his words. But it's his actions that continue to speak louder than words when I see that the cash position Berkshire is holding has yet again risen over the past year to a growing all-time high level of $116 billion. Objectively looking at Berkshire's balance sheet you come to the conclusion that his largest position isn't Apple ($28 billion), Wells Fargo ($28 billion), Kraft ($25 billion), Bank of America ($20 billion), or Coca Cola ($18 billion), but rather cash at $116 billion. Over the past twelve months Buffet's company made $36 billion from operations and his cash position increased by $29.6 billion during that period (an 82% allocation to cash). Below is an excerpt from the letter that provides some context to his thinking:

Acquisitions

There are four building blocks that add value to Berkshire: (1) sizable stand-alone acquisitions; (2) bolt-on acquisitions that fit with businesses we already own; (3) internal sales growth and margin improvement at our many and varied businesses; and (4) investment earnings from our huge portfolio of stocks and bonds. In this section, we will review 2017 acquisition activity.

In our search for new stand-alone businesses, the key qualities we seek are durable competitive strengths; able and high-grade management; good returns on the net tangible assets required to operate the business; opportunities for internal growth at attractive returns; and, finally, *a sensible purchase price*.

That last requirement proved a barrier to virtually all deals we reviewed in 2017, as prices for decent, but far from spectacular, businesses hit an all-time high. Indeed, price seemed almost irrelevant to an army of optimistic purchasers.

Why the purchasing frenzy? In part, it's because the CEO job self-selects for "can-do" types. If Wall Street analysts or board members urge that brand of CEO to consider possible acquisitions, it's a bit like telling your ripening teenager to be sure to have a normal sex life.

Once a CEO hungers for a deal, he or she will never lack for forecasts that justify the purchase. Subordinates will be cheering, envisioning enlarged domains and the compensation levels that typically increase with corporate size. Investment bankers, smelling huge fees, will be applauding as well. (Don't ask the barber whether you need a haircut.) If the historical performance of the target falls short of validating its acquisition, large "synergies" will be forecast. Spreadsheets never disappoint.

The ample availability of extraordinarily cheap debt in 2017 further fueled purchase activity. After all, even a high-priced deal will usually boost per-share earnings if it is debt-financed. At Berkshire, in contrast, we evaluate acquisitions on an all-equity basis, knowing that our taste for overall debt is very low and that to assign a large portion of our debt to any individual business would generally be fallacious (leaving aside certain exceptions, such as debt dedicated to Clayton's lending portfolio or to the fixed-asset commitments at our regulated utilities). We also never factor in, nor do we often find, synergies.

Our aversion to leverage has dampened our returns over the years. But Charlie and I sleep well. Both of us believe it is insane to risk what you have and need in order to obtain what you don't need. We held this view 50 years ago when we each ran an investment partnership, funded by a few friends and relatives who trusted us. We also hold it today after a million or so "partners" have joined us at Berkshire.

If the sagest investor of all-time is having a difficult time finding investments with a favorable margin of safety, perhaps it's wise for all investors to do a bit of introspection on what they own and why. Lastly, although patience in today's day and age seems as though it is outlawed, perhaps that is exactly the asset that is most undervalued currently with enormous potential at a future date.

This bounce in the market has a lot in common with the correction that came before it, but I continue to view it as an indication that markets are going through a regime change. Those clinging solely to the "fundamentals are strong narrative" are missing the bigger picture and that is the shift in the landscape we have not seen in a very long time, notably a distinctively different and more ambitious fiscal agenda via protectionist trade policies, deregulation, and massive budget deficits, and a more aggressive Fed tightening cycle, potentially forcing their hand to follow through on balance sheet reductions and perhaps hasten the pace of interest rate increases.

Lastly, all of this has consequences for the U.S. dollar and for the most part that means a weaker exchange rate relative to other currencies. Let's not mince words here – fiscal stimulus at a time of a shrinking capital account surplus, a 4% unemployment rate, an output gap that has been closed for over six months, and a government that treats a weak U.S. dollar with benign neglect can only result in higher interest rates over the intermediate term. There is no theoretical construct that leads to an alternative conclusion. Those investors that haven't taken a look at the commodities markets might want to consider doing a little work in this space to get a little inflation protection – the precious metals (gold and silver) are a good place to start, but this area is ripe with opportunity. The increase in volatility to start this year is the market's way of signaling this regime change is afoot.

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