October 22nd, 2018

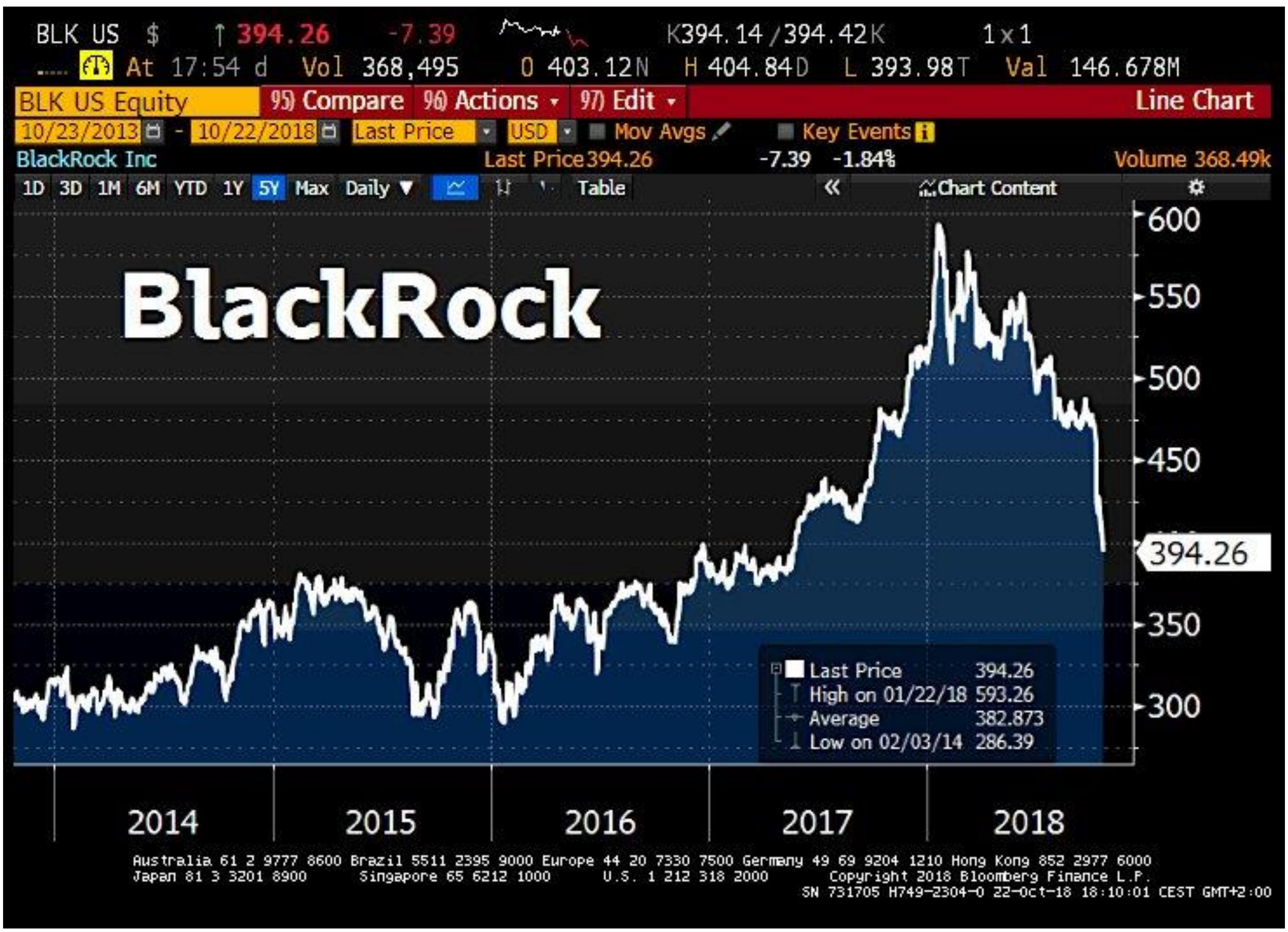
Time to think like an investor, not a speculator…

U.S. equity markets continue to be in a funk as both bullish and bearish investors alike are greeted with daily doses of humble pie in what has become a state of heightened volatility with the S&P 500 averaging a daily change of 32 points over the last 22 trading days. A rather ominous pattern has emerged for the bulls since the S&P 500 peaked at 2,930 on September 20th in that since reaching this high, the index has closed at a lower level than where it opened in 17 of the last 22 trading days. A market that starts the day strong and sells off throughout the day is not the price action one associates with a bull market. Not to mention that the S&P 500 hasn't been able to string together two consecutive daily gains since the September 20th high and when you see defensive market segments like Consumer Staples and Utilities leading the sector leaderboard last week (up 4.4% and 3.05% respectively last week), you know that investors are taking a more defensive posture.

Perhaps this week will bring about a change in sentiment with 30% of the S&P 500 market cap reporting earnings. I must say, the earnings season thus far has really only been a disappointment relative to what were overly hyped up expectations coming into reporting season – thus far, 72% of companies beat their EPS estimates and 64% came in above revenue estimates. In my opinion, it's the disappointing revenue performance that is upsetting investors as the 64% beat rate is the lowest share in 6 quarters. EPS growth is on track for +22%, but analysts are lowering their revenue growth forecast to 5.4% for 2019 from 8.2% this year – this change doesn't exactly comport with the narrative of a booming U.S. economy. One other thing to note is the disparity between bottom-line EPS growth (+22%) and top-line revenue growth (+7.3% YoY); this divergence tells you all you need to know about where the benefit from the tax cuts are going – share buybacks, which are on pace to approach $1 trillion this year.

What else has caught my eye so far this earnings season is the inability of companies being rewarded with a post earnings pop in their share prices after releasing a strong report to maintain these gains over the next couple of trading days. Netflix (NFLX) stands out like a sore thumb in this capacity as its share price ran up to $400 following strong subscriber growth, but as I type the stock is trading under $330, which is below where it was before it reported. The Financial sector has also been taken to the woodshed following what were perceived to be strong earnings results and the sector as a whole is now down more than 6% on the year (little better than the return Gold has put up on the year, and the yellow metal is dealing with the stiffest level of fundamental headwinds so far this cycle, while the Financial sector should be reaping the full tailwind benefits of an economy operating at peak capacity and peak lending). But therein likely is what investors are beginning to sniff out and that is that this is as good as it gets for the banks, while the investing horizon for Gold looks bright with the economy peaking, the Fed (after another couple of rate hikes) on the cusp of a policy mistake, intractable fiscal deficits for as far as the eye can see, and geopolitical risks rising around the world.

One more observation on the financial sector before moving on, and this relates specifically to Blackrock (BLK) who is the single largest asset manager on the planet (overseeing in some capacity $5.25 trillion in capital) and the world's largest purveyor of ETF's. What does it say about the stock market (capital markets at large) to see the share price of this company down nearly 34% from its peak on January 23rd? In my opinion, this company is a great institution with one of the sharpest and most respected CEO's (Larry Fink) in the industry, so I don't want to make an indictment on the fundamentals of the company by pointing out the poor performance of the stock. Rather it was what I took away from the conference call that stood out to me in that the firm experienced a little more than $3 billion net withdrawal from its funds in Q3, which was the first such occurrence since Q2 of 2015. What's more is that almost all of these withdrawals were from the institutional community – kinda makes you wonder what they know that perhaps the rest of us may be unaware of?



I always find that there is a tremendous amount of information that can be learned about capital markets and an investor's portfolio by how it acts during periods of stress, volatility spikes, and sell-offs. The last two weeks in particular have afforded investors a window to reflect upon what really, in the overall scheme of markets, is little more than a tremor. Yes, relative to the last couple years of calm and one-way upside price action, this year and the last two weeks seem like an outlier, but by not performing even a modest autopsy on your portfolio I fear investors would be missing out on an important opportunity to adjust and adapt their strategy if what has transpired over the last couple weeks becomes more of the norm going forward.

Looking ahead over the balance of the year, there are several catalysts that should provide some support for equity markets. Given the speed and severity of the sell-off there is a reasonable basis for investors to expect a short-term bounce is likely (mean reversion from an elevated VIX, relative strength readings are near their most oversold conditions of the cycle, and investor sentiment has been reset lower from overly optimistic levels). What's more is that following this massive wave of earnings reports this week, the black-out period for corporate buyback programs will be coming to an end and given the decline in share prices it is expected that the largest buyer of equities (the companies themselves) will be back to provide some support to the equity market. Lastly, as the calendar flips to November we will be entering the strongest part of the seasonality calendar for the equity market that runs through January. These catalysts have to be juxtaposed against an array of metrics that I’ve been highlighting over the last several weeks that represent stiff cyclical headwinds going forward. So, what I’m suggesting is for investors to use any strength we see in the equity markets over the next several months as a window of opportunity to reposition their portfolios into a mix that allows them to endure more frequent periods of heightened volatility (both up and down) that allow you to take advantage of tactical opportunities and not be reactionary or compelled to make poor decisions based upon emotion and fear.

Scribbling down some thoughts on some topics:

Fiscal Policy, Interest Rates, and the Bond Market:

U.S. fiscal policy is traversing some very dangerous territory and President Trump floating the notion of another tax cut over the weekend isn't going to do anything to help this mess. Although if we've learned anything about the President, it's that he is one of the few politicians in history that actually implements what he said he was going to when running for office. Nevertheless, and I know it's still early, but there's enough evidence to suggest that the promise of this year's tax cuts paying for themselves was nothing more than lip service to get the policy passed. Here we are with an unemployment rate at the lowest level since 1969 and nominal GDP running north of 5% yet revenue growth for the Federal Government is flat. Given this level of growth, one would expect revenue growth to be running close to 7% year-over-year – not flat. It's spending growth that has become unhinged and it's this toxic cocktail that has pushed the deficit to $779 billion last year (17% above 2017) and on pace to eclipse $1 trillion this fiscal year.

Why I continue to harp on this issue has nothing to do with politics and everything to do with capital markets, as it's my view that we are now reaching the point where this is going to become an issue for investors going forward. With the Fed now three years into its interest rate normalization cycle and also allowing the Treasuries it holds on its balance sheet to run-off at a clip of $30 billion per month, funding the U.S. Federal deficit going forward is starting to meaningfully crowd out other investments. Take this week for example, where the U.S. Treasury will be issuing over $270 billion in Treasury bonds which is an enormous amount for capital markets to digest. But that's just a start where over the next 12 months they have to roll-over more than $7 trillion of maturing Treasury paper and issue an additional $1.3 trillion in new Treasury debt to fund the deficit. What happens if at some point over the course of the next twelve months one of these many Treasury auctions fails? Bond yields would spike higher and, given U.S. Treasury securities are the world's perceived risk-free asset that virtually all other assets are priced off of, then investors will have a major problem on their hands as we all scramble to reprice every asset on the planet.

This is no laughing matter, and I have no intention of trying to sound hyperbolic or dramatic. Frankly, it would be much easier and a lot less time consuming to ignore this issue, bury my head in the sand, and fall back on the "no one could have predicted it" excuse if it did go awry. I am in no way suggesting that the solvency of Uncle Sam is at risk (it's not), but what is becoming obvious in the price action of the capital markets is that this massive supply of Treasury bonds from the $21 trillion in Federal debt (and counting) is starting to weigh on other asset prices. Sure, there are other variables at play, but in a year where the stock market has experienced some pretty meaningful volatility, and none of those episodes coincided with corresponding (offsetting) strength in Treasuries, it's telling given the capital markets history of flocking to the safety and security of this asset class during periods of heightened risk.

At this point there isn't much of a concrete conclusion to be derived from this potential shift that is afoot other than to continue to observe how it evolves and monitor it in real-time going forward. Our research is leading us down the path of a couple theses with one being that we are reaching the point of diminishing returns from fiscal stimulus – at least in its current form with handing out unfunded tax cuts. There is some scope and potential economic benefits that could be procured from infrastructure spending but the payback period and economic multiplier impact can only be measured over years/decades with time not exactly being a major luxury. A common argument I come across when broaching this subject with other market practitioners is that the rest of the world is in just as bad of shape, if not worse. What's more is that these other regions

(China, Europe, Japan, Britain) don't control the world's reserve currency, so it's an even bigger problem for them. True, but it may not be that simple because the U.S. controlling the world's reserve currency has also made our running chronic current account deficits dependent on capturing the lion's share of world capital flows and made us reliant on the rest of the world always being comfortable funding our debts by holding their foreign exchange reserves in U.S. Treasuries. This is a dynamic that has a higher level of uncertainty today than it has at any point since the early 1940's when the U.S. was taking the baton of the world's reserve currency from the British Pound.

In a nutshell, as is the case with investing – there is no free lunch, and I fear we may be reaching a point where this fiscal profligacy is no longer tenable for the way the global monetary system is structured. This isn't a current administration issue either, this is a problem that has been brewing for decades, it's just that the current collection of elected officials chose to put the icing on the cake. One outcrop of this situation, in conjunction with a Fed raising the Fed Funds rate, is that it's kept interest rates at the short-end of the Treasury curve elevated which gives investors the option of buying a 2-year T-bill yielding 2.91% with virtually no principle risk. This yield now exceeds the dividend yield on the S&P 500 by a full 100 basis points which, in my opinion, puts to bed the era of T.I.N.A (There Is No Alternative) and perhaps commences the era of C.I.T.A (Cash Is The Alternative).

The Fed and Inflation:

Last week the minutes from the most recent Fed meeting were released and while this meeting was conducted prior to this most recent bought of equity market volatility, the message they conveyed was pretty clear to me: they are on high alert for inflationary pressures building in the economy and growing more worried about the build-up of financial imbalances. A couple weeks ago, it was the comments by Chairmen Powell mentioning the need to move the funds rate to a modestly restrictive stance that ignited the last leg higher in interest rates. These minutes suggest that he is not alone in this view: (emphasis is mine)

> *"Reports from business contacts and surveys in a number of Districts also indicated some firming in inflationary pressures. In particular, some contacts*

indicated that input prices had been bolstered by strong demand or import tariffs. Moreover, several participants reported that firms in their Districts that were facing higher input prices because of tariffs perceived that they had an increased ability to raise prices of their products."

"*Participants offered their views about how much additional policy firming would likely be required for the Committee to sustainably achieve its objectives of maximum employment and 2 percent inflation. A few participants expected that policy would need to become modestly restrictive for a time and a number judged that it would be necessary to temporarily raise the federal funds rate above their assessments of its longer-run level in* *order to reduce the risk of a sustained overshooting of the Committee's 2 percent inflation objective or the risk posed by significant financial imbalances."*

What will be important to monitor going forward until we get to the next expected Fed hike in December is how the capital markets and economy cope with Quantitative Tightening increasing to its $50 billion / month pace in October. Should this reduction in liquidity (coupled with massive Treasury issuance, also draining liquidity) and the lagged impact of prior rate hikes working their way through the system (which will also have the impact of slowing the economy more aggressively than it already is) then I would expect the Fed to back off and reverse course. My guess is, indications of such a pivot will start to percolate sometime in the first half of next year and this is likely when precious metals like gold and silver will have their time to shine.

Already we're seeing the highly interest rate sensitive parts of the economy cry uncle, with both the housing and autos segments of the stock market down roughly 30% from their peaks earlier this year. For those contrarian investors out there, you may want to start kicking the tires on the homebuilding stocks and some parts of the housing sector as this market is not the epicenter of the largesse it was in the last cycle. What's more is that for those with a longer-term time frame, the demographic tailwind for housing is favorable and there remains a shortage of available inventory for interested purchasers. Surely, affordability has something to do with this as home price appreciation has drastically outstripped wage growth this cycle, but should home prices moderate and the Fed eventually backs off its aggressive hiking path, there is a rather constructive long-term investment thesis underpinning the housing sector.

China, Europe, and the Trade War:

It looks as though the Chinese stock market has finally succumbed to a level that is bothering officials over in Beijing, as the various governing bodies were out in full force yesterday saying they will do all they can to turn the Chinese economy around. Even President Xi Jinping commented that he would provide "unwavering" support for the national economy. Words are words and actions are actions, and unfortunately the imbalances in China can't be overcome with just the flip of switch (not anymore, anyways, given we're now talking about a $12 trillion economy). It looks like one of the tools China is going to use is "sweeping" tax relief (what a unique concept – yes, that's sarcasm you sense) – but like the U.S., how it gets funded is anyone's guess given the massive debt ratios China is currently operating under.

We'll have to wait and see what the next shoe is to drop in the ongoing trade war between the U.S. and China. A thawing in the battle lines for each side would be a constructive development (apparently a meeting between Presidents Trump and Xi at the G20 meeting next month is in the works), but should we move into 2019 with no progress, with the 10% tax on the last

$200 billion of Chinese goods set to increase to 25%, that will be a big negative development for the global economy to swallow.

Unfortunately at a time when political divisiveness is high in the U.S. and China is contending with an economic slowdown (and trade war with the U.S.), it would be convenient if the Eurozone were in a solid position to fill the void. However, that is anything but the case as Italy and the EU are embroiled in a budget showdown with neither party willing to back down. Capital markets have pushed yields on Italian sovereign debt to the highest levels since the European debt crisis, but until a compromise is found, you can continue to expect Eurozone banks to experience downside price pressure with many of them trading at one-year lows. What's more is that for the first time we are seeing contagion risks spread out from Italian bonds to Spain and Portugal.

While this is playing out, the most prominent leader in the EU, Germany’s Angela Merkel, is seeing her political clout diminish by the day. Emmanual Macron’s popularity in France has nosedived 20 percent this year to 33%, and the Brexit talks in the U.K. are at a stalemate again with Theresa May contemplating an extension to the deadline to 2021 to reach a deal.

If it seems like a lot is going on around the world, you’re right, there is and it definitely impairs a prudent investor’s ability to act with a high level of confidence and conviction. Which is why investors should rely more heavily on diversification, risk management, and discipline in their investment strategies today. By diversification I don't mean blindly following cookie cutter domestic/international stock, bond, and cash exposures. Yes, a foundation of this theory can serve as a reference point, but there are elevated risks in the bond market today with interest rates just coming off 5,000 year lows a short two years ago. Within the bond market, investors should be focusing on reducing both duration and credit risk. Within international equity markets – they are likely to continue to experience pain until both the U.S. dollar and interest rates stop rising (if you know when either or both of these are going to occur, give me a call because I'd love to know.) As for U.S. equity markets, the one thing about 2/3rds of companies in the S&P 500 being down more than 10% from their 52-week highs is that you can for the first time in a while find some areas of the market that offer some decent long-term value. However, it's important to notate that should we be entering the most challenging part of the economic and stock market cycle (potential recession and bear market), then take a look back at what stocks did on Thursday October 11th. This was the second day of the nearly 1,200-point decline in the Dow and every sector of the stock market closed in the red that day. When/if things get bad, be open minded to the possibility that all stocks go down – good / bad, cyclicals / defensives… at that point it's just a matter of relative performance in what is an indiscriminate sell-off.

** Please note, Capital Market Musings & Commentary will be taking a brief hiatus next week to attend an investing conference, but will be back with a fresh missive in early November. **

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