Issue 45 January 2018

2017 -- Déjà Vu All Over Again

This may all seem familiar.
Stocks rose sharply in the past year, accelerating gains from the prior 12 months. Major US indices rose by double-digit percentages, with new all-time highs set by the Dow Jones Industrials, S&P 500, and Russell 2000 small cap index.

It didn't stop there. Fixed income comfortably provided positive, if uninspiring gains. Investors willing to accept paltry yields in Treasurys, corporates and high yield bonds, for the most part earned returns in the single-digit-percent range. Reaching for yield by extending maturities or lowering credit quality was rewarded, if not recommended. Doubling down is ill-advised.

Gold and crude oil rose by slightly over ten percent, mostly reflecting a weak US Dollar.

International equity markets were even stronger, with gains typically exceeding 20 percent. Emerging market equities were among the standout performers for the year, boosted by an accelerating global economy and rising valuations. Developed international markets caught a similar tailwind. Japan's Nikkei index attained levels not seen since early-1992. Even the UK, mired in the uncertainty of its Brexit decision, saw its benchmark FTSE 100 index hit all-time highs.

If this sounds like something you have heard before, it could have been written, with a few tweaks here and there, to describe 2013. Or 2009. The difference was that in those years, not all markets went along for the ride. In the past year, if you were invested in traditional assets, and avoided the broader commodity complex, you netted satisfying returns. Also noteworthy is the timing of these gains. Nine years into our economic expansion and a similar time-frame into our bull market, it is highly unusual to see such synchronized global economies and markets. It's Goldilocks on a worldwide basis.

And the best part was, all this took place with nary a bit of volatility. The S&P 500 rose every month but one, the exception being a fractional decline in March. The same benchmark experienced no daily price changes of over two percent for the entire year, whereas eight days is more typical. The standard deviation of returns throughout the year was the second lowest on record, and less than half the norm.

Above average returns with below average risk. What's not to like?

Silly Season

Yogi Berra was right when he said, "It's hard to predict, especially about the future", even if he never really said it. We are about to enter silly season, when Wall Street wanna-be-gurus take their best shots on all things financial and otherwise for the coming year.

As a parlor game with nothing at risk, it is all good fun, especially over a beer, the highlight of the exercise being the beer. Stella Artois is preferred, if anyone is keeping tabs. Beyond that, don't confuse predictions with wisdom.

Here are last year's predictions from Byron Wien, the sage who started the zaniness and probably brings more insight to the discussion than anyone else, readers of this newsletter excluded. As published on the Blackstone.com website last January:

"This is the 32nd year Byron has given his views on a number of economic, financial market and political surprises for the coming year. Byron defines a "surprise" as an event that the average investor would only assign a one out of three chance of taking place, but which Byron believes is "probable," having a better than 50% likelihood of happening."

With some interpretation, we provide a grade of pass/fail/incomplete after each prediction.

Byron's Ten Surprises for 2017 are as follows:

Still brooding about his loss of the popular vote, Donald Trump vows to win over those who oppose him by 2020. He moves away from his more extreme positions on virtually all issues to the dismay of some right wing loyalists. He insists, "The voters elected me, not some ideology." His unilateral actions throw policy staffers throughout the government into turmoil. Virtually all of the treaties and agreements he vowed to tear up on his first day in office are modified, not trashed. His wastebasket remains empty.
fail, bigly

The combination of tax cuts on corporations and individuals, more constructive trade agreements, dismantling regulation of financial and energy companies, and infrastructure tax incentives pushes the 2017 real growth rate above 3% for the U.S. economy. Productivity improves for the first time since 2014.
pass, right on direction even if overly optimistic and the three percent growth target was not attained

The Standard & Poor's 500 operating earnings are $130 in 2017 and the index rises to 2500 as investors become convinced the U.S. economy is back on a long-term growth path. Fears about a ballooning budget deficit are kept in the background. Will dynamic scoring reducing the budget deficit actually kick in?
pass, profits are due to hit the 130-dollar target, but estimates started the year there, so it was no great leap. right on the market though

Macro investors make a killing on currency fluctuations. The Japanese yen goes to 130 against the dollar, stimulating exports there. As Brexit moves closer, the British pound declines to 1.10 against the dollar, causing a surge in tourism and speculation in real estate. The euro drops below par against the dollar.
fail, wrong on the direction of currencies versus the US Dollar

Increased economic growth, inflation moving toward 3%, and renewed demand for capital push interest rates higher across the board. The 10-year U.S. Treasury yield approaches 4%.
fail, not even close on inflation or the 10-year Treasury yield

Populism spreads over Europe affecting the elections in France and Germany. Angela Merkel loses the vote in September. Across Europe the electorate questions the usefulness of the European Union and, by the end of the year, plans are actively discussed to close it down, abandon the euro and return to their national currencies.
fail, the status quo held in European elections and the euro currency is stronger

Reducing regulations in the energy industry leads to a surge in production in the United States. Iran and Iraq also step up their output. The increased supply keeps the price of West Texas Intermediate below $60 for most of the year in spite of increased world demand.
incomplete, right on the price target but 60-dollar oil was a lofty goal to begin with.
the bigger story is OPEC and Russia maintaining production discipline

Donald Trump realizes he has been all wrong about China. Its currency is overvalued, not undervalued, and depreciates to eight to the dollar. Its economy flourishes on consumer spending on goods produced at home and greater exports. Trump avoids punitive tariffs to prevent a trade war and develops a more cooperative relationship with the world's second largest economy.
fail, wrong on currency again

Benefiting from stronger growth in China and the United States, real growth in Japan exceeds 2% for the first time in decades and its stock market leads other developed countries in appreciation for the year.
pass, right on Japan's improving economy and the Nikkei index is at a 25-year high

The Middle East cools down. Donald Trump and his Secretary of State Rex Tillerson, working with Vladimir Putin, finally negotiate a lasting ceasefire in Syria. ISIS diminishes significantly as a Middle East threat. Bashar al-Assad remains in power**.**
pass, right on Syria and ISIS, if uncertain about the rest of the region

Four out of 10 correct. And this is from the sage.

More Guesses
Far less ambitious, a year ago, the financial information and media company Bloomberg asked economists to make rudimentary predictions for 2017. Here is a recap of their insights.

On unemployment, the median forecast called for a year-end level of 4.6 percent, which would have meant only the slightest improvement from a starting point of 4.7 percent. As of November 2017, the actual rate was 4.1 percent.

On core-PCE inflation, widely touted as the Federal Reserve's favorite inflation measure, the median forecast was 2.0 percent, whereas the most recent reading is 1.5 percent. Of significance, this and other measures of core inflation fell during the year, contrary to consensus expectations.

As for long-term interest rates, the median forecast expected the 30-year Treasury yield to rise to 3.34 percent. Instead, it ended the year at 2.74 percent. Once again, the forecasts were not even correct on direction, as long-term rates fell during the year.

With experts like these, who needs rank amateurs? Now you know why we typically steer clear of predictions… eventually they will make anyone look foolish.

World's Briefest Long-term Prediction
Speaking of foolish, here was Nobel-laureate economist Paul Krugman, writing on the night of the 2016 Presidential election:

"It really does now look like President Donald J. Trump, and markets are plunging. When might we expect them to recover? Frankly, I find it hard to care much, even though this is my specialty. The disaster for America and the world has so many aspects that the economic ramifications are way down my list of things to fear.

Still, I guess people want an answer: If the question is when markets will recover, a first-pass answer is never."

Mr. Krugman retracted his prediction days later, perhaps observing that markets had already recovered.

True surprises
Here are some noteworthy developments, mostly unexpected, which came true:

A single Da Vinci painting, "Christ as Salvator Mundi" sold at auction for 450 million dollars, smashing previous art sale records by multiples.

A bloviating bag of braggadocio stormed into Washington, intent on disrupting, insulting and over-turning every bit of etiquette, precedent, and conventional wisdom our nation's capital had ever established. He succeeded, the world did not end, and markets roared in approval.

The cryptocurrency Bitcoin rose 18-fold, from 952 to a peak of 18,000 dollars, and was not even the best performer in its asset class, if that term applies.

The outlook for US budget deficits moved decidedly higher, and total Treasury debt exceeded 20 trillion dollars, larger than our overall economy. Meanwhile, the Federal Reserve hiked interest rate three times. US corporations flooded the market, selling a record, nearly two trillion dollars in bonds. Yet intermediate and long-term bond yields declined.

German 10-year Bunds still yield under half-a-percent, and Swiss bonds of the same maturity offer negative yields. European junk bonds traded at interest rates under two percent. Japan's 10-year note yields just above zero. Argentina, a serial defaulter, issued 100-year bonds to sophisticated investors. Nearly 10 trillion dollars of global debt was priced to a negative yield. Nobody cares. If there is a credit bubble, it is not centered in the United States.

After failing to repeal and replace 'Obamacare', Republicans pulled a rabbit out of a hat with a last-minute tax cut bill. Statutory corporate tax rates will drop from 35 percent to 21 percent, and most US households are likely to receive a tax cut, effective 2018. The US economy is poised to accelerate, and we may hear talk of over-heating. Offering comic relief, demagogue senator Elizabeth Warren put on her war paint, "The bill that the Republicans jammed through the Senate tonight isn't tax reform. It's a heist. Let's call this out for what it is: Government for sale." And more, "It's just delivering one gut punch after another to hardworking people." Ouch, who knew that keeping more of your own money could hurt so bad?

Tulip Mania

We can all be excused for being unfamiliar with the company Long Island Iced Tea. It's a tiny firm with just five million dollars of annual sales, hardly enough of a business to merit attention. Give it credit for being clever though. In December the company rebranded itself as Long Blockchain Corp., attaching itself to the underlying technology driving Bitcoin and other cryptocurrencies. While we have no idea how this translates into a business plan, the market responded by driving the stock 300 percent higher in a matter of days. So much for efficient markets.

Not to be outdone, The Crypto Company was on its way to stock-of-the-year honors, amassing a market capitalization of 11 billion dollars on virtually no revenues. In just under three months, the stock price rose from 3.30 dollars per share to a high of 642 dollars. According to one source, the company now offers a portfolio of digital assets, technologies, and consulting services to the blockchain and cryptocurrency markets. Whatever that means. Before its change of direction, the company was known as Croe, Inc. and was in the sports bra and supportive apparel business, again with minimal revenues. Alas, all good schemes must end. Regulators halted trading on the stock in mid-December, and the sharks -- err, litigation attorneys -- are circling.

Moving to the heart of the matter, a reputable investor recently appeared on television, doing what so many financial-media guests do best: talking his book. In this case, his book owned Bitcoin, the Dutch tulip bulbs disguised as a cryptocurrency. The guest investor was making the case for Bitcoin trading at 400,000 dollars per unit, up from its recent high of 18,000.

It's simple math he says: gold is worth eight trillion dollars. If there are 20 million Bitcoins in the world, their gold equivalent price is 400,000 dollars. Plus, Bitcoin is lighter than air, while gold, having substance, is heavy. Pesky thing.

Why stop there? Compare Bitcoin to the total US credit market, at 63 trillion dollars; or the global equity market cap, near 100 trillion dollars. That makes Bitcoin worth five million dollars per unit.

And what would you receive for your imaginary five million dollars? 83,000 barrels of oil? 1.5 million pounds of copper? Partial ownership of a business generating revenues, profits, and perhaps paying you a dividend? No. You would receive a number, with hopes of trading it to someone else at a higher price. That's it, a number. Veel geluk.

Happy New Year!!

Tidbits..

Merger mania:
On again, off again merger talks between wireless providers Sprint and T-Mobile are terminated.
Broadcom makes 105-billion-dollar hostile bid for Qualcomm, proposing blockbuster merger of chip manufacturers.
Disney announces plans to buy Fox media assets valued at 66 billion dollars, as Fox's Rupert Murdoch, the consummate empire builder, becomes a seller.
US Justice Department files suit to block 85-billion-dollar merger of AT&T and Time Warner.

General Electric, under new leadership, slashes dividend, targets business divestitures of 20 billion dollars.

International Energy Agency predicts US will become 'undisputed' leader in oil production, accounting for 80 percent of supply growth from 2010 to 2025.
US oil production approaches 10 million barrels per day, highest in over three decades.

US Senate moves to reduce by two-thirds the number of banks labelled systemically important, aka, "too big to fail".
Rolling back the Obama agenda.

US Postal Service records 11th consecutive year of losing money.
Government at work: turning a billion-dollar monopoly into a foundering enterprise.

Venezuela, oil rich and once South America's wealthiest nation, defaults on its debt.
Another victim of socialism's false promises.

Federal Reserve raises target interest rate in December, meets three-rate-hike target for the year, projects three additional hikes in 2018.
Chicago Fed National Financial Conditions Index indicates loosest financial conditions since 1994.

Atlantic hurricane season ends with record property damages, estimated at over 200 billion dollars.

Study shows American students perform better on standardized tests when financial incentives are included.
Performing well for its own sake is passé.

Survey of chief financial officers' sentiment shows highest business optimism in 13 years.
US consumer confidence reaches 17-year high.
US index of leading economic indicators hits record level.

Share repurchase activity in US declines for first time since Great Recession.

Source:
Blackstone.com
Bloomberg
Huffington Post
The New York Times
The Wall Street Journal
Washington Examiner

Equities

SP 500 Index

US large cap equities extended their late-2016 rally, reaching all-time highs in 2017.

Russell 2000 Index

Small cap stocks tagged along, but continued a trend of under-performing large cap stocks.

MSCI EAFE Index

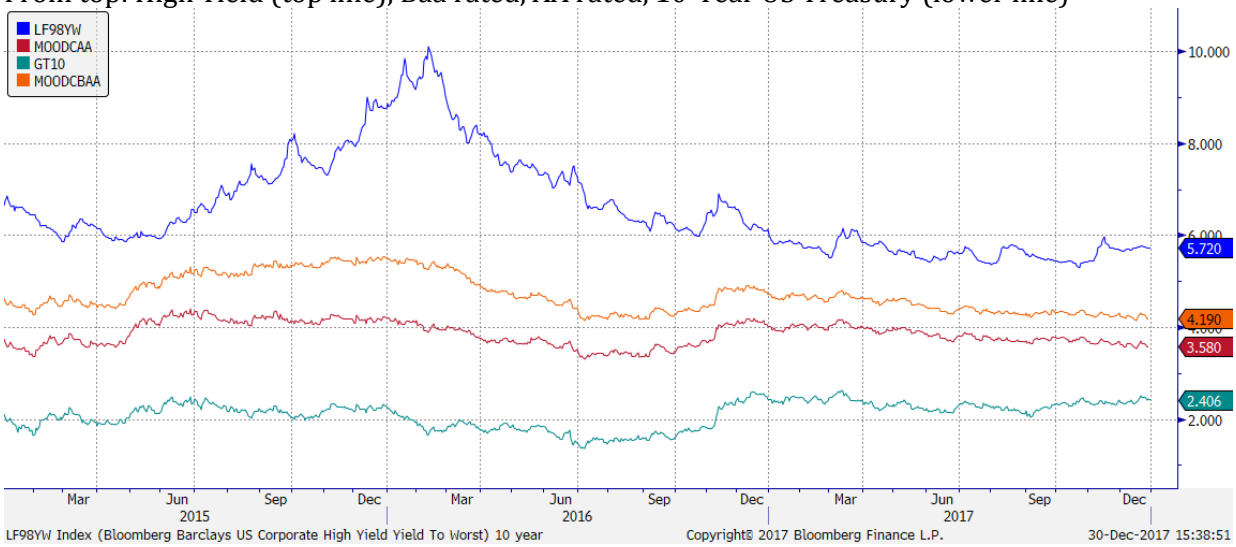
Developed international markets broke out of their malaise, boosted by improved economies and higher valuations.

MSCI Emerging Markets Index

After declining four years out of five, emerging market equities have generated solid returns for two consecutive years; but have not yet regained their price levels of a decade ago.

Bonds

Bond Yields
From top: High Yield (top line), Baa rated, AA rated, 10-Year US Treasury (lower line)



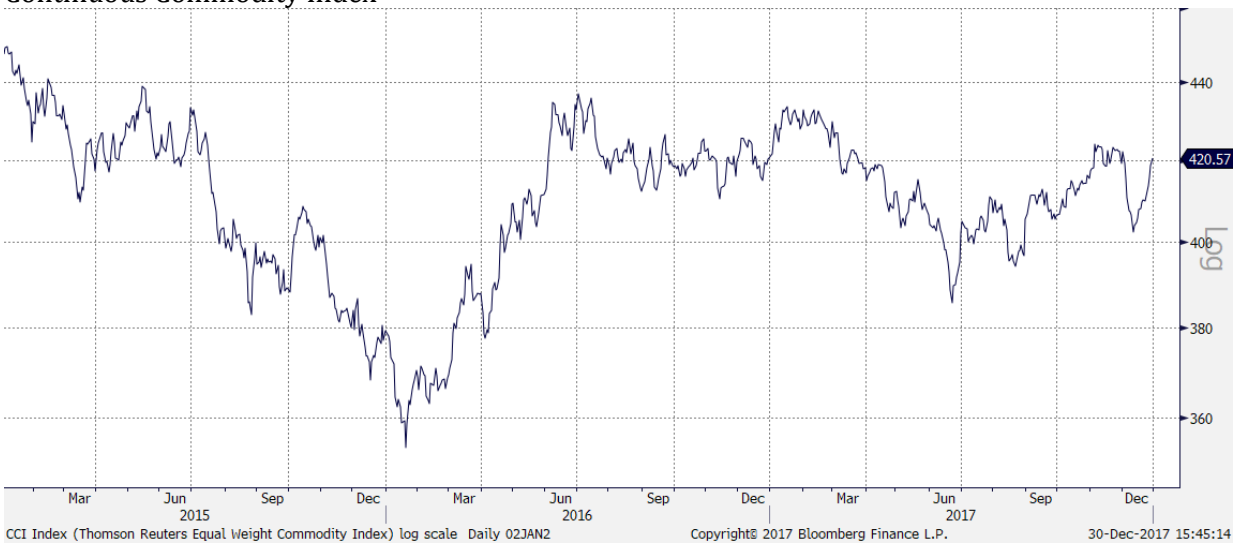
The bond market continues to confound, offering low yields and surprisingly little volatility.

US Treasury 10-year note yield

The 35-year US bond bull market looks to be over, but meaningfully higher rates are far from certain.

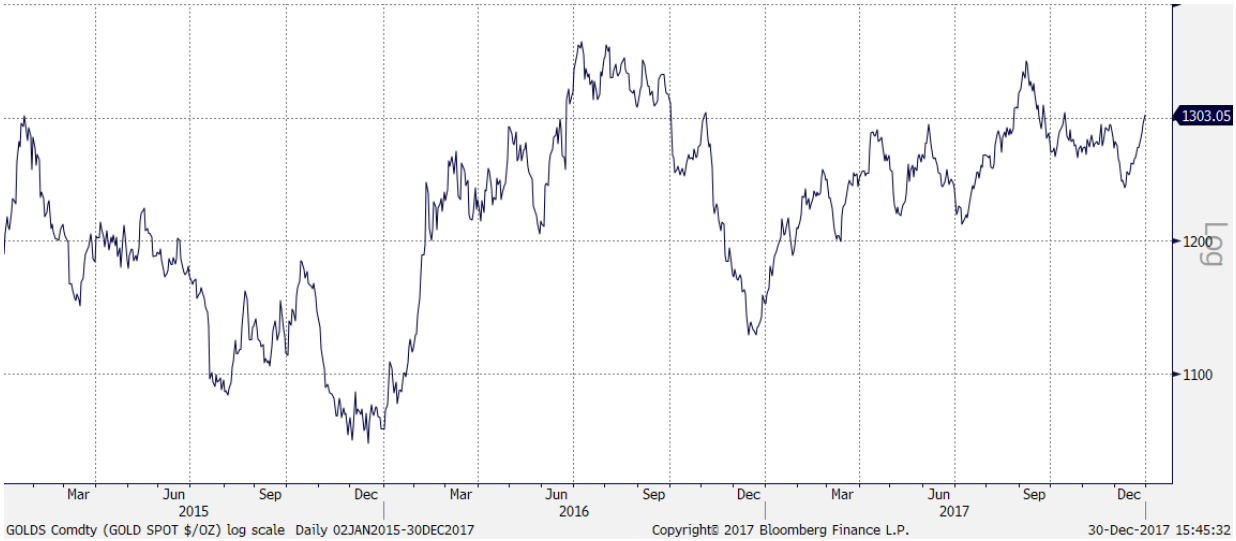
Commodities

Continuous Commodity Index



Commodities overall show no sign of inflationary pressures, and remind us that over extended periods of time, commodities rank among the worst performing asset classes.

Gold Price

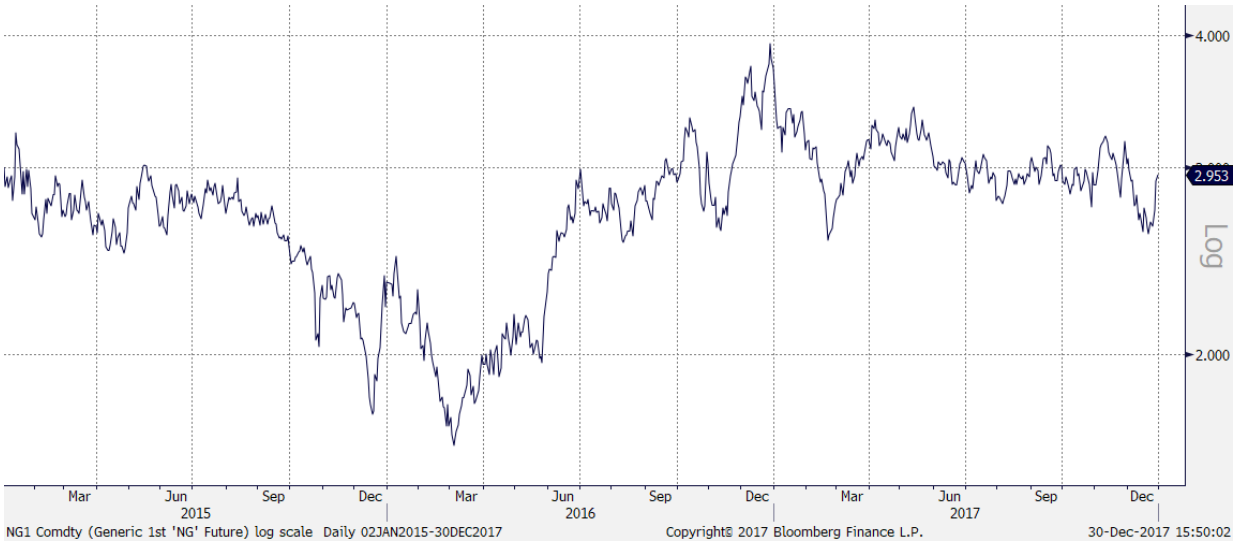


Gold prices rose for the year, but have been stuck in a trading range for almost five years.

West Texas Intermediate Oil Price

Oil has established a new, higher trading range, as OPEC-led supply restraint and strong global demand have placed a floor under prices... for now.

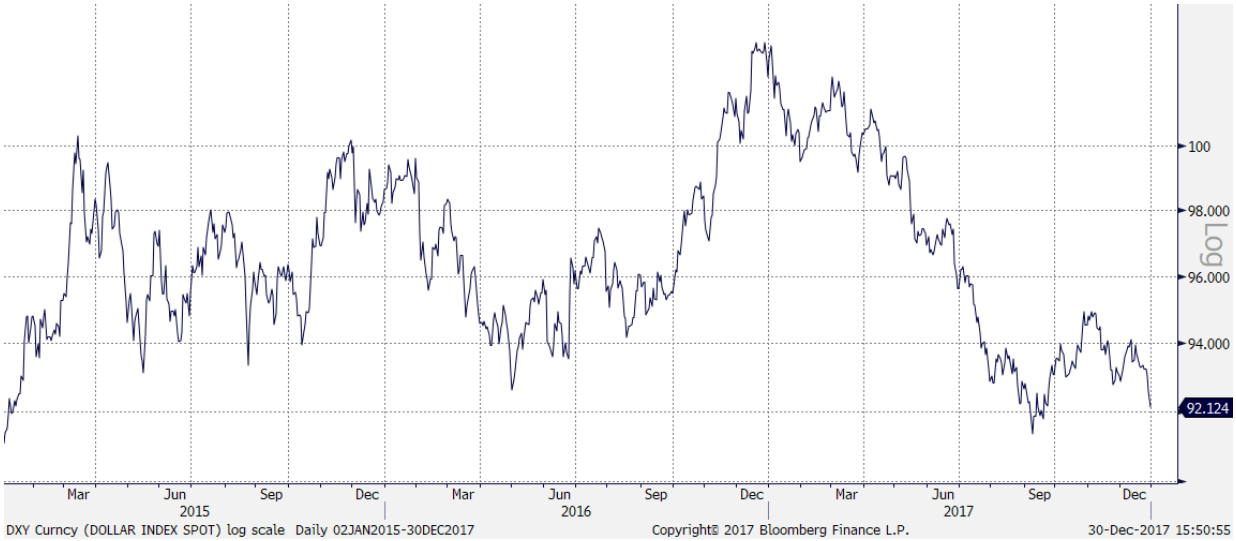
Natural Gas Price



Natural gas -- clean, plentiful, and cheap -- is the gift that keeps on giving.

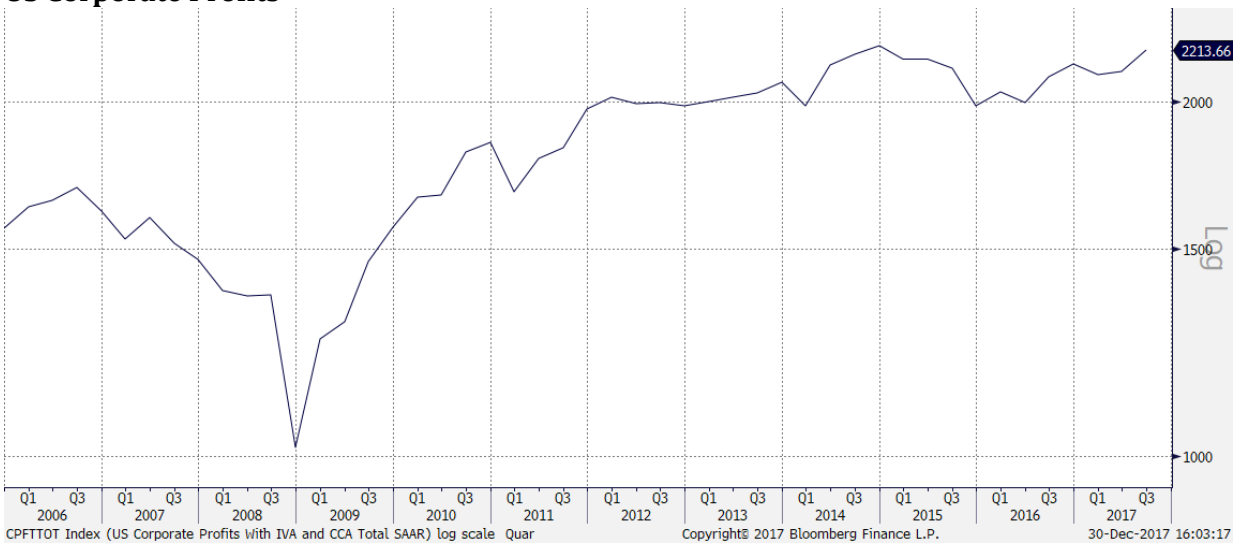
Currencies

US Dollar Index



To no one's chagrin, the US Dollar ended its five-year year rally, declining against major currencies and emerging market currencies alike.

US Corporate Profits



US corporate profits are approaching record levels, and tax cuts and fiscal stimulus can only help.

S&P Case-Shiller Composite Home Price Index

Nationwide home prices continue their strong recovery and are now at record levels. Year-over-year price gains have accelerated to a six percent pace, well ahead of inflation.

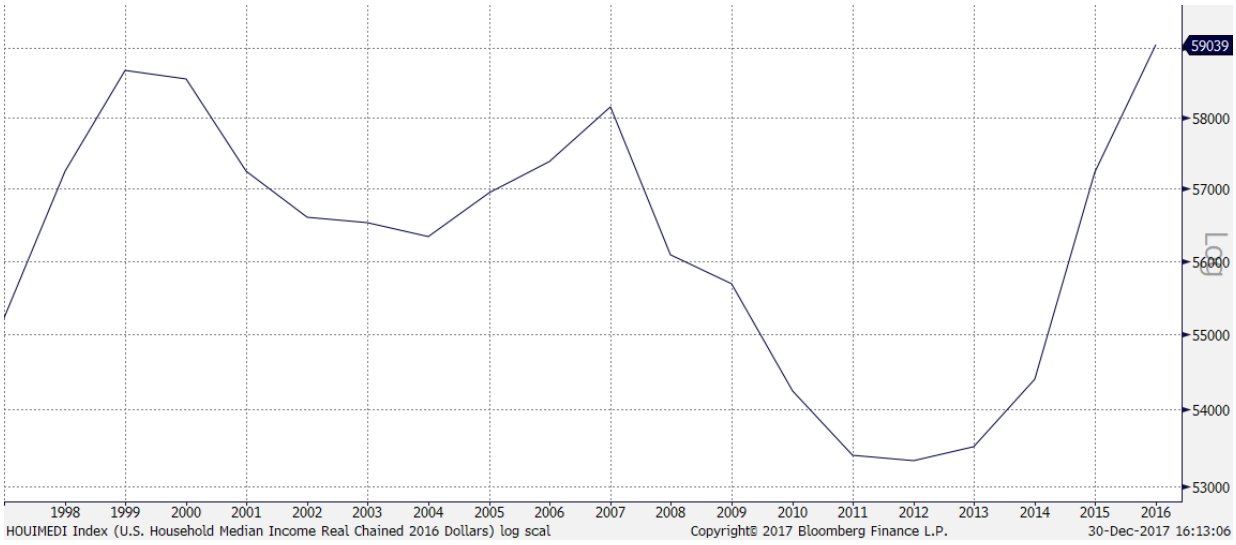
US Unemployment Rate

The jobless rate is near four percent, approaching what many economists view as full employment. Wage gains are running above inflation, but have not accelerated as expected.

US Labor Force Participation Rate

Same as last year: labor participation rates are still at anemic levels. Too many people have decided to skip work, whether they can afford to, or not.

US Household Real Median Income



A lost generation of wage-earners: household median income, inflation adjusted, finally exceeded its 1999 peak.