Issue 55 January 2020

2019 -- Reversal of Fortune

A year ago, the prevailing theme was a most-anomalous condition, in which essentially every investable asset class lost money in the prior 12 months. This included US and international equities, Treasurys, quality corporate debt and high yield bonds; along with gold, oil, bitcoin and anything else an investor might venture into. In other words, stocks, bonds and commodities all suffered.

The year just ended offered a complete reversal. Most every asset class produced investment gains in 2019, led by US large cap equities, with their best year since 2013, joined by small cap and international stocks, gold, bonds, and commodities, in descending order of magnitude. About the only place an investor did not make money was in the US Dollar, with the Greenback ending the year basically unchanged. No matter, a stable currency is a favorable currency.

Among the myriad issues facing investors a year ago, a number have been favorably resolved, including a reversal of monetary policy from tightening to easing, lower bond yields, narrowing credit spreads, and renewed hopes for a global economic acceleration.

All clear then? Hardly.
Corporate profits have hit a wall, with S&P 500 earnings down for the year. Economic growth in the US is likely to continue its deceleration in 2020, right back to the tepid two percent growth rate we all previously came to accept, begrudgingly, as a new normal. And then there are the trade wars, not just with China, but against seemingly every major trading partner we can imagine. Where this takes us is anyone's guess, but if betting when it all ends, take the 'over' against the 'under', all day.

We also enter the new year with valuations substantially higher than a year ago. Indeed, the bear market / bull market swings of the past 15 months have sent valuation multiples on a roller-coaster ride back to multi-year highs. That's not to say prices cannot edge higher, just that a year ago much more was likely to go right than wrong. As we begin 2020, markets are more nuanced. For the bulls, after the Federal Reserve's reversal of policy, financial conditions are far more favorable. Investor sentiment remains uncertain, fighting the advancing market for a decade and still not convinced. This too is encouraging. And stocks continue to be far more attractive than bonds.

All this points to higher equity prices, unless and until something breaks. History says something usually gives, just when further gains seem inevitable and complacency sets in. 2020 will almost certainly be a more volatile, and less rewarding, year than the one just ended. That's just the reality of it all.
Happy New Year!

Surprises, Predictions, and Peculiarities

With the turn of the calendar, silly season is upon us once again, as Wall Street prognosticators distribute their annual lists of predictions, surprises, and best of all, predictions about surprises. While it may be good clean fun, the batting average of these pundits is trending toward the Mendoza line, wherein no investor should tread. Here is our contribution, tongue slightly in cheek, yet flawless in its accuracy.

Our nine favorite surprises for 2019, which almost nobody predicted, include:

Greece, Western Europe's perennial economic basket case, issued short-term debt promising a negative return. Somebody bought it.

17 trillion dollars of government debt in Europe and Japan were priced at negative yields. Global bond markets never flinched.

The US trade war on the world extended throughout the year, from China to India, Europe to Brazil, Global stock markets learned to live with it.

US economic growth slowed to roughly two percent and corporate profits stalled. Investors continued to withdraw money from equity funds. Stock prices rose by the most in six years.

The US Treasury yield curve inverted, and every Chicken Little warned of recession. Then it un-inverted with nary a mention.

Federal Reserve policy changed direction, going from a multi-year tightening mode, to a rate-cutting adjustment. At least that is their explanation.

For only the fourth time in 13 years, the maximum annual drawdown in US equities was less than ten percent (seven percent). Markets still felt volatile.

New York State's Attorney office wasted its time and taxpayers' money in a nuisance lawsuit against Exxon Mobil, claiming the oil giant failed to properly account for the costs of climate change. Sanity prevailed, as New York lost.

Disfunction in Washington intensified. Fiscal restraint is taboo, as budget deficits exceed one trillion dollars. Presidential aspirants and others proposed everything from Medicare-for-all to free college education, from a wealth tax to a green new deal. Congress called its own bluff, issuing articles of impeachment against President Trump. Yawn.

Mighty Mouse
The Walt Disney Company must be the world's most expensive blue-chip stock, riding high on the launch of its Disney+ streaming service and a record-setting year for its movie studio. Based on Wall Street estimates, the company is in the midst of a four-year profit drought, with its 2018 earnings not being exceeded until the year 2023. With a long-term growth rate of one percent (long term is not forever), and a price-earnings ratio of 26, the PEG ratio stands at 26. This in a world where a PEG ratio of four is considered lofty.

Drill baby, drill
According to recent International Energy Agency(IEA) projections, 85 percent of the world's oil production growth over the next decade will be supplied by the US. Relatedly, the US is now a net exporter of oil. The IEA also expects global oil demand to reach a plateau in 2030, at which point oil markets will stop growing. Forever.

Fuzzy Logic
One definition of insanity is "doing the same thing over and over again, and expecting different results". This seems to apply to European Central Bankers, who have driven interest rates below zero, toppling centuries of banking history and financial theory. To what purpose? The further Europe cuts rates, the more it weakens its banking system and savers, and the more its economy suffers. The response, naturally, is to cut rates further. No surprise then, under the insanity theory, at this news...

> "Europe is also prepping a major stimulus injection, according to Olli Rehn, who sits on the ECB's rate-setting committee. That could include 'substantial and sufficient' bond purchases, cutting rates deeper into negative territory and purchasing equities under the QE program."

If it works so well, why not cut rates to minus 10 percent, buy up all of Europe's stocks and bonds at a premium, and create an enormous wealth-effect stimulus? Why not? Because it doesn't work.

Misery For All
Senator Elizabeth Warren, who masquerades as a Presidential candidate, has a plan for that. She must, as she has a plan for everything. The biggest, and the one that crashed and burned before it got airborne, is her Medicare-for-all plan. While the Senator claims a 10-year cost of 20 trillion dollars for her scheme, this figure was immediately dismissed as optimistic, to the tune of 10 trillion dollars or more.

Adding to the idea's unpopularity, 170 million Americans would lose their private health insurance, which for the most part they find satisfactory. Instead, Americans' health would be placed in the

hands of government bureaucrats who earn their salary, and punch out at the same time every day, regardless of your health care needs.

And as a reminder, our current Medicare program is the most ill-financed item in the federal system. Estimates vary, but the net present value of future unfunded Medicare expenses totals somewhere near 40 trillion dollars. That's twice the size of our economy and over eight times the annual federal budget. Taking a gargantuan money hole and making it ginormous does not sound like a winning plan, but it may be the path to financial ruin.

Perhaps Senator Warren and her campaign should have heeded the advice of humorist P.J. O'Rourke, who warned long ago: "If you think health care is expensive now, wait until you see what it costs when it's free."

Bunk debunked

A popular narrative says growth stocks outperform value stocks in a sluggish economy, because growth companies do not need a favorable backdrop to prosper. When the economy accelerates, value stocks are supposed to benefit. This idea has more than a few holes in it.

For starters, the 1990s were a period of great prosperity, yet growth stocks trounced value stocks. In the 2000s, the opposite took place, with a tepid economy and value stocks outperforming for seven consecutive years (2000-2006). Both these extended periods went against the narrative.

In 2017, value profits outpaced growth profits by 14 percent to 10 percent, yet growth stocks outperformed by over 1600 basis points. In 2018, a year of robust economic activity, growth earnings' pace slightly exceeded value earnings, yet growth stocks outperformed by nearly 700 basis points.

And in 2019, it was more of the same. Growth stocks outperformed value by 1000 basis points. Was this earnings driven? Nope. Growth profits declined for the year while value profits rose. Go figure.

Unicorns Deflated

Ever since the tech craze of 20 years ago, investors have been on the look-out for the next big bubble about to burst. Sure, it was right in our face, the housing mania that triggered a global financial crisis, but at the time housing seemed different, for no good reason. In 2019 a bubble did burst, and unlike housing it was a benign source of either disappointment or amusement.

This bubble was in Unicorns -- a label given to private, up-and-coming businesses that attain private market valuations of one billion dollars or more. Three notable Unicorn busts of 2019 include Uber, Lyft, and WeWork.

Uber and Lyft, two ridesharing platforms, made it public in highly anticipated but poorly received initial public offerings. Lyft stock has declined 40 percent since its trading debut, although it still sports a market value of 13 billion dollars. The much larger Uber is worth 51 billion dollars despite its 34 percent price decline. Neither company is profitable, foregoing earnings as they re-invest in growth. At least that is what they claim. Re-invest what?, is a reasonable question, as losing money while making it up in volume has seldom proven a winning strategy.

WeWork is of a different dimension. Under the leadership of its charismatic founder, Adam Neumann, and with the backing of some of the world's best-known financiers, WeWork grew to a 47-billion-dollar valuation as a private company.

On its website, WeWork states as its mission: "Create a world where people work to make a life, not just a living." And as part of its story: "We wanted to build a community. A place you join as an individual, 'me', but where you become part of a greater 'we'. A place where we're redefining success measured by personal fulfillment, not just the bottom line. Community is our catalyst."

If this seems confusing, let us clarify. WeWork is a "Shared Office Space" business. It signs leases to obtain space in, or entire, office buildings. It then spruces them up, and sub-leases to smaller tenants.

All seemed fine until the company dared to go public, at which point investment bankers and institutional investors take a good hard look at the business model until all the cracks and warts come to the surface. In WeWork's case, the cracks were mile-wide fissures. A crisis of cash flow, debt and lease obligations combined to imperil the business. Instead of a celebratory initial public offering, the company ousted its leadership, accepted a private market bailout, and settled on a valuation near eight billion dollars -- an 80 percent haircut from its prior level.

It's a fitting reminder: Unicorns are imaginary, and so was WeWork's business model.

A Free Pass

Nobody loves a runaway budget deficit more than the clowns in Washington. And why not? It allows our political class to deliver the goods on government programs of every sort, without sending an accompanying bill to the American taxpayer. And when your profligate ways are supported by 500 co-conspirators in our nation's Capitol, the self-assurance is contagious.

In the past, financial markets provided a counterbalance to fiscal irresponsibility. As deficits grew worrisome, the bond market would respond with the sharp rebuke of rising interest rates. At times, our stock market took notice as well. It all served as a market-based regulator on spendthrift Washington.

Lately, things have changed, as the counterbalance is gone. Consider the recent budget math. We are running annual fiscal deficits of one trillion dollars, roughly 4.5 percent of our yearly economic output, and this in a time of prosperity, when we should expect the deficit to be shrinking. Yet the bond market does not respond, as most Treasury rates sit under two percent and below inflation.

What's going on?

Consider three constructs, all using the same numerator:

A. The US Treasury adds one trillion dollars per year to its total debt, currently at 23 trillion dollars. This equates to a 4.3 percent increase in Treasury debt outstanding, a rise sure to trigger a supply-demand imbalance in the bond market, driving prices down and yields higher.
B. The overall US bond market, combing all government debt and non-financial corporate debt, approximates 50 trillion dollars. Using this comparison, Treasury's one trillion dollars of added borrowing amounts to only two percent of the existing market, a more manageable level.
C. Globalization has reached the bond market, and our Treasury's needs should be compared to a worldwide bond market well in excess of 100 trillion dollars. On this basis, our government is adding less than one percent to global debt every year, a rounding error.

In the past 35 years we have transitioned from the first scenario to the third. Investors around the world, led by central banks, are willing to lend money at rates below inflation, and in many cases at rates below zero. There is a free lunch after all, in what was once considered the world's greatest source of collective wisdom… the bond market. For now, deficits don't matter, Washington gets a free pass. And that is a scary idea.

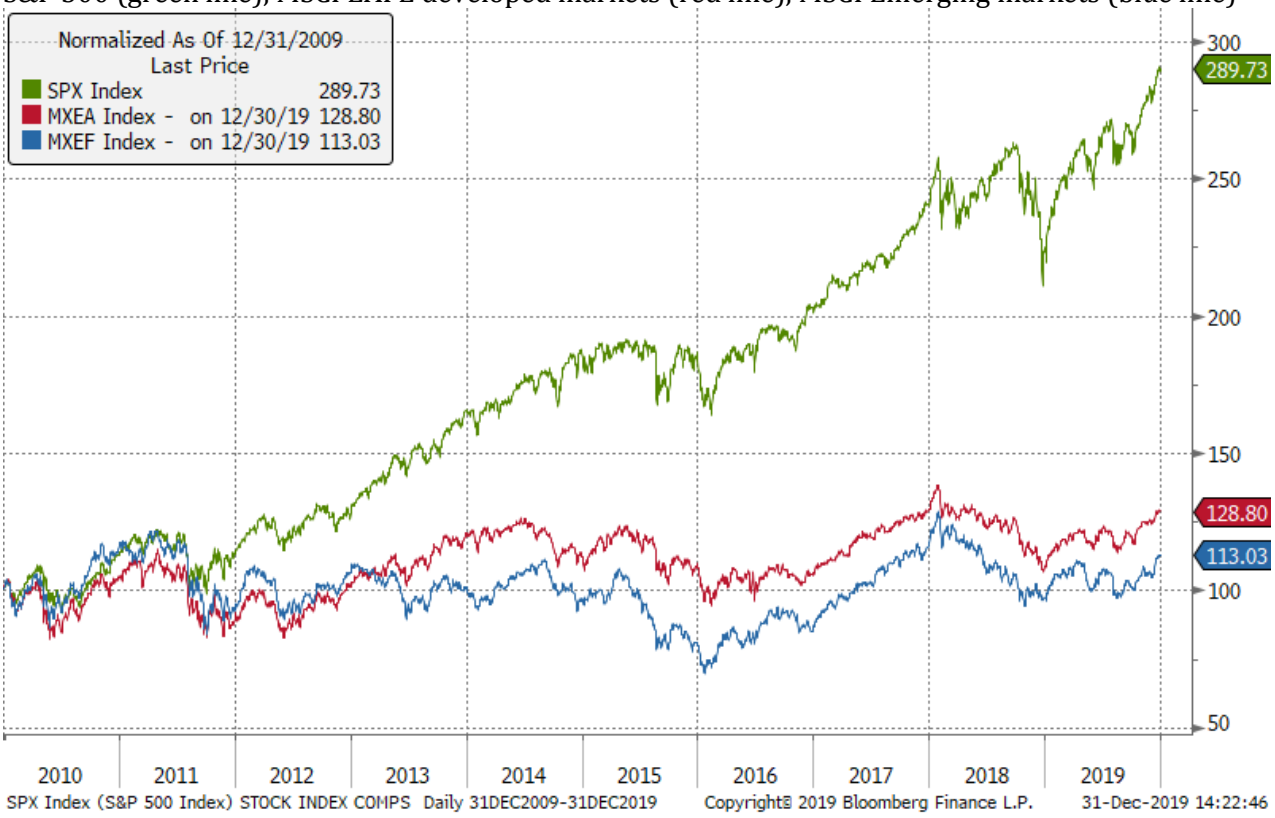
Four Trends of the Teens

In equity markets, four dominant trends have been at work for all or much of the past decade.

These are…
US stocks over International stocks
Large cap over Small cap
Growth over Value
Momentum over Mean reversion

US over International

S&P 500 (green line), MSCI EAFE developed markets (red line), MSCI Emerging markets (blue line)



While US stocks have performed well, it has been a lost decade for international equity investors, be it in developed markets (EAFE), or emerging markets.

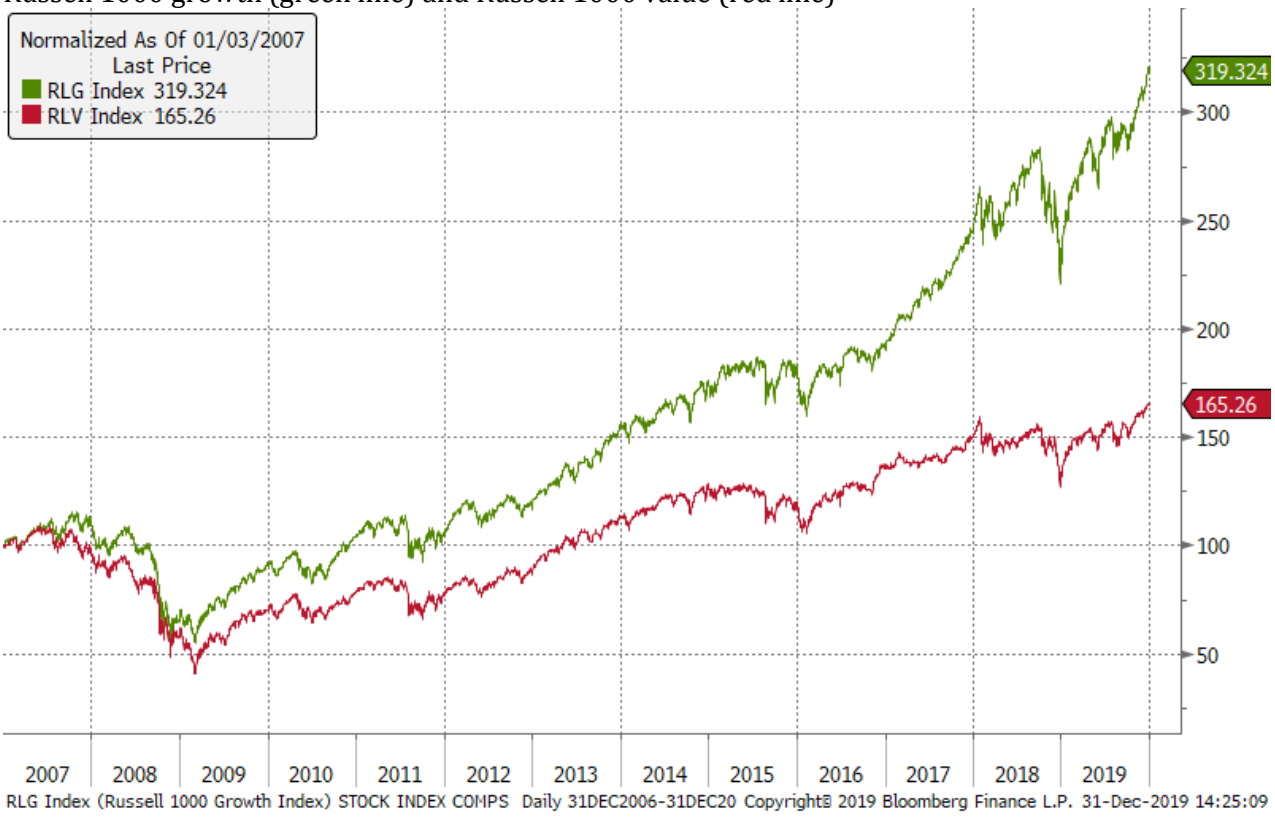
Large capitalization over Small capitalization

S&P 500 (green line), Russell 2000 (red line)

US small cap stocks performed well into mid-2018, but have yet to fully recover from their bear market decline.

Growth over Value

Russell 1000 growth (green line) and Russell 1000 value (red line)



Growth stocks have trounced value stocks over the past 13 years, with the trend accelerating in the last three years.

Momentum over Mean reversion

MSCI momentum index total return (blue line), S&P 500 (green line),
DB US mean-reverting index (red line)

In this decade, and for the past three decades, the easiest way to make money has been to buy stocks that are already outperforming, while shunning laggards.

Put it all together, and investors have been rewarded for owning US, large-cap, growth stocks with strong price momentum.

Hindsight is always 20-20, and this approach seems too simple. It ignores faster-growing regions (international), higher-growth companies (small caps), price considerations (value), and the tendency for performance to mean revert. The teens have ended, and this too shall pass, some of it likely in the coming year.

Tidbits…

Organization for Economic Cooperation and Development cuts global growth forecast for 2019, 2020 to 2.9 percent, slowest pace since global financial crisis.
European Central Bank leadership pushes climate change agenda as part of its mandate.
United Kingdom voters overwhelming support Conservative party in December election, set path for British exit from European Union in early 2020.

After 3 ½ years since Brexit vote… we're waiting.

US becomes net energy exporter on sustained basis for the first time in 70 years of data.
Saudi Armaco, representing Saudi Arabia's oil interests, launches world's largest initial public offering, becomes most highly valued company in public markets.

US wins World Trade Organization complaint against Europe's subsidies of Airbus, gets green light to impose record-setting penalties.
White House imposes tariffs on steel and aluminum from Argentina and Brazil, on Champagne, handbags, cheese and other consumer products from France; threatens tariffs on Austria, Italy and Turkey.
US, Mexico, Canada reach agreement on NAFTA 2.0 trade deal, renamed USMCA.
US and China reach minor trade agreement, label it "phase one", forestalling further tariffs.

Economic cold war between US and China will continue for years, why drag rest of world into it?

Congress moves to raise smoking age from 18 to 21.
United Parcel Service receives approval for package delivery by drone.

Get ready to duck.

California responds to housing shortage by imposing state-wide rent controls.
California utility PG&E pre-emptively shuts off power to homes and businesses to prevent more wind-induced wildfires. State of California threatens takeover of bankrupt utility.

Just tumble into the sea, already.

US shopping mall vacancies hit eight-year high, approaching 10 percent, as traditional retail continues to struggle.

United Auto Workers ratify new contract with General Motors, end longest auto strike in 50 years.
Auto makers Fiat Chrysler, Peugeot's PSA Group, agree to merge.

Academic study claims Bitcoin bubble of 2017 was due to market manipulation by a single party.

Not a comforting thought.

Boeing ousts chief executive over 737 Max crisis.

US population growth in 2019, at half-a-percent, is slowest in 100 years.

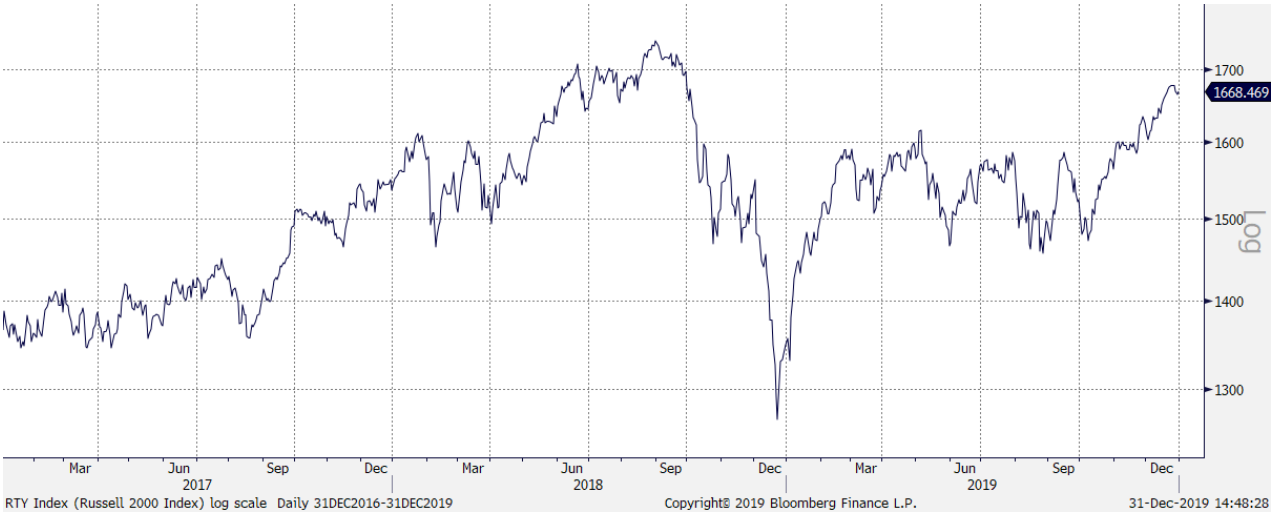
Source:
Bloomberg
FederalReserve.gov
The Wall Street Journal

Equities

S&P 500 Index

US large cap equities recovered from the bear market of late-2018, setting all-time highs.

Russell 2000 Index

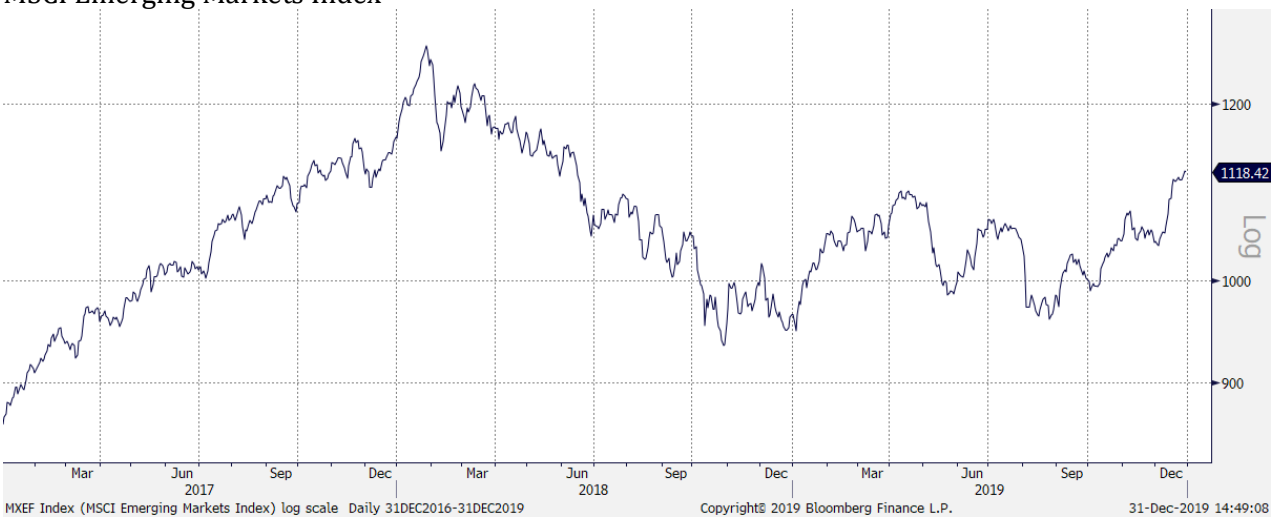


US small cap stocks recovered in 2019 but failed to reach new highs.

MSCI EAFE Index

Even after a strong year, developed international markets are still well off their prior highs.

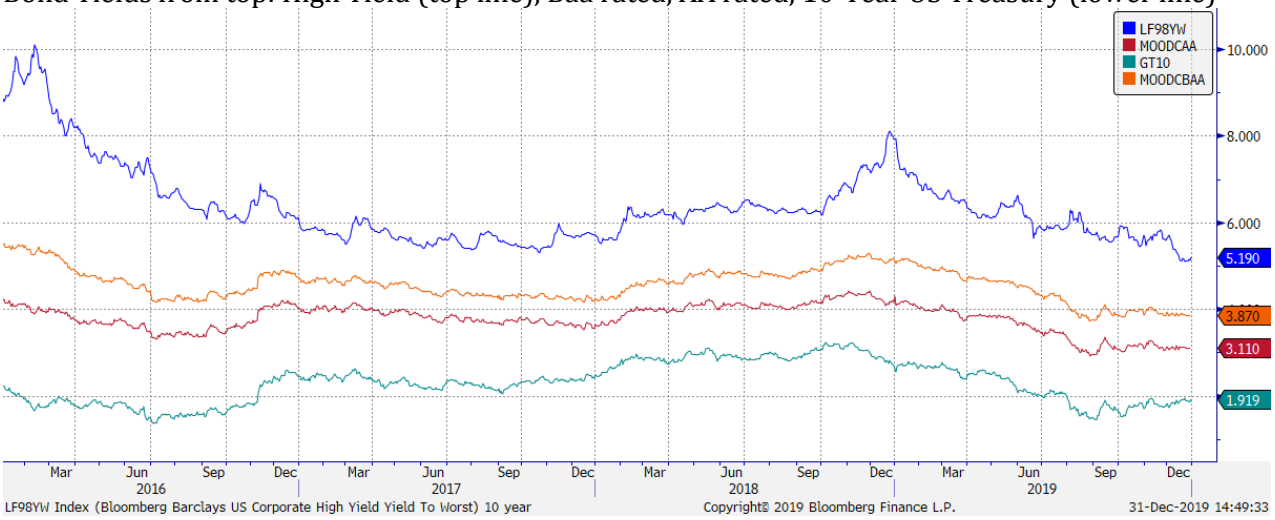
MSCI Emerging Markets Index



Emerging markets are also well off their highs.

Bonds

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



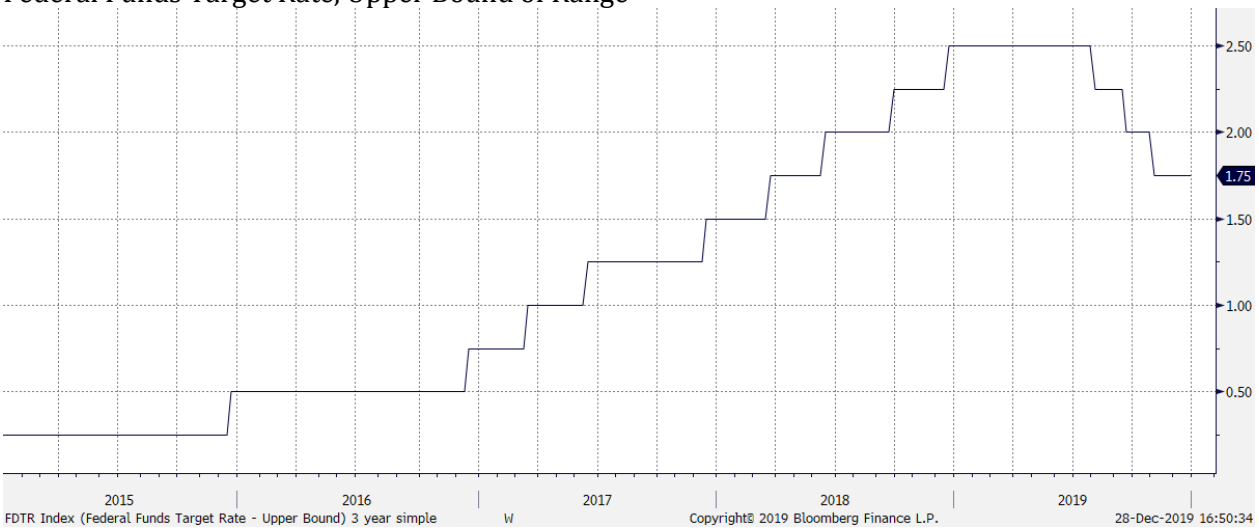
Yields fell across the board in the US, from Treasurys to corporates to high yield bonds.
It remains difficult to find any value in the US bond market, even more so overseas.

US Treasury 10-year note yield

The long-term bond market rally has driven yields lower for nearly four decades, an achievement that is one part remarkable, one part dumbfounding.

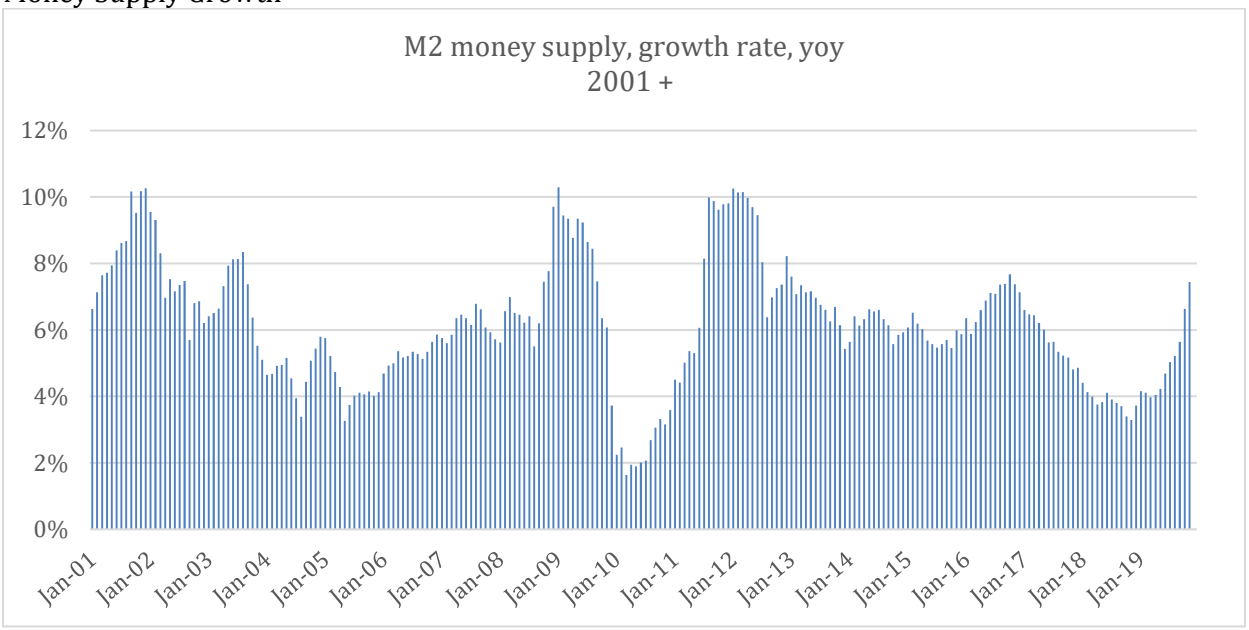
Monetary Policy

Federal Funds Target Rate, Upper Bound of Range



After a multi-year rate-hiking cycle, the Federal Reserve reversed course in 2019, and suggests it will be in no hurry to resume raising rates.

Money Supply Growth



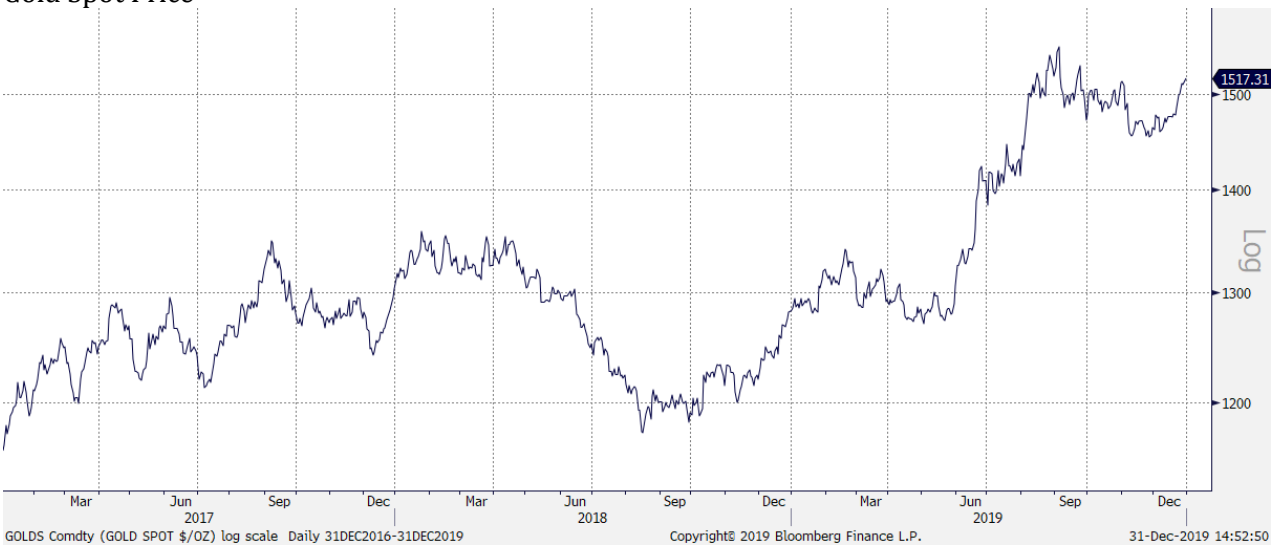
Money supply growth has accelerated, indicating financials conditions have loosened since the Fed changed course in 2019.

Commodities

Continuous Commodity Index

A rising tide lifts all ships… even commodity prices rose in 2019… but still declined for the decade.

Gold Spot Price

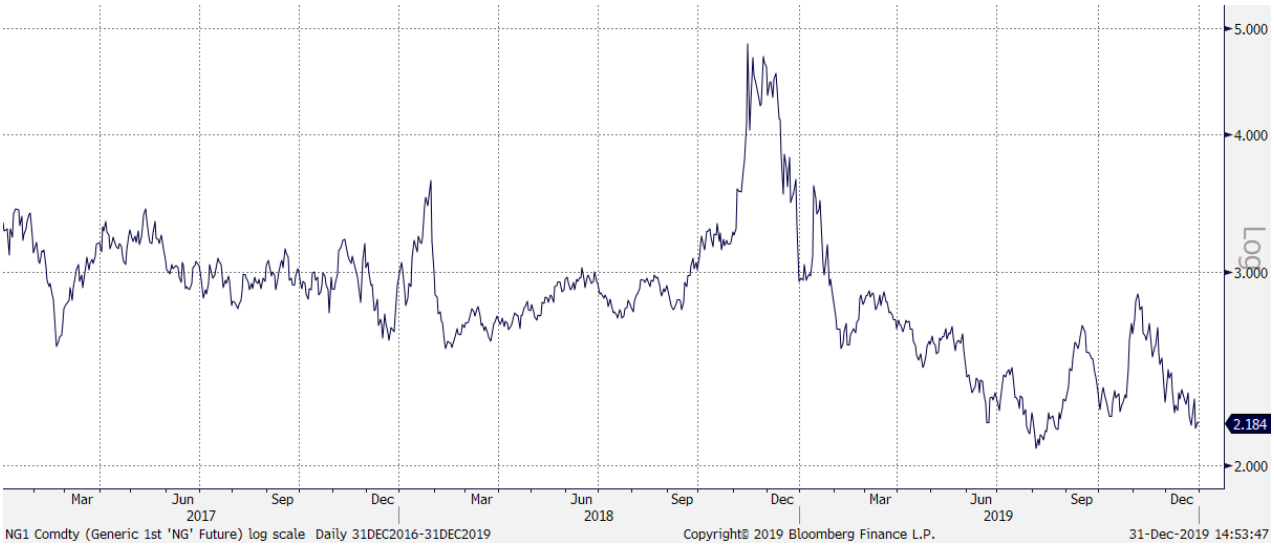


Gold broke out of its multi-year trading range, recording its best peformance since 2010.

West Texas Intermediate Oil Price

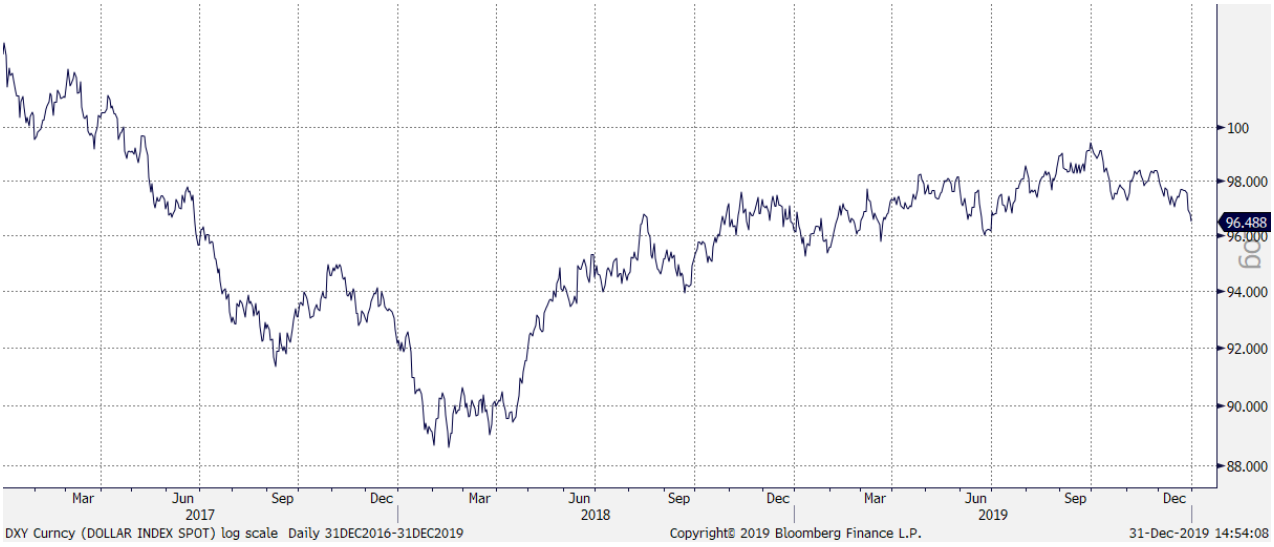
Oil prices rallied nicely for the year, but still seem unable to support the global energy complex, as the supply response to higher prices hangs over the market.

Natural Gas Price



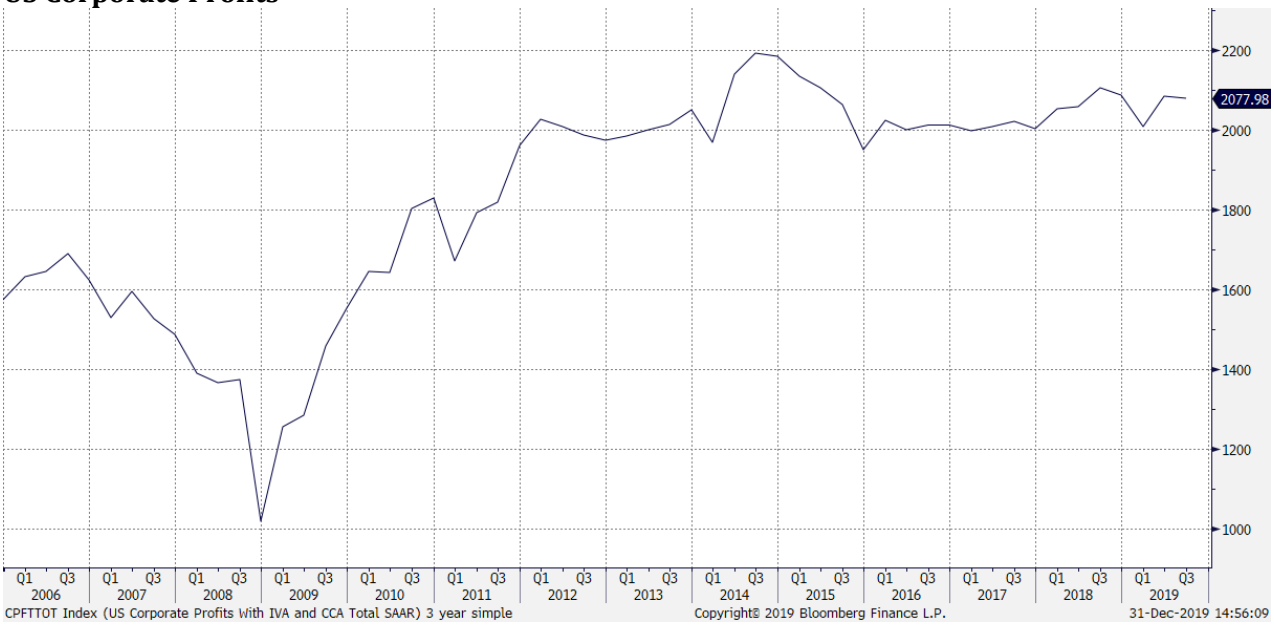
Natural gas prices remain remarkably low, with no hope in sight other than pure contrarianism.

US Dollar Index



The US Dollar ended the year unchanged, and most investors would prefer to see it weaken in 2020.

US Corporate Profits

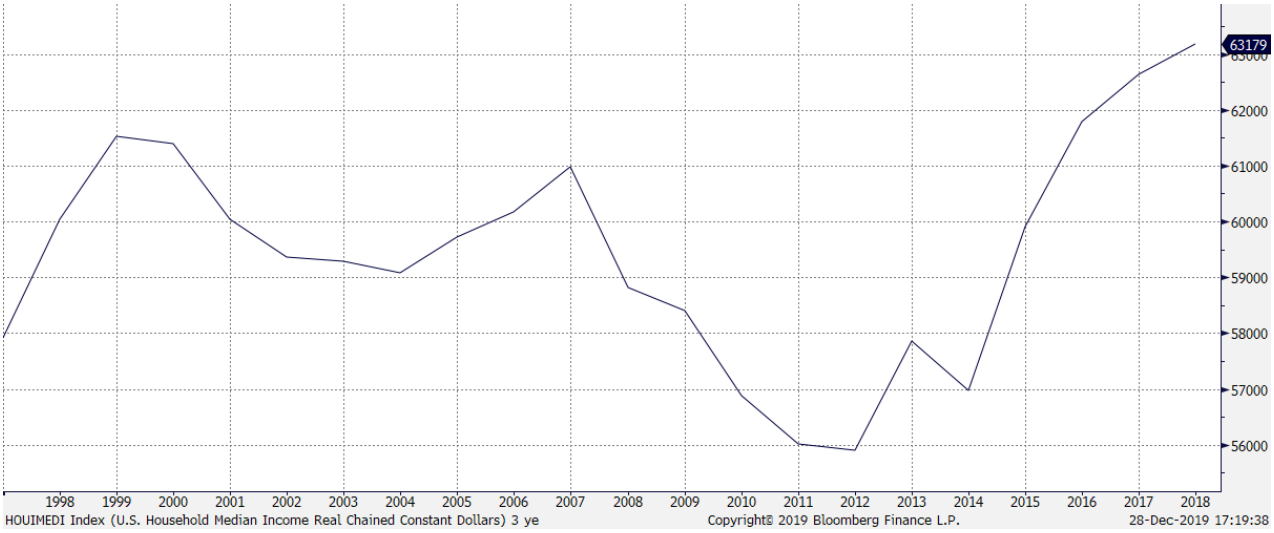


US corporate profits, on a pre-tax basis, have stalled. Any S&P 500 profit growth is being driven by the corporate tax cut and share repurchases… but the former is not repeatable.

US Privately-owned Housing Starts

The housing market recovered in 2019, supported by lower mortgage rates. We still face a housing shortage in many local markets, and affordability is an ongoing problem.

US Household Real Median Income



Household median income, inflation adjusted, has moved sharply higher to a new record level, after a lost generation of stagnant incomes.

US Unemployment Rate

The jobless rate, at 3.5 percent, is just off 50-year lows.

US Labor Force Participation Rate

A broken record: labor participation rates are still at anemic levels, perhaps reflecting a meaningful underground economy, a large social safety net, or just plain laziness.