

## 2019 SUMMER NEWSLETTER

What a difference a year makes. Just 12 months ago, the US Economy was accelerating. It recorded its first 4% quarterly growth rate in years. The tax cuts provided the kicker. Corporate Earnings responded too. Growth accelerated in 2018, sending the DOW and S&P to new, all-time highs. A year later, growth is slowing. The economic cycle is maturing. This is now the longest economic expansion in American history. But it's showing signs of fatigue. Trade tensions are adding to the pressures. Recession is a real threat overseas. Recession is a possibility at home too. But after a scare in December, and a serious slowdown from unsustainable growth rates, the DOW and S&P still find themselves back near those all-time highs.

### GROWTH ENGINE SPUTTERING

Forget whether we see an economic recession in the US for a minute. What if there's an investment recession? Money has been really cheap for years. It encouraged investment, which stimulated growth. Asset prices soared. It's reflected in the Stock Market as well as Real Estate. But it never lasts forever. Young Tech companies have received substantial investment, despite no profits and more importantly, no near-term plan for profits. We saw that happen before, a mere two decades ago. Though far from identical, there are many similarities between today and the Dotcom days. More on this later.



We titled our Spring Newsletter: The Check Engine Light is On. The S&P had its best start for a year in decades. The Stock Market in 2019 is a mirror image to how it ended 2018. Our Research Team hunkered down and continues to study things very closely under the hood. We found some alarming developments that this Market still seems to be ignoring, for now. The inverted yield curve was a big one, which has always signaled stress in the system. It just has not been effective on timing. To us, the yield curve is the check engine light. Sure, you can keep driving when the light hits the dashboard, but the responsible thinking is that you are on borrowed time until the issue is

resolved. The Bond Market is telling a different story than the Stock Market. The Bond Market is saying the growth engine is no longer running smoothly.

### CHEAP MONEY HAS LIMITS

Money has been cheap and easy since the Financial Crisis. Interest rates rose last year but that didn't last. Interest rates are the price of money. Money has gotten cheap again. But it's not necessarily easy to get anymore. When growth slows, access to capital generally gets tougher. Spending has been massive. How it's paid for seems to be an issue that keeps getting kicked down the road. There's a lot of debt out there which needs servicing. With such low-interest rates, companies have borrowed a lot, even to buy back their own stock. Debt-to-equity ratios are pushing 80% on average, the largest in decades. And over half of investment grade companies fall in the BBB credit rating, which is just one level above junk. It won't take much to see a slippery slope into junk which would rattle the Credit Market.



The Stock Market has been sending conflicting messages about the impact of trade tariffs and the slowing global economy. A big reason is the Fed. The Fed went from a plan for four rate hikes in 2019 to the strong possibility of three cuts. They

outlined it at the June meeting. There has been a complete 180-degree turn in monetary policy. The Market has already priced in the first cut in July. The 10-Year Treasury yield fell from 3.25% to 2% in just nine months. That is not normal or healthy. A decline like that rarely happens.

Aggressive monetary policy is not a Bullish investment theme. It's happening for a reason. Growth is slowing. Economic slow-down and Central Bank backstop are the name of the game now. That's not sustainably Bullish. The result is manipulation and artificial stimulant to asset prices. That normally occurs during recessions, not with the Stock Market at all-time highs. But it can certainly prop up prices for a while.

The acceleration of the economic slowdown is apparently upon us. Despite no clear resolution to the trade tensions and an escalation of tensions between the US and Iran, global stocks ended June in rally mode. Central banks came to the rescue. The only question: for how long will it work? European Central Bank President Mario Draghi famously said, "Whatever it takes." He's not going to be at the job for much longer. There will be a new President in the Fall, the identity and approach are a big unknown. That matters.

### TROUBLE RHYMES WITH BUBBLE



We see many similarities between today and the late 1990s. That was a period in American history which saw a Market rally that defied logic. The adoption of the internet in broad scale fueled the growth as well as enthusiasm for exciting growth stocks that were tied to the web, regardless of adequate business model or plans for profit. The belief was that this time was different. There was a substantial upfront investment in fiber optics and internet infrastructure to handle the traffic. In addition, there was a massive one-time investment ahead of the calendar year 2000 which was feared could have brought about a disaster, as digital clocks were not programmed to

adjust with the calendar. It was called Y2K. Gobs of money was spent. Then it went away. The Bubble burst soon-there-after.



History does not repeat itself, but as Sam Clemens pointed out, it tends to rhyme. Today's Market environment might not defy logic, but it does seem to lack discipline. Cheap money and excessive liquidity in response to the Financial Crisis have sent asset prices soaring. Companies, countries and municipalities have issued substantial debt in response to the low borrowing costs. Venture Capital has invested mightily in Silicon Valley and Silicon Valley has thrived. At some point in time, the law of large numbers sets in. Tech companies have become titans. Tech valuations are even bigger. The hot IPO Market is full of companies looking to tap Wall Street while the getting is still good at high prices, while growth rates have shown signs of topping. Asset prices are expensive, in nearly every traditional metric, eight common ones we track are now in the 94th-99th percentile of historical norms. The only thing missing now, compared to 1999, is euphoria. We believe the deep political and economic divide in our nation explains the lack of exuberance. We also live in a time which seems to require instant results and instant gratification. There's very little patience. If things go against expectation, there's plenty of blame to throw around.

### AMERICAN IMMUNITY CAN'T LAST FOREVER

There is a lot of short-termism going on. We've seen it in trade discussions. We've seen it with earnings cycles. We see it constantly with election cycles. The Market has been focused on headline after headline with instant results in mind. The whipsaw price action can be gut-wrenching. Thinking long-term has been challenging. The fast-growing companies which have a longer-term focus have stock prices with nose-bleed valuations. Private companies have sought the IPO Market to sell while they can at these high prices. The cycle is maturing.



The American Consumer has been resilient. Consumer spending accounts for 70% of the US economy. It's been holding up well, but for how long? The unemployment rate is at a five-decade low. It's almost like it's as good as it gets. The US economy saw accelerated growth last year. Earnings skyrocketed too. But the growth rates were unsustainable and likely peaked. The risk is now stacked towards a faster deceleration of growth, and possible contraction. The US has been immune to problems overseas for years, but the immunity seems to be breaking down a bit and the US Stock Market seems vulnerable to another sell-off. We are still concerned that expectations are too high. We don't anticipate an economic recession in the US. But we do anticipate another earnings recession, which last happened in 2015. In our work, risks are on the rise. We understand the metaphor that the US Stock Market is the best house in a bad neighborhood. But that only lasts so long. Everything is connected these days. Market trends are very powerful.

### CHINA & TRADE

The Trade War continues between the two largest global economies. Tariffs have been raised, and more could be coming if a trade deal isn't forged. Regardless, the economic impact has already been felt and companies have been forced to scramble to account for additional costs and delays. The American Consumer ultimately pays for it. There is a short-term and long-term component here.



A trade deal would certainly be a positive, but merely transactional. It would address some economic inefficiencies and unfairness. But the issue of spying and stealing is a much bigger issue, one that will not be addressed anytime soon, particularly with the 2020 Presidential election on the horizon. Huawei is at the center of it. Beijing is seeking to project an image of strength and stability as it grapples with an economic slowdown and a bitter trade conflict with the US. Something to consider is the recent backlash in Hong Kong presenting President Xi Jinping with the most high-profile challenge yet to his authority. Xi's goal of reintegrating Hong Kong and Taiwan into the mainland suffered a setback. It does not reflect his China positively around the world and risks inspiring similar actions in mainland China. This could be a wakeup call for Xi and catalyst to get some sort of deal done with the US. But it won't stop them from their plans. The Belt & Road initiative is their version of the Marshall Plan to invest and influence the rest of the world. That said, China is playing the long game and they're in it to win it.

### IRAN AND THE MIDDLE EAST



Tensions continue to rise, and the US has been increasing the number of troops on the ground. The chances of a military engagement between the US and Iran is still low, but it is not zero and it is growing. The price of crude oil fell despite these increased tensions and decreased production in Iran and Venezuela. Demand is slowing around the world as economies cool, while the US continues to increase its supply. American Energy independence has been so critical to economic and geopolitical stability at home. Its significance cannot be overstated. We are no longer dependent on the Middle East. We just cannot believe that the Market does not seem to care about the growing tensions. It just does not feel right.

**FRONT-LOADED**

Both Stocks and Bonds have enjoyed a solid 2019 at the halfway mark, but the month of May might have provided a preview of things to come. Dollar strength hurts American exports as well as Emerging Markets. Bonds and stocks don't normally rally together. The Bond Market rarely lies. Asset prices are high and at risk of declines. At a minimum, the rate of increase is unsustainable. How much higher can California real estate prices go? It's pricing out a large segment of the population. What happens when Silicon Valley struggles? It's been a long time since Silicon Valley faced serious challenges. It is now. Tech has been such a dominant space for investors for a decade and a half. But it will pay to remember that Tech struggled mightily from 2000-05, after the Bubble burst.

The Stock Market feels front-loaded to us. The tax cuts last year provided stimulus for acceleration. It worked. But it was temporary. Call it Wimpy Economics (named after Popeye's pal), where a hamburger today will get paid for on Tuesday. The US Economy accelerated its growth. Corporate earnings accelerated too. Both are at risk of contraction. At a minimum, their growth rates will fall from the unsustainable rates. But the Market expects more.



We think expectations are too high. Earnings grew at the fastest rates in decades last year. A continuation is nearly impossible at this stage of the economic cycle. Earnings grew over 20% last year for the S&P 500 companies. They're expected to grow 8% this year, though that estimate has been revised down from the double-digit growth expected at the beginning of the year. But the big kicker comes with really high expectations for the second half of this year and even more so for 2020. We don't see the Stock Market returning to double-digit earnings growth while the Global Economy is slowing faster than previously thought and the Fed is having to reverse its monetary policy. Record highs for the DOW and S&P seem to have paid investors forward. It's our feeling that growth has been front-loaded.



With so much going on around the world, the whipsaw action from trade tensions, turmoil and tweets make it natural to proceed with caution. Taking it a step further, the logic-based approach that had us so bullish in 2016 and 2017 has us feeling quite defensive heading into the Summer of 2019. We do see opportunities, however. We are positioning defensively and like things that should do well in a low-interest rate environment: Mature Dividend Stocks, Bonds, Gold and growth companies with unique opportunities for isolated growth in a challenging economic environment. There are some longer-term themes which we find quite compelling. We see significant opportunity ahead for the expansion of fresh food delivery, which is still in its early days. We are investing in digital payments and see great opportunity for investment in Blockchain. We like the digitalization of housing. We like the growth and demographics in India. We also see tremendous opportunity in content creators in the media and entertainment space. We believe the Digital Age will reward companies with unique content and a direct to consumer distribution model.

We still believe the secular Bull Market, which began a decade ago, is very much alive and has more room to run. At this stage though, with the US Stock Market back near all-time highs, we feel the risks are significantly greater than further rewards. Central banks can only do so much. Our plan is to keep a defensive positioning for this next stage until we see signs of improvement, which would come at lower levels. For now, we want to preserve gains and continue to protect your life savings. This is a moment which we feel patience and discipline will be rewarded.

