INVESTMENT TRENDS AND OUTLOOK

Investment Club
Men's Club of New Canaan
Monday, September 10, 2018

Next meeting: Monday, November 5 at 10 am at Lapham
Topic: Financial Leverage and Interest Rates Trends

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Reaching financial success is a marathon, not a sprint.
Slow and steady wins the race.

Quiz

- If we define a recession as two consecutive quarters of negative economic growth and a bear market as a pullback of 20%+ in stocks ....

- Within the next two years:

  - Who expects a recession and a bear market in stocks in the U.S.?

  - Who expects the economy to continue to grow and the stock market to remain in an upward trend, despite regular pullbacks of less than 10%?

10 years since 2008 crisis

- This week, it has been 10 years since Lehman Brothers collapsed
- Investors are still scarred and can’t deal with another 2008 situation
- The U.S. stock market achieved its longest rise in its history on Aug. 22, with the Standard and Poor’s 500 index up by 230% since 2009.
- Although we have been in longest bull market in recent history, we had two 19.9% corrections during this run
- It is not about the length of the bull market, which has no predictive value, but it is about the strength of the economy
- This has been called the most unloved bull market – the market is climbing a wall of worry
- Fear of loss has been replaced by fear of missing out (FOMO)
- Everyone has a plan until they get punched in the mouth – Mike Tyson
- To paraphrase Mark Twain, September is a peculiarly dangerous month to speculate in stocks. Since 1950, it has been the worst month of the year for the Dow and the S&P 500, with average respective declines of 0.7% and 0.5%, according to the Stock Trader’s Almanac.

Predicting the next Recession is futile, but avoid warning signs at your peril

- The stock market has forecast nine of the last five recessions - Paul Samuelson
- More money has been lost in forecasting recessions than in actual recessions - Peter Lynch
- Economists are not helpful. As a consensus, they called none of the past 7 recessions since 1970. They only ‘forecast’ a recession after it had started.
- The number of investors who can correctly identify the beginnings and endings of bear markets can comfortably fit in a minivan.
- It is time in the market, not market timing
- The stock market is climbing a wall of worry
- Warren Buffett said on his 88th birthday (8/30/2018): “I’m buying stocks … I’m buying them because I think they’ll be worth quite a bit more money 10 years or 20 years from now.”

U.S. economy is robust

- We’re in the late cycle part of the business cycle
- U.S. economy grew at 4.2% rate in Q2, helped by business investment.
- Consumer confidence hits best level in 18 years.
- Business optimism is leaping
- Low unemployment rate of 3.9%
- The ISM reported that manufacturing activity grew at the highest rate in 14 years. The index rose to 61.3 in August versus 58.1 in July
- The bull market will last as long as the economy expands
- Negative: Trade deficits with the European Union and China hit record highs in July as tariffs hit and the dollar strengthened

Encouraging Productivity

- Productivity is the increase in output per hour of work – a vital economic indicator
- Over time, productivity gains enable an economy to improve its living standard without inflation
- Combined with labor-force growth, productivity determines an economy’s potential growth rate
- U.S. worker productivity grew at an annualized rate of 2.9% in Q2
- Force behind it: Business investment has accelerated over the past 18 months, thanks to corporate tax incentives and deregulation

Historical Productivity Growth

- Over the past two decades, productivity has been in decline, which helps explain America's tepid economic growth despite monetary and fiscal stimulus
- Productivity grew at a sluggish growth rate of 1% over the 10 years through 2017. During the 70s, 80s and 90s productivity grew at a 2% rate thanks to the entrance of more women into the workforce, the introduction of the personal computer and the advent of the internet

Earnings continue to come in strong; Valuations are not that high.

- Low interest rates, the corporate tax reform (from 35% to 21%), repatriation of foreign earnings and deregulation in several industries have raised both current profits and expected future profits.
- S&P 500 earnings expected to grow at 20%+ this year and another 10% in 2019
- There has been an additional boost to earnings per share from share repurchases
- The S&P 500 is trading at 16.8 times 12-month forward earnings

Bear Market Checklist

- Omega Advisors (Leon Cooperman and Steve Einhorn) has a bear-market checklist with five items that almost always are present when a bull market ends, and a bear begins:

1) accelerating and problematic inflation,
2) tight monetary policy,
3) the threat of a recession
4) investor exuberance, and
5) high valuations

Omega's responses on checklist

- The Federal Reserve is lifting rates, but is friendly. Most bull markets in the postwar period are murdered by the Fed, but it isn't in a murderous mentality principally because inflation is fairly tame.
- Nothing we look at suggests a recession is likely in the next couple of years.
- We don't see many signs of euphoria. Investment flows have been going into bond funds, not equities.
- Finally, the market valuation is above average on an absolute basis, but relative to interest rates, it is quite low. The S&P 500 multiple has averaged 16 times earnings, or an earnings yield of 6%, with a 10-year Treasury yield of less than 3%.

Yet fears of recession

- The flattening of the bond market's yield curve is signaling that the risk of recession is rising.
- The curve typically slopes upward, with shorter maturities yielding less than intermediate and long ones to compensate for the risk of locking up an investment for a lengthier period
- Inversions of the yield curve has a history of preceding economic downturns
- When short term money earns more than lending, banks begin to tighten credit standards for commercial loans. When those standards tighten, a recession ensues

Yield Spreads

- The difference between the 2-year Treasury note (2.67%) and the 10-year note (2.91%) has grown narrower to 24 basis points
- According to a San Francisco Fed paper: the difference between the 3-month T- bill and the 10-year Treasury Note is the most useful spread for forecasting recessions, which is a wider gap
- Another yield spread that may matter more is that between the fed-funds rate and the 2-year note.

The Fed is raising rates at a turtle's pace

- The Fed's actions are well telegraphed; it is a gradual and transparent rate tightening cycle. Historically large and unexpected increases in rates were problematic
- In other words: the Fed will continue to raise interest rates at a turtle's pace, rather than a hare's
- The Federal Reserve is expected to boost its federal-funds target rate one-quarter of a percentage point, to a range of 2% - 2.25%, at the conclusion of its September 25-26 policy meeting. There's a 64% chance of another quarter-point hike in December.
- The Fed's goal is to raise the federal funds rate to 3.1% by the end of 2019 and 3.4% by the end of 2020

End of QE; Begin of QT

- End of Quantitative Easing and begin of Quantitative Tightening - the unwinding of the massive $4.3 trillion balance sheet of the Fed is a headwind, but that also is implemented gradually when bond maturities expire
- Quantitative Easing, or asset-buying, increase the money supply to stimulate the economy – was a big support to the bull market and led to Price/Earnings ratio expansion
- Quantitative Tightening is the reverse and will decrease the money supply and economic growth. It could lead to P/E contraction and the stock market could be more volatile under QT than QE.

Long Term Interest Rates are moving up gradually

- 10 year Treasury nominal rate at 2.91%; real yield: 0%, historically real yield is 2%, so expect 5% nominal rate over time.
- The long-term interest rate will be driven higher by:

1) rising short-term rates as the Fed normalizes monetary policy,

2) higher inflation in response to tighter labor and product markets, and

3) the explosion of the federal debt that needs to be absorbed by investors. The U.S. budget deficit is expected to exceed $1 trillion next year.

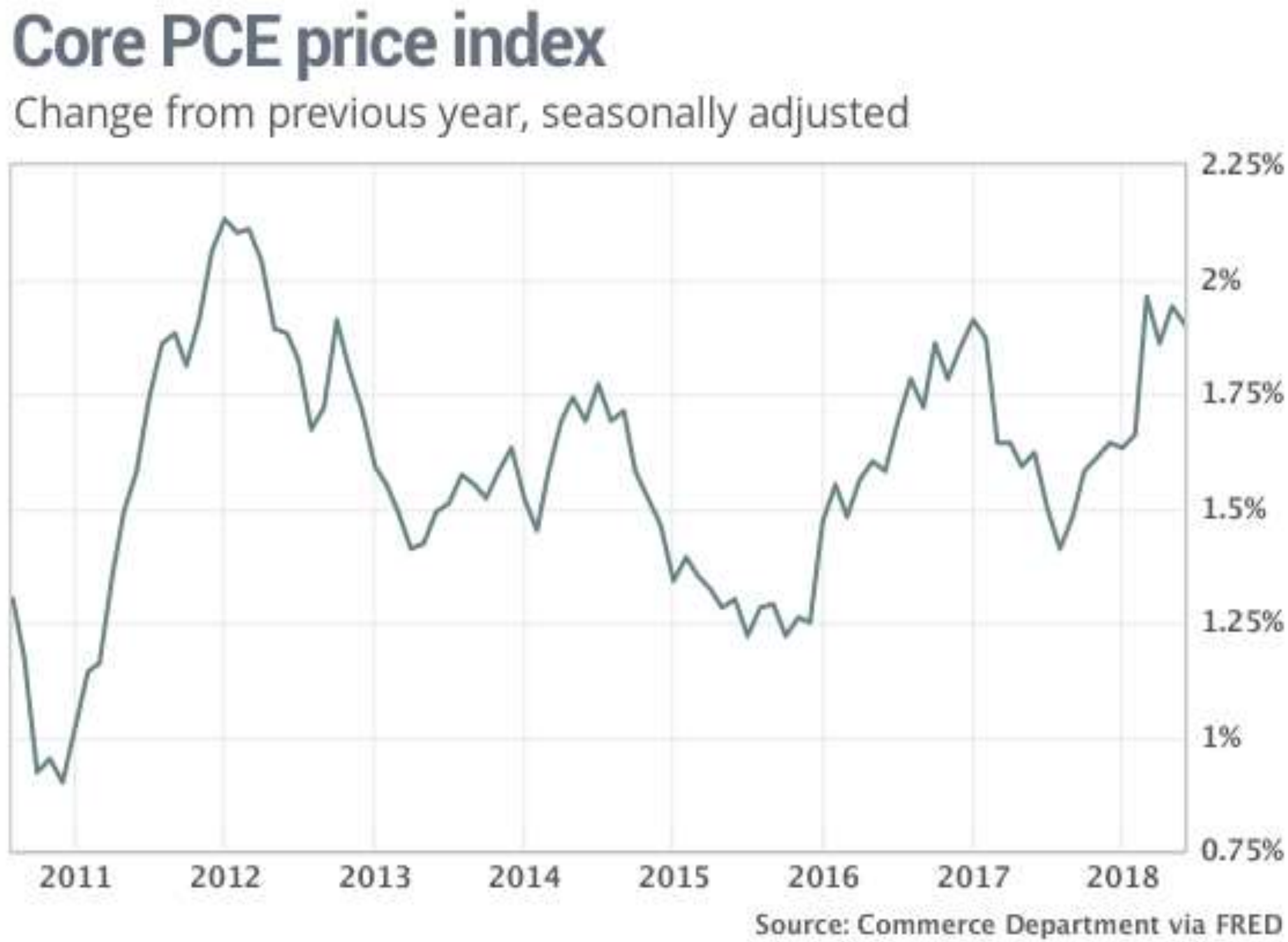
Leverage increased and will be problematic with higher interest rates

- Share buybacks with borrowed money is leverage – IBM's balance sheet for instance deteriorated
- Private Equity is leveraged equity portfolios
- Tax cuts financed with Treasuries is leverage.
- The budget deficit will come in at just over $1 trillion next year. That's about 5% of GDP, a record excluding wars and recessions
- The Federal Reserve's balance sheet ballooned to $4.3 trillion
- Consumer debt at $4 trillion is at an all-time high
- One measure of leverage in the stock market is margin debt. Margin debt has soared for nine years in a row and at $650 billion exceeds the prior peak of July 2007 ($416 billion) by 56%

Inflation is picking up, but not a problem yet

- Fed's target inflation rate is 2%.
- The Fed favors the PCE (Personal Consumption Expenditures) index = 2%. This includes food and energy
- Right now the PCE index is 2%. Normal range: 2%-3%. It was 1% three years ago and 4% in 2008.
- CPI (Consumer Price Index) is 2.9% and 2.4% excl. food and energy
- Wages grew at a 2.9% annual rate in August
- Stronger growth in low-paying jobs has tended to dampen gains in overall hourly wages. So, too, has the resurgence of 25- to 34-year olds into the workforce, relative to other age groups. As younger workers replace older, better-paid ones heading into retirement, labor costs are being restrained. That has kept compensation-cost growth from reaching the 4% mark that historically has been burdensome for the economy.

Core PCE Price Index



Trade Conflicts

- No one wins a trade war
- Tariffs are taxes that punish American consumers and producers.
- While the tax cuts put one foot on the gas pedal, tariffs place another on the brake. Fiscal stimulus pumps up demand; trade curbs restrict supply
- Worries about growth hindering trade conflicts have hurt stocks around the world
- The widespread presumption is that the U.S. and its major trading partners, especially China, won't allow the disputes to escalate to a full-scale trade war
- Free trade, even if it is not completely fair trade, is better than no trade, according to the conventional view. Trade boosts economic growth on balance
- Adam Smith demolished comparable mercantilist beliefs in The Wealth of Nations (1776). Smith argued that high tariffs immiserate (impoverish) a nation, while low tariffs and flourishing trade increase the wealth of a nation.
- President Trump booked successes in bilateral trade talks with European Union and Mexico. Canada is still up in the air and so is China

Mid-term Elections + Potential Government Shutdown

- Odds that Democrats regain control of the House of Representatives are as high as 70%
- Republicans most likely will regain control of the Senate
- A mixed Congress is usually bullish for stocks
- President Trump said he would shut down the government to get the funding to build his wall on the Mexican border. He insisted, he would force Democrats in Congress to support his immigration plan, including the wall. A shutdown crisis would come less than a month before midterm elections – early October
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Geopolitical Risks

- Debt situation in southern Europe, especially Italy – will put pressure on European Union
- China's ballooning debt: 300% of GDP
- Emerging markets weakness, primarily Turkey, Venezuela, Argentina, Brazil, South Africa, Indonesia
- The higher dollar hammered emerging markets currencies
- The MSCI Emerging Market Index has dropped by more than 20% since January, entering bear market territory
- North Korea, Iran, Syria, Russia

Integration of Telecom, Media & Internet Companies

- Indexes for tech, telecom, and other key industries are headed for big change after the market closes on September 28
- Unprecedented overhaul by S&P and MSCI of their Global Industry Classification System, or GICS, that carves up the stock market into sectors and industry groups.
- The biggest change: a new sector: **Communications Services** replacing the telecom services sector. The communication sector will cherry pick stocks from the technology, consumer discretionary and telecom bins
- The new sector will be the fourth largest, tied with consumer discretionary out of 11, behind information technology, health care and financials
- The changes will affect the SPDR sector ETFs from State Street, which track the S&P 500 sector performance
- The changes won't affect the QQQ, which tracks the 100 largest nonfinancial stocks on the Nasdaq exchange. This Invesco ETF holds all of big tech, regardless of sector classification

The Main Individual Stock Changes

- Facebook, Googl and Twitter and other social media / internet stocks move from technology to the new sector
- The tech sector will be more oriented to chip stocks, software and hardware, like Apple, Microsoft and Intel
- Media stocks like Disney, CBS and Viacom move from consumer discretionary to the new sector
- Amazon stays in consumer discretionary and will have the biggest weight (about 35%); this sector gains Ebay and consists of stocks like Home Depot, General Motors

Share of the 11 S&P 500 Sectors

Technology declines from 26.5% to 20.4%
Health Care 14.6%
Financials 13.9%
Comm. Services 10.6% (was Telecom 2%)
Cons. Discretionary goes from 12.6% to 10.6%
Industrials 9.6%
Consumer Staples 6.7%
Energy 5.9%
Utilities 2.8%
Real Estate 2.7%
Materials 2.5%

XLC – The Communications Services Sector ETF

This ETF is launched by State Street and tracks the new S&P Communications Services sector - Rebalancing after the market close on 9/21

Top Holdings and Weightings (as of 8/31/18)

- Facebook 18.3%
- Alphabet C 12.6%
- Alphabet A 12.6%
- Comcast 5.1%
- Verizon 4.9%
- Disney 4.9%
- Charter Comm. 4.8%
- AT&T 4.6%
- Activision 4.5%
- Netflix 4.2%
- Electronic Arts 3.7%
- Twitter 2.4%
- CBS 1.9%