April 18, 2019

Dear Fellow Investor:

Everything we had been concerned about for years is playing out in real time as the central banks have become the only thing that matters to investors. The big risk is that they are trying to become more dovish when there is not much room to become more dovish without permanently altering the structure of the global economy. At the same time, investors are placing enormous confidence in monetary policy while ignoring changes in other dynamics and narratives that drove this cycle.

Those touting this year's rally after the December swoon seem to forget that stocks have gone nowhere for a year. The earnings boost and growth mirage from tax cuts in the U.S. are fading fast. Inventories were built ahead of more possible tariffs, juicing GDP in 2018, but they must now be worked down. Rail traffic has is down 2% this year. J.B. Hunt, a major logistics company, just reported weak earnings, echoing earlier concerns from FedEx. Containerboard companies have come under pressure as well due to weak demand for boxes. Industrial production has been coming in soft this year. All the usual loud voices are telling us there is nothing to see here, folks. Not so!

In a matter of weeks, the Fed has turned on a dime. It says it will not raise rates this year and will end quantitative tightening in September. Like most of Wall Street, it missed the slowdown of the last two quarters and is clearly worried, but it refuses to admit it may have a big problem on its hands. It is using misleading rhetoric about low inflation and global growth concerns to confuse matters and allow it to keep doing what it wants to do i.e. manipulate the stock market at the behest of Trump and the Street.

Based on uneven consumer spending patterns and elements of the confidence surveys, it appears a lot of people did not get much benefit from tax cuts and don't like what's trickling down from the corporations that did. It's becoming a PR problem for Trump and makes it more likely U.S. voters elect a socialist for President.

Frustration is building among those voters who can't seem to get ahead. The "Medicare for all" slogans from some of the pols are not falling on deaf ears. Investors in healthcare stocks are getting nervous and they should be because the issue of insurance coverage hits home for a lot of the people who feel disenfranchised and were not bailed out by the Fed. This is one sector where monetary policy may meet its match. Calls for lowering healthcare costs will only grow louder.

Meanwhile, those who "think" they have been helped by the powers that be are happy…for now. That might be shortsighted because the long-term consequences of monetary and fiscal recklessness are not good for anyone. Japanese monetary meddling and a huge debt habit have left their stock market trading at half of its peak with decades of poor growth. Keep that in mind when you hear those praising the Fed or demanding it do more. Saying Europe is turning into Japan is becoming common now, but we are not far behind in the U.S.

Calls for increasingly radical measures like central bank buying of corporate bonds and stocks are not unusual anymore. The BOJ already buys stocks in a big way. We also hear more discussions about printing currencies that governments would disburse directly to the populace. Never mind that the only difference between that and what we did during QE is that Treasury debt had to first pass through the hands of traders on Wall Street and the government spending was more narrowly allocated to select friends of the Establishment.

The next iteration is to have the Fed deal directly with the Treasury and distribute the cash to the masses. This is to prevent the current populism from becoming more unseemly. Once wise investors are embracing this concept. It won't happen tomorrow, but don't be surprised if it happens in the next few years. How is it that gold trades only near $1,300?

"Hello, young man.
I'm with the Federal Reserve.
Today, we're buying baseball cards."

This cartoon may seem like a stretch, but not like it did before the monetary madness began in earnest in 2009. The Fed put us in a place where tightening is next to impossible and there is no room for error. We have been warning about the misguided Fed for years, so don't count us among the "Monday morning quarterbacks."

The absurdity of the President and his minions running around begging the Fed to lower rates and conduct more quantitative easing should not be lost, particularly as they discuss how strong the economy is because of their policies. Every chance they get they talk about a wonderful China trade deal being close to done to goose stocks. On that front, we remain skeptical that much of substance will result from the drawn-out trade negotiations because holding China accountable would mean no deal gets done and trade volumes soften more. Neither side wants that.

Let's get this straight. Real rates never became positive in the U.S. in this cycle and overall financial conditions indicate policies are quite easy while the federal deficit skyrockets in a supposed boom, yet somehow the Fed needs to become more dovish after behaving incredibly irresponsibly for a decade. If participants refuse to see the problem with that, we can't help them.

The Fed's dovish turn this year went too far, too fast. It panicked after the late-year equity swoon highlighted that the financial system suffers from a lack of liquidity when real selling begins. Translation: The Street does not take the other side of trades like it used to in down markets and contrarian investors are a rare breed these days.

The Fed is finally realizing that normalization is not possible and that must be concerning to it. Because it became too dovish, too soon given the landscape, it risks having to move to the hawkish side if economy bounces like stocks have. Regardless, the current M.O. is talking about not tightening while still shrinking its balance sheet for a few more months. That is not easing, though participants act like QE is back already.

It is late cycle, not mid-cycle, so the challenges are immense. Many professional investors feel trapped by the monetary shenanigans. Play along with stocks broadly trading at 2-3 times normal valuations or risk losing clients. Long-only managers mostly refuse to go to cash, feeling compelled to chase an expensive market even when the downside risk is high. Remember most of the gains of a cycle are usually erased by the end of the cycle, but that is ignored in every cycle. We are content to remain hedged.

Treasury bonds and stocks can't both be right after each rallied strongly in the first quarter. The recent unusual inversion of the curve between bills and the 10-year Treasury that typically marks a cycle that is long in the tooth would suggest that stocks may have it wrong. We have always put a lot of credence in this measure as an important sign that risk needs to be reduced, especially when economic indicators are softening like they are now. For instance, the current annual rate of employment growth of 1.4% is usually only seen near recessions, but you'd never know that listening to the pundits who mostly still sound ebullient.

The legacy of the Fed is that it taught the masses to ignore risk and short volatility (VIX), betting that rain will never come after so many sunny days. Hedging equity exposure is supposedly for suckers even with stocks at expensive levels late in a cycle.

So, here we are again at levels of complacency that have proven troublesome in recent years. At the same time, the push towards the highs is again being led by a somewhat narrow group of stocks like last fall before the correction.

We got here because of the Fed pivot and a big jump in Chinese lending in recent months. China regularly manages its economy with bursts of lending when growth softens. All it took was a decent equity selloff late last year to force the Fed to fire almost every bit of ammunition that it could, at this point, just shy of more QE. It's kind of an unflattering policy reversal even for an institution that has failed so miserably for thirty years.

Suddenly, the Fed wants to stop normalizing its ridiculously large balance sheet, one well beyond what was needed for decades when GDP growth was a lot stronger. While we expected this reversal, it does not make it any less noteworthy and historic that what were once termed emergency measures must now remain in place according to those in the Eccles Building. It's like the patient never left the hospital.

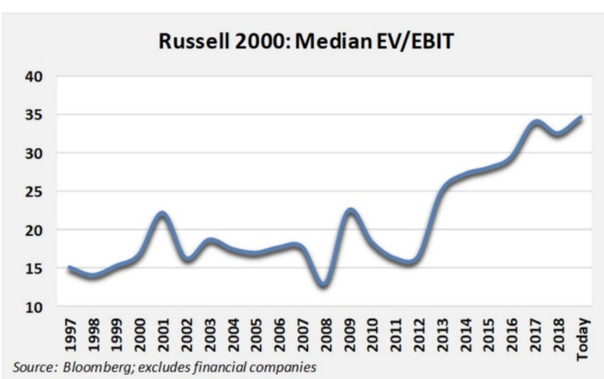
The workaround for the Fed is all about pivoting to discussions about the low inflation "problem" and how the FOMC must, in its so far unproven expertise, manage price levels higher through "inflation targeting." It is framing this as if it is some groundbreaking initiative. It is more of the same jabberwocky we have come to expect, but it will give the Street another tall tale to spin. The ECB and BOJ chatter endlessly on this topic as well. Never mind that if they really are running monetary policy for the greater good, why do they want inflation to be higher? Besides, it's already higher than their heavily massaged data indicates.

Newsflash: Nobody in the real world wants to pay higher prices for things. The economists tell us inflation is 2%. We all know that's silly. It's much higher. Most consumers are being squeezed. Everyone buying groceries, a house or a car and paying medical bills and tuition knows that. The new focus on inflation targeting is cover to allow the central banks to do whatever the heck they want without making people worry that the economy is soft. They just want control of the narrative.

Economic growth is the real problem and the Fed is unable to fix that. Add together workforce growth and productivity in the U.S. and it's not hard to see why real GDP of 2% is tough to surpass, especially late in the cycle when the additional boost from bringing workers off the sidelines is diminishing. If the deciders want wage inflation, stop making capital so cheap. Why create asset bubbles that just make houses unaffordable and future returns on equity investments low?

Those buying stocks now because the "Fed has their backs" aren't exactly making a contrarian call. They are expecting euphorically priced securities to become more euphorically priced even as earnings uncertainty rises. Profits are expected to be down about 4% for the first quarter and this quarter looks soft as well. Remember, some of the worst returns in the stock market occur when the Fed is easing, but investors become risk-averse as earnings deteriorate.

Just look at the graph below. No worries in small caps! Remember, EV, or Enterprise Value, includes the huge debt on many corporate balance sheets, not just the equity market cap. Companies are expensive to say the least. A recent article by Mark Hulbert re-visited an issue we have mentioned more than a few times. It discussed how misleading it is to say that the Russell 2000 trades at 17 times earnings as many pundits and participants do when it really trades at a P-E of 75. Yes, 75. The 17 figure is "derived" when the roughly one-third of companies that lose money are excluded from the calculation.



As we have been for years, we are positioned to a moderate degree to try to take advantage of this mis-pricing. It is the sort of trade that long/short value managers like us dream about, but it certainly has not made us famous yet.

The S&P 500 has its own set of problems. Trailing twelve-month GAAP EPS is $132. The gap between GAAP earnings and Wall street's contrived "operating earnings" number has now gapped to $20 from about $10 not that long ago. What happens when record profit margins that are already being squeezed fall from currently lofty levels? How much longer can wages be suppressed in favor of management and stockholders? Higher short rates should pressure interest expense figures and the strong dollar hurts as well. It's not hard to get to a $100 EPS number and a market that would be trading near a 30 PE at current levels. A normal multiple of that $100 puts us at 1100-1500 not 2900.

It is the same every cycle. At market peaks, investors are routinely encouraged to use peak earnings and not worry about a negative inflection point. However, valuations should be based on more than just one year's profit number. Also, if one wants to put a higher multiple on stocks because interest rates are lower than recent cycles, one must also reduce the earnings growth rate implied by those lower interest rates. The two basically offset each other. Remember, GDP used to run at 3-4% real rate, now we run at 1-2%. Interest rates are lower to reflect that fact.

Poorly acting bank stocks are once again telling the Fed that its policy is wrongheaded. The flat curve is obviously an issue for them. Their stocks have generally performed much more poorly than the market leaders over this entire cycle and some have even failed to reach their highs of the last cycle. We have thought it strange, but it points to how this cycle is atypical. We do also think credit problems are beginning to play a role now.

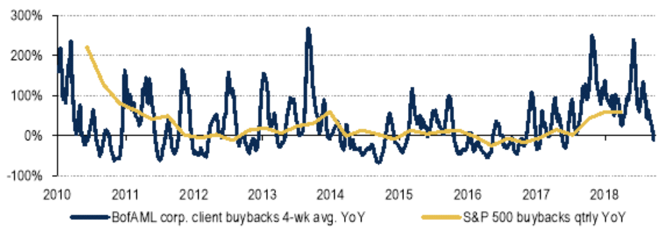
As we mentioned earlier, the curve is flat or inverted depending on where you look and refuses to steepen much even with the dovish Fed pivot. Treasury bills relative to the 10-year recently inverted for the first time since 2007. The German 10-year hit a negative yield. Those are powerful signs of trouble, but again, we are told not to worry. All of those who questioned the flatness of the curve as a harbinger of a monetary policy mistake may want to re-think that notion. The Fed will focus on trying to steepen the curve. Usually once it begins to re-steepen, risk becomes a dirty word.

A big reason that losses around recessions are so severe is that investors ignore valuations and put all their faith in central banks or the buy-and-hold credo even when the economy begins to soften. They forget that earnings collapse quite dramatically in a downturn and capital preservation takes hold of the crowd. The tendency to remain complacent has become extremely pronounced in recent decades because the Fed has overstepped its bounds.

This time around, the Fed has much less ammunition at its disposal because it is already so far down the easy path. Globally, over $10 trillion in debt trades at negative yields already and central bank balance sheets are quite bloated. The BOJ is running out of bonds to buy because QE has already been taken to the extreme. Can China borrow another $30 trillion over the next ten years to power the global economy?

Numerous talking heads think Congress will pass legislation in the middle of the next major downturn allowing the Fed to buy corporate bonds, which are currently excluded from its allowable purchases list. Do we really want that level of government intervention? Remember, they weren't supposed to buy mortgages either and did, so nothing would surprise us.

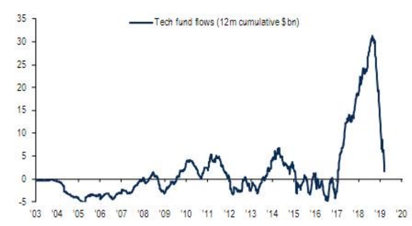
Perhaps buybacks are starting to run into deteriorating corporate credit quality or desires to conserve cash in the event of a recession.



This is important because corporations were the big net buyers of stocks in recent years to the tune of about $400 billion per year, much of it financed with debt. Investors generally rotated from active to passive exposures without taking overall equity exposures that much higher. Our point is that for all the talk of low rates and QE driving investors to pay high valuations for stocks, that has not been the only important factor. The actual buying power came from corporations themselves and they are now leveraged beyond typical cyclical extremes.

Chasing growth stocks was another big factor in this cycle and that group may be running into the reality that trees don't grow to the sky. For instance, the social media stock craze was just a surveillance marketing epidemic that has finally been correctly perceived as an invasion of consumer privacy. Now the practice is under scrutiny, crimping its growth. The cloud migration cycle and software-as-a-service euphoria may be ebbing as well. It also appears that constantly gazing at one's smartphone is now becoming "uncool" and perceived as unhealthy according to what we read. Plus, phones are lasting longer, and everyone already has one. Investor flows into tech stocks may reflect less enthusiasm for all these narratives.

Chart 2: Cumulative flows to tech funds have stalled

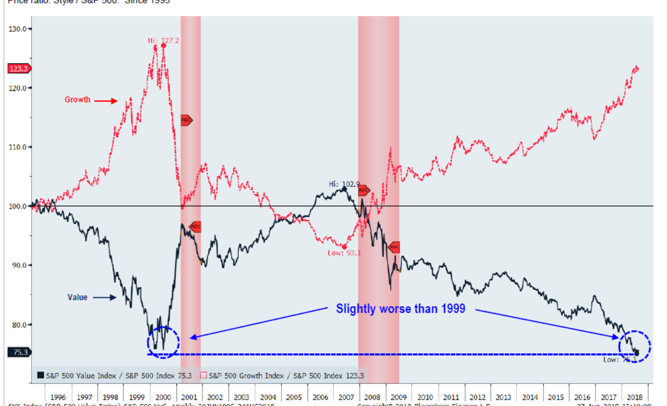


Source: BofAML Global Investment Strategy, EPFR Global

The Fed may not be able to ride the coattails of the tech cycle drivers for much longer and Wall Street is running out of stories to tell.

We are now 106% long and 46% short with a 15% net equity exposure without including option positions. Closed-end bond fund holdings comprise a 41% total position (14% municipals, 5% TIP's, 4% mortgages, and the remaining 18% in diverse sectors). Shorting cyclical shares and growth stocks whose fortunes are fading seems like the most compelling trade available from a mean reversion standpoint. We continue to offset those positions mostly with longs in value stocks that have compelling free cash flow characteristics or trade at a discount to our assessment of underlying asset value.

Figure: S&P 500 Growth and Value relative price performance (vs S&P 500) past 25 years
Price ratio: Style / S&P 500. Since 1995



Source: Fundstrat, Bloomberg

From our vantage point, it comes down to whether equities return to anywhere near normalized valuations, let alone become cheap. Not only have indices become priced at 2-3 times normal, they have done so with value stocks being left behind as the most expensive growth stocks led the charge. The biggest reason they are ignored is not because sharp pencils were put to work regarding valuations. Blind buying of index funds has created its own momentum in the direction of growth stocks, creating a bear market in the value arena.

We never make bets that run counter to long-term valuation metrics, though that is currently quite fashionable. We do position ourselves to attempt to take advantage of the tendency of stock prices and relative valuations to mean revert over time.

The Fed is now panicking as it trips over itself to sound more dovish. It conducted a huge monetary experiment called QE that is now more widely seen as failing. The entire economy is balanced on belief in this policy.

What if growth or inflation were to pick up from here? The Fed would be forced to become hawkish again, creating volatility in markets. What if growth continues to look weak and stocks remain unable to break above levels of over a year ago because risk aversion returns in force? The Fed would be exposed as not having many more weapons.

Be careful what you wish for! Following events of the last decade to their logical conclusion would mean an even greater level of government involvement in markets is at-hand because the cycle is losing steam and the current playbook has been exhausted. That thought used to make enough thoughtful people cringe that government was held at bay. Not anymore because the here and now is all that matters to those in charge to a degree and on a scale that makes most past instances of such shortsightedness seem quaint in comparison.

We would suggest investors be alert to the possibility that current absolute and relative valuations may not hold up just because monetary tightening is ceasing. China will have a hard time repeating its massive debt binge. The ECB and the BOJ have maintained incredibly loose policy for years, but what more can they do to inspire market awe. Those three international tailwinds are in the past. Globally new policy ideas seem like more of the same medicine that didn't work or further assaults on capitalism.

It's likely that fading domestic factors including the passive investing mania, the tech narratives of this cycle, unsustainable profit margins, incredible corporate debt growth, and massive stock buybacks played more of a role in markets over the last ten years than many central bankers and investors would like to admit now that it looks like the Fed is becoming the only game in town. Regardless, U.S. equities are priced for perfection and the world is, if anything, less than perfect.

Sincerely,

Scott E. Brown, CFA