EPIC INVESTMENT MANAGEMENT

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2016 -- Revolt, Reversal, Revival

The year just ended was shaped by voter revolts, broad market reversals, and a bull market revival. In the UK, the power and risk of pure democracy was put on display, as British voters chose to exit the European Union, placing immigration concerns above political and economic ties that date back generations. Thus, the British produced a mild upset of major importance -- mild because polling indicated only a slight edge for the pro-Europe 'stay' cause; major because it threatens to isolate the UK economy from its closest markets, forces Scotland into a pro-Europe or pro-UK decision of its own, and weakens Europe's core. Indeed, we may be watching a slow-motion disintegration of European unity, as an anti-globalization, anti-immigration movement gains momentum.

In the US, pollsters likewise had it wrong, their scientific methods unable to measure the nation's discontent with the Washington establishment. Unlike Europe, the economic ramifications are mostly salutary. Republican-party control of Washington suggests that a pro-business agenda, featuring tax cuts, regulatory reform, and fiscal stimulus, is at hand. Growth forecasts are ratcheting higher based on little more than campaign promises and political appointments. But markets don't always wait for clarity. For now, policy details take a back seat to policy direction, with the latter clearly pointing to accelerating growth.

For investors, market reversals were just as significant. The Brexit vote sent bond markets into a buying frenzy, with yields around the globe hitting historic lows. UK bank lending rates plummeted to levels unseen in over three centuries of recorded data. Japan, Germany and Switzerland saw trillions of dollars of government debt priced to negative yields. And in the US, 10-year to 30-year Treasurys offered record-low rates. This mid-year buying panic may have marked the final stage of a three-decade bond rally. The subsequent yield reversal since the Brexit-vote bottom offers hope for renewed sensibility. In the US, benchmark 10-year Treasury yields rose more than a full percentage point from their summer lows, touching 2.6 percent by December. While conventional wisdom always worries about rising rates, a move toward normalcy should be welcomed by bond and equity markets alike.

The price reversal was not limited to bonds. Commodities broke their multi-year downtrend in 2016, providing relief to a strained global commodity complex. An OPEC production-cut agreement helped oil grab the headlines, with prices bouncing from February's 26 dollars per barrel, to over 50 dollars at year end. Natural gas enjoyed similar gains. And the rebound spread

well beyond oil and gas. Sharp recoveries were staged by iron ore, coal, aluminum and copper, suggesting a healthy re-balancing of supply and demand, and a global economy that is resilient if not quite strong.

Equity prices showed more of the same. Emerging markets awakened from a five-year stupor after sinking to 2009 levels. Developed international markets were the laggards, rallying nicely post Brexit vote, yet still reflecting an ongoing struggle for economic vibrancy in Europe and Japan.

In US equity markets, many of the discouraging trends from early in the year were reversed by December. Major market indices broke out of a nearly two-year trading range that saw no progress from early-2015 to late-2016. The post-election rally marked an end to this trendless, profitless period. Small cap stocks caught the fever, busting out of their own funk. Various measures of market breadth and credit spreads, cause for concern a year ago, have likewise turned favorable.

All in all, markets are painting a picture of hope: equity breadth, momentum, new highs, and decent global participation; rational bond markets; a recovering commodity complex. This is encouraging action, not just a favorable backdrop, but market moves suggesting "all is well", if only for the time being. That's all we ever really know, so we take what we can get.

The wet blanket on all this is price. In this long equity bull market, valuations have moved from cheap, to fair, to expensive. Stocks are pricing in, and thus demanding, an earnings growth revival. It's an odd phase in the cycle to expect an economic and profit resurgence, but stranger things have happened. A tailwind may appear, justifying lofty values. It's a rosy picture, maybe too rosy, but it may well turn out. The catch is, at these prices, it needs to.

Beyond this guarded near-term optimism, we continue with thoughts on these and other ideas for the coming year and beyond.

Happy New Year!!

Gargantuan

If Wal-Mart has long been the 800-pound gorilla of retailing, Amazon is becoming the 10-ton Godzilla, threatening to destroy everything in its path. According to a Barclays research report, until recently, e-commerce was gaining approximately 100 basis points of retail market share per year. In 2015, the number accelerated to 150 basis points of share gain. And for the measured months of 2016, the increase is almost 250 basis points. Still citing Barclays, this represents the strongest year of market share gain that any one category of retail sales has achieved in 25 years of historic data.

While not all these gains are accruing to one company, it is a fair assessment that Amazon is the big winner, especially since its Amazon Prime program, including 'free shipping', is so successful. And with Amazon there is always a new twist. The company has begun opening traditional retail stores, and is flirting with the idea of rolling out a major grocery-store chain.

Disruption is painful for legacy players, and every retailer must ask itself how to deal with the threat of online shopping in general, and Amazon in particular. For many retailers, and owners of retail space, there is no satisfactory answer.

The Free Pass

One reason Amazon has been so successful, and able to venture into brick-and-mortar retail, grocery stores, and free shipping, is that it has been able to continuously re-invest in its business with little concern over profitability.

Consider this comparison: In the past 10 years, Wal-Mart has accumulated 149 billion dollars of profits. Over the same period, Amazon has amassed total profits of just seven billion dollars. As recently as 2014, the company lost nearly a quarter of a billion dollars, using generally accepted accounting principles, aka GAAP accounting. We cannot remember the last time Wal-Mart recorded a loss, if ever.

So for the past decade, Wal-Mart has been over 20 times more profitable than Amazon, with more consistent bottom-line results to boot. Yet Amazon's market value, at 358 billion dollars, is 70 percent larger than Wal-Mart's.

And when Amazon was losing money, there was nary a peep of complaint. Management is playing the long game, half-way through a 40-year battle it is almost certain to win. Shareholders know this, and give Amazon a free pass. For most other companies, investor demands for better results would have already forced out senior management. Trust us on this one, Amazon Chairman and CEO Jeff Bezos does not suffer job insecurity. Amazon's free pass is justified.

Another company receiving a free pass is electric car company Tesla, led by visionary founder Elon Musk. Since its initial public offering in 2010, Tesla has amassed 2.6 billion dollars in losses, with no signs of profitability on the horizon. Sure, revenues are growing at 40 percent per annum, but losing money on every sale and making it up in volume is a dubious business plan. At one time, Tesla was expected to earn 700 million dollars in profit for 2016; today the estimate is a loss

of over 600 million. Product launches and production targets are as reliable as the Italian rail system, where seldom is a train on schedule.

Part of Tesla's magic is its skill at managing its image, equaling its ability to create beautiful, expensive and unprofitable cars. The stock's market value, at 34 billion dollars, is more than half that of industry giant General Motors. Yet GM's quarterly sales are more than five times Tesla's annual sales, and GM is nicely profitable.

The history of Tesla is yet to be written. It may prove to be a profitable innovator; or it may inspire an automotive renaissance that leaves it a creative genius and financial disaster. This free pass makes Tesla a cult stock, and most cult stock stories end in misery.

Fear Not The Fed

For seven-plus years investors, bankers, economists and anyone else with a pulse but nothing better to do have focused on the Federal Reserve, and what it might do and say about monetary policy. The fixation took on an obsessive, maniacal quality; parsing words like 'moderate' verses 'modest' for clues to the next policy move. All the while, the default position of "no change in rates" was the easy-money bet. Pardon the pun.

And for seven years, our central bank maintained its zero-interest rate policy, finally breaking the streak with a single rate increase in late 2015. This was followed by another hike last month, a year later. Truth be told, the Fed is lagging, not leading, market interest rates. Unless it wants to invite a flat yield curve, the Fed can only nudge rates higher to the extent the market allows; and the market will accept short rates at or above one percent. Meanwhile, Quantitate Easing seems to be an experiment whose time has come and gone, so long as our economy is expanding. Good riddance.

Most likely, the Fed will accelerate its policy moves, hiking at least twice in 2017. At the same time, monetary policy will take a back seat to fiscal policy -- including infrastructure spending and tax reform -- along with easing regulation and who-knows-what on trade and immigration. The Federal Open Market Committee will still hold its eight scheduled meetings, and offer plenty of extra-meeting morsels for insatiable Fed watchers to chew on. It just won't be all that important. Here's a guide to Fed watching in 2017: ignore our central bank until a headline appears, announcing the year's second rate hike, or real policy change. Then we can start paying attention again.

Slow, Longer

The great moderation was great while it lasted, with a US economy featuring high growth, low inflation, and only two modest recessions in a 25-year boom. But if all good things must end, this one ended in near-catastrophe, the Great Recession of 2008 and beyond. Since then, the concept of a great moderation has been relegated to the history books. Maybe it was a fanciful idea to begin with, policy-makers laying claim to a statistical fluke. Maybe it was all built on a mountain of debt, unsustainable no matter how enjoyable it was. In any event, it's all over.

Not so fast.

While no one should argue that our current expansion has been exemplary, it does have staying power. We are now in the eighth year of this up-cycle, long enough for economic alarm-bells to be ringing. Yet if you listen closely, all you will hear is silence.

Indeed, even a cynic would be hard pressed to find signs of a recession, or even a slowdown.
Are there warnings from the leading economic indicators? Nope.
Is Wall Street trimming its growth projections? Just the opposite.
And what of the Treasury yield curve? Widening, more good news.
Credit spreads? Narrowing, just as we want.
Labor market? Output gap? No worries.

Perhaps this is the upside to a sluggish expansion: the cycle is extended.
If so, investors have been worried about the wrong thing. Maybe the prior recession was the true aberration, and the moderation -- in modest form, no longer great -- survives.

Low, Longer

For 35 years interest rates have been trending lower, and seemingly every third year of this remarkable bond bull market, prognosticators have called a bottom in yields. This time, they may finally get it right. The panic buying that accompanied the UK's Brexit vote shock may have been the climactic finale to this extended bond run. It sure was a long, fun ride.

The key issue for bonds is whether this marks the start of a bear market, where rates move sharply higher and fixed income investors lose capital to rapid price declines; or if it simply means a return to sanity, where government debt around the world provides positive yields, and where long-duration bonds offer a premium to expected inflation.

Over the years, the bond market mantra became "lower for longer". Lower has run its course, but "low for longer" is still a fair bet, and would offer a benign backdrop for financial markets. Hope for sanity to prevail.

Pumping Up The Bottom Line

A hallmark of this equity bull market has been strong earnings growth in the face of modest economic expansion. The forces driving profits to record levels include cost cutting, lower interest expense, technology, globalization, and the typical earnings leverage accompanying revenue growth. Still, there is a limit to how far American businesses can outrace the global economy. By early 2015, this limit was reached, with corporate profits slipping into a year-and-a-half recession marked by a strong dollar, sputtering revenues, and collapse in energy earnings.

With stock valuations above historic norms, a re-acceleration of earnings growth is essential to extending the bull run. Just in time is a new Administration with a basketful of stimulus ideas,

including infrastructure spending, personal and corporate tax cuts, plus regulatory reform in the financial and energy sectors. Some portion of President-elect Trump's wish list is likely to be enacted, simultaneous to a rebound in the energy business. This should lead to a resurgent economy and record after-tax profits. As corporate America's bottom line gets turbo-charged, we can hope that workers and consumers go along for the ride. Either way, investors should be happy with record earnings.

Whether this stimulus has staying power remains to be seen, but for now the profit outlook seems clear. The earnings recession is over.

Built For Speed

On May 6 of 2010, the Dow Jones Industrial Average suffered an intra-day collapse of nine percent, with much of the loss hitting in the matter of minutes. By the final bell marking the end of trading, the loss had been pared to three percent, on the highest volume in years. There was no news to account for the mini-panic that lasted less than an hour.

US investors had just withstood a 'flash crash'. Months later, a report issued jointly by the Commodity Futures Trading Commission, and the Securities and Exchange Commission, blamed the crash on a careless equity-futures trade placed by a large mutual fund company. If this explanation seems a bit lacking, or even far-fetched, regulators now have a better story for us: the crash was caused by a man in London, trading from the basement of his parent's house. Okay, that's not fair; mostly he was pretending to trade before cancelling orders. Feel better now?

In early November of 2016, Hertz Global Holdings issued disappointing guidance on its turn-around efforts. That the company needed a turn-around plan was evidenced by its stock price, which had already fallen over 70 percent in the prior two years. If anything resembled a washed-out stock, it should have been Hertz by early November.

Here's what happened next. Within an hour or so, Hertz traded over six times its average daily volume, significantly heightened activity for any widely-traded stock. And the cost of this liquidity? The stock price was cut in half.

Years ago, when stocks traded in price increments of eighth-and-quarter points, it was common to see bid-ask quotes in the thousands of shares. That is, a seller, before placing a trade, knew that a buyer was willing to take thousands of shares at a given price. Often, these quotes would number in the tens of thousands of shares. Liquidity was aplenty, at the meager cost of one-eighth to one-quarter of a dollar.

Today stocks are quoted in increments of a penny, ostensibly providing a fairer, more liquid market to buyers and sellers. Not so. The unintended consequence of penny quotations is reduced quote size. Even the most heavily traded stocks often show a bid-ask quote limited to hundreds of shares. Whatever trading interest lies behind that quote is a mystery to most investors.

In the marketing of his superb story 'Flash Boys', author Michael Lewis labelled the stock market as rigged. What he meant took hundreds of pages to detail, but the gist of the claim is that high-frequency-traders sit between traditional buyers and sellers, acting as opportunistic middlemen. They trade in fractions of a second, for fractions of a penny, and pretend to add liquidity to the market. What they really add is a layer of complexity and secrecy that serves little purpose but their own. Wall Street proprietary trading desks, once wielding big capital as an integral part of the system, are being regulated down to an inconsequential role. Vultures, in the form of high-frequency-traders, have taken their place.

The growth of exchange-traded funds may compound the problem. These funds create passive owners disinterested in scooping up stock-specific bargains as bargains present themselves. A company's float-adjusted market value no longer reflects active ownership interest. The larger an exchange-traded fund's position, the less immediate buying power in any given stock. When bad news hits, weak holders always run for the exits; the first line of defense is current owners willing to add to positions. Within exchange-traded funds, these active buyers don't exist. Passivity drains liquidity.

The evolution of trading means financial markets are now built for speed -- rapid-fire order execution measured in microseconds -- at the cost of stability. Human market makers, deep price quotes, Wall Street desks, and transparency have all been replaced by electronic connections, computer algorithms and opaqueness. When it works, it seems like business as usual. And when it fails, it crashes.

Tidbits..

International Monetary Fund managing director Christine Lagarde is convicted of negligence by French court, receives no sentence, stays on as IMF chief.

Rank has its privileges.

US GDP growth accelerates above three percent in third quarter, fastest pace in two years.
Mortgage rates rise above four percent, highest level since early 2014.
Existing home sales attain strongest pace in nine years.
Dual Consumer Sentiment surveys reach decade highs.

OECD raises global growth forecast in wake of Trump election, expectation of fiscal stimulus; sees 2018 generating highest growth in five years.

European Central Bank to extend and taper its Quantitative Easing program in 2017, targets 60 billion euros of monthly bond buying.

OPEC agrees to first oil production cut in eight years, Russia joins in.
US becomes net exporter of natural gas, after 60 years as net importer.

Former Treasury Secretary Larry Summers says Federal Reserve independence should be sacrificed for the sake of promoting pro-growth policies.

Smart people have dumb ideas too.

Scan-and-pay retail systems being developed to eliminate check-out lines.
McDonald's to accelerate technology spending, including self-service order kiosks and mobile ordering app.

Did someone say minimum wage hike?

In face of election concerns, October merger and acquisition activity reaches record level.

Markets hate uncertainly, unless there is a trade to be made.

Previously-approved Dakota Access pipeline is blocked by Obama Administration over environmental and tribal-land rights concerns.

Global smartwatch shipments drop 50 percent year over year.

US household net worth exceeds 90 trillion dollars, all-time high.

The rich get richer, the rest get left behind.

Yahoo reveals second data breach exposed personal data of one billion users.

Columbia University graduate students vote to join United Auto Workers Union.

Can't make this stuff up.

Source:
Barclays
Bloomberg
Credit Suisse
The Wall Street Journal
Wikipedia

Equities

SP 500 Index 2014-2016

US large cap equities went nowhere for almost two years -- from late-2014 to November 2016 -- before staging a major rally and breaking out to all-time highs.

Russell 2000 Index 2014-2016

Small cap stocks' multi-year underperformance ended in early 2016, providing encouragement that a broad-based equity rally is a sustainable rally.

MSCI EAFE Index 2014-2016

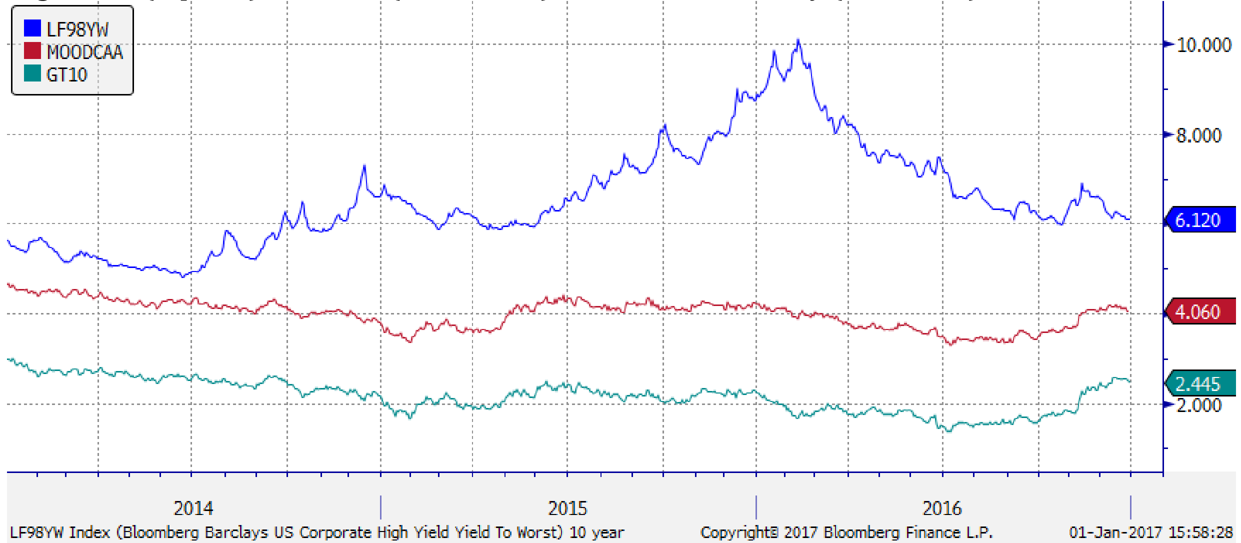
Developed international markets remain in a malaise, as do many of their economies.

MSCI Emerging Markets Index 2014-2016

After declining four of the prior five years, and re-testing mid-2009 prices, emerging markets generated solid returns in 2016.

Bonds

Bond Yields 2014-2016
High Yield (top line), AA rated (middle line), 10-Year US Treasury (lower line)



The early-year scare -- a rapid rise in high yield rates -- was followed by a snap reversal, a broad interest rate decline through mid-year, then a turn to higher Treasury and quality-corporate yields near year end.

US Treasury 10-year note yield 1980-2016

Conventional wisdom says interest rates have finally bottomed, marking the end of a 35-year US bond bull market.

Commodities

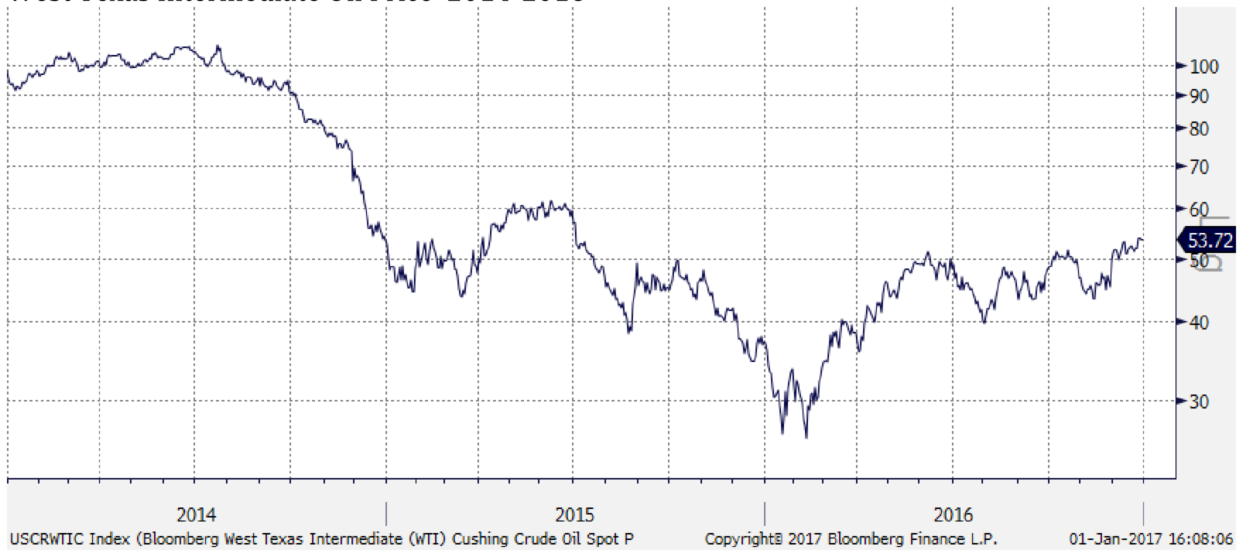
Continuous Commodity Index 2014-2016

Suffering for years, the commodity complex finally caught a meaningful upturn, in more than just energy prices.

Gold Price 2014-2016

After three years of losses, gold staged a six-month rally in 2016 before heading lower once more. With rising interest rates and a strong dollar, any investment case for gold is questionable.

West Texas Intermediate Oil Price 2014-2016



Oil's bear market has ended, as prices below 30 dollars per barrel were unsustainable. Almost as unlikely is a return to 100-dollar oil. That leaves a wide range to determine an equilibrium price.

Natural Gas Price 2014-2016

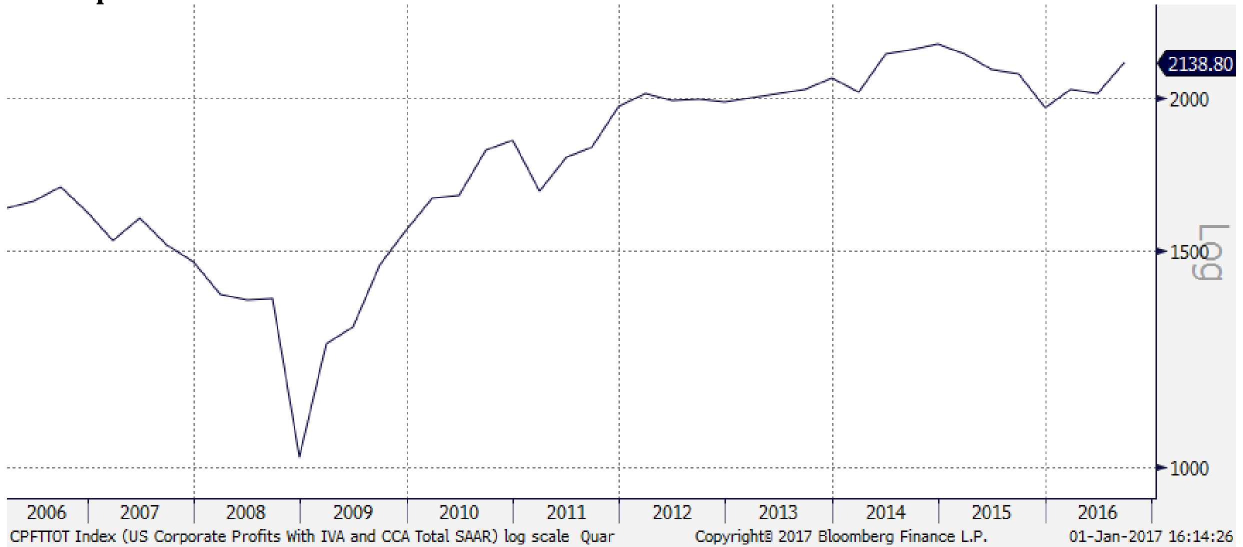
Natural gas is still clean, plentiful, and cheap, even after a big price recovery.

Currencies

US Dollar Index 2014-2016

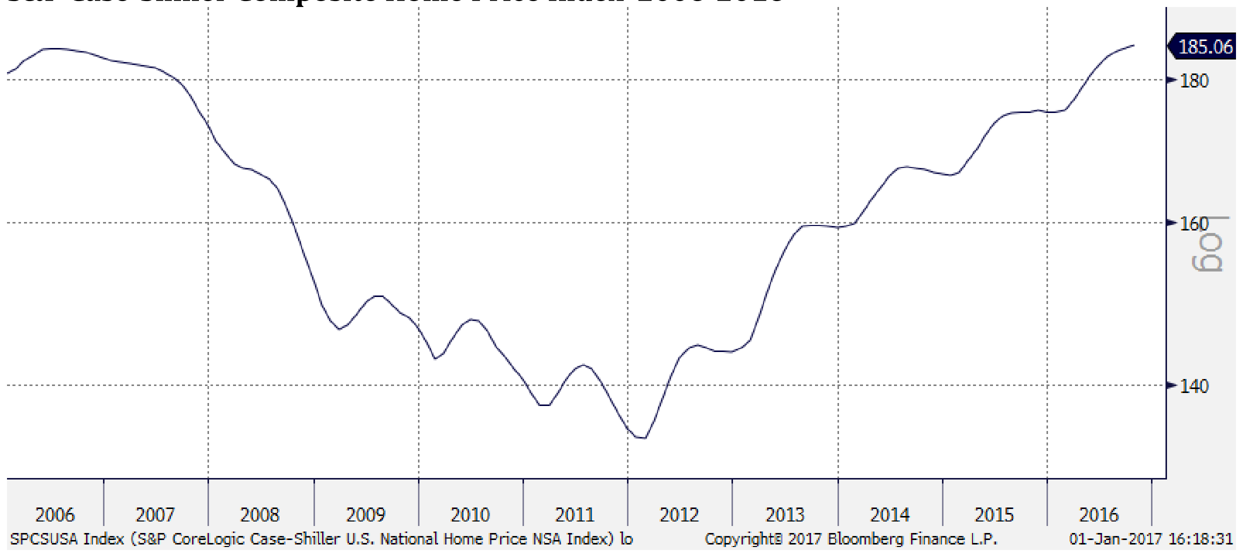
The US Dollar is in the midst of a multi-year year rally, and the path of least resistance is higher.

US Corporate Profits 2006-2016



US corporate profits are expected to jump to record levels, driven by fiscal stimulus and tax reforms.

S&P Case-Shiller Composite Home Price Index 2006-2016



Nationwide home prices finally surpassed their peak of 2006, marking a lost decade of wealth accumulation for homeowners. Year-over-year gains continue at a five percent pace, well ahead of inflation.

US Unemployment Rate 2006-2016

Some good news for workers: Unemployment rates are back to healthy levels, and recent wage gains are running above inflation.

US Labor Force Participation Rate 2006-2016

It's not all good news, as labor participation rates are still at anemic levels. Too many people have decided they do not need to work.

US Household Real Median Income 2006-2015

Longer-term, incomes are not keeping up. Household median income, inflation adjusted, rose by a record amount in 2015. Yet it still sits below its 2007 level, and 1999 peak.