EPIC INVESTMENT MANAGEMENT

Issue 51 January 2019

2018 – Nowhere To Hide

The year just ended was a sharp reversal of the prior year, and in many cases of the first nine months of 2018 itself. In a rebuke to market history and conventional wisdom, nearly every asset class moved in the same direction -- down. US equity markets suffered their first losing year since the global financial crises, with large cap stocks down mid-single digits, while small cap stocks fell by over twice that rate. Global investors fared even worse, as both developed international and emerging market equities declined by double-digit percentages on a dollar-adjusted basis.

Fixed income, typically a safe port in a market storm, likewise suffered. Long-term Treasurys, quality corporates, and high yield bonds all produced negative results for the year, a first since 1994.

It didn't end there. Gold, oil, and broader commodity benchmarks all lost value, as did Real Estate Investment Trusts, along with most other yield-based assets.

Of the 11 asset classes we track on a regular basis, only Treasury bills produced a positive return for the year. That return, low single digits, was the smallest top-ranked return in three decades or more.

All this in a year where, as of late September, US equity prices were making all-time highs. What happened? In the US, a three-month bear market appeared, punctuated by the worst December since 1931. The proximate cause -- other than more sellers than buyers -- was a combination of Federal Reserve rate hikes, rising bond yields, widening credit spreads, slowing global growth, and trade wars.

Curiously, these conditions all existed as our equity market was marching ever higher into its autumn peak. Of further note, the first two concerns, Fed tightening and higher bond yields, now seem to be off the table. Of the other three worries, credit spreads were unusually narrow and due for a widening move; global growth decelerates every other year, usually without market disruptions; and the trade war issue seems more likely to be resolved than it did a few months ago.

That leaves us with one more culprit -- more sellers than buyers. Indeed, while this trite phrase generally serves as a sarcastic explanation for any downturn, there is a worrying pattern of our equity market getting caught in short and severe downdrafts. Trading by machine-driven algorithms is a little-understood reality of modern markets, with large implications. As individual investors, mutual funds, and traditional institutions become more passive, the marginal computer-based trader takes on greater importance. When a buying-vacuum arises, liquidity dries up and sellers rule the day. Piling on, short-selling activity is unrestrained, thanks to a long-ago repeal of the uptick trading rule. This prior restriction served as a brake on run-away short-selling, preventing a market death spiral. To regulators: there is a simple solution, re-instate the uptick rule. Alas, someone is having too much fun, making too much money at the expense of market stability. Regulators seem comfortable sitting on their hands, content to let others take the blame and clean up the mess after the fact.

A year ago we wrote:

> In the past year, if you were invested in traditional assets, and avoided the broader commodity complex, you netted satisfying returns. Also noteworthy is the timing of these gains. Nine years into our economic expansion and a similar time-frame into our bull market, it is highly unusual to see such synchronized global economies and markets. It's Goldilocks on a worldwide basis.
>
> And the best part was, all this took place with nary a bit of volatility.

So 2018 became payback time, with negative returns and high volatility. The synchronized global markets again moved in unison, just in the wrong direction. We enter the new year in a bear market for US and global equities, yet believe this was a market correction gone haywire; that there was no good reason for prices to drop so far, so fast. And we note that, on many measures, it has been years since stocks have been so attractively priced as they are today. Hope springs eternal.

Happy New Year!!

New Year's Wishes for 2019

The Federal Reserve, having raised interest rates nine times this cycle, for a total of 225 basis points, will hit the brakes on further hikes. The best bet for the coming year is just a single, 25 basis point, increase in the Federal Funds target rate.

Long-term interest rates, well off their lows of 2016 and settled into a trading range, will rise in a two steps forward, one step backward pattern. The benchmark 10-year Treasury note, currently yielding 2.68 percent, will move into the three-percent range.

If these two initial expectations come to pass, investors can stop fussing over the implications of an inverted yield curve, as it will have steepened instead.

The US Dollar, surprisingly strong in 2018, should stabilize or relinquish some of its gains in the coming year, and is unlikely to continue its advance.

The energy market, retrenching from a fourth quarter price collapse, will recover. Production cuts by OPEC and Russia should drive oil prices meaningfully higher, especially if sanctions on Iran finally bite. Energy stocks, flat on their back and by some measures near historic lows, will rally sharply.

The trade war with China will cool off or end completely, as both sides look for political victories and economic stability.

US and global economies will slow in the coming year, as recent growth rates have been above trend and unsustainable. Despite media fear-mongering, the only talk of US recession should be that one is not in the cards for 2019. Between the US, emerging markets, and developed global economies, Europe remains the basket case. Some things never change.

In the US, earnings growth will decelerate from the torrid 20-percent pace of 2018. This should be no surprise, as corporate tax cuts cannot be enacted every year. Nevertheless, single digit profit growth should make investors happy.

A do-nothing Congress will live up to its reputation, at least in terms of legislation. When not throwing political jabs at one another, the only bi-partisan consensus may be in favor of an infrastructure overhaul. Funding it is another issue, yet Congress is always willing to spend money it doesn't have. For investors, the key considerations are that corporate taxes remain low, regulatory roll-backs continue, and the trade war with China is resolved.

If all this comes to pass, and surely it all will not, then global economies and markets will return to a 'Goldilocks' condition -- not too hot, not too cold. With stock prices having re-set to reasonable levels in the fourth quarter, that should be quite satisfying to investors. And to the extent these conditions are not all met, well, let's see how far reality veers from hopes and expectations.

Epic Awards for 2018

Best Sleight of Hand…
To the US Government, for repeatedly understating its fiscal deficit by using a 'unified budget', netting out Treasury issuance for intra-governmental purchases, including the Social Security Trust Fund. The problem is, this trust fund will be moving from a net saver to a net spender, meaning its days of financing our government debt are numbered. The real debt bill, 22 trillion dollars and rising by over a trillion dollars per year, will one day come home to roost. Playing along with the trick, most ratings agencies still consider the US a solid AAA credit.

Big Bold Over-the-top Magic Trick…
Global central bankers, for the better part of a decade, convinced investors to accept short-term interest rates set at zero percent, or even negative levels. Based on records dating back centuries, these are the lowest rates ever seen in the world's major money centers. This turns financial theory on its head by proving you can charge people to give you money, and some people will acquiesce.

And to the Federal Reserve, whose low interest rates and Quantitative Easing program stimulated our nation's largest accumulation of personal wealth -- a near doubling of US household net worth in just under a decade -- to 109 trillion dollars.

Best Imitation of a Mad Genius…
Elon Musk, Tesla's founder and chief executive, falsely tweeted that he had financing in place for a buyout of the electric car company; and in so doing lost his Chairman position while paying a 20 million-dollar fine to the US government. Worry not, Mr. Musk remains a billionaire and is still running the company. Or, worry so.

Real Cojones…
General Motors and its chief executive Mary Barra, announced plant closings and job cuts in midwestern states, knowing it would draw sharp rebukes from the Trump Administration. Contrary to political rhetoric, GM's actions come at the right time -- when business is healthy and the job market strong. By cutting the fat of unprofitable plants, GM strengthens its long-term prospects, benefitting remaining employees, stockholders, and creditors -- three stakeholders far more important than any political group.

Lacking Self-awareness…
To Mario Draghi. The European Central Banker spent the past decade encouraging debt formation through his policies of negative interest rates and bond purchases, yet has now turned 180 degrees by warning on the perils of excessive debt. Well, not quite 180 degrees, Mr. Draghi still believes in negative rates, and the central bank retains a bloated balance sheet. Someone seems confused.

Most Adept Enticement of Corporate Welfare…

Amazon announced that New York City and Northern Virginia won the bake-off for its two new headquarters, providing the company some of the most-lucrative incentives US cities and states have ever offered. The bribes, err, enticements, total 5.5 billion dollars, slightly more than the online retailer promised to invest. This expansion was going to take place, and end up near our nation's capital, regardless of any incentives. Amazon simply invited, and received, government subsidies. As for the 236 cities that spent time and money in a long-shot bid, never having a real chance but strengthening Amazon's gambit: P.T. Barnum was right.

Displaying a penchant for hyperbole and an ineptitude for math, New York Governor Andrew Cuomo declared: "For every dollar we invest, we're going to get back about nine dollars. To find the money that we need to invest in subways, to invest in schools, et cetera, this is a big moneymaker for us. It costs us nothing -- nada, niente, goose egg." In other words, the incentives exceed the promised investment, and that somehow adds up to a nine-to-one return for the city and state. Sure it will.

Least Surprising Bubble Bursting…

Cryptocurrencies, including Bitcoin, which declined over 80 percent since last December, reversed most of their historic ascent of the prior years. The problem with greater-fool schemes is that eventually they run out of fools.

Slowest Death of a Long-standing Business…

Sears Holdings, owner of Sears and Kmart stores, filed bankruptcy after losing money for eight straight years, and losing relevance in the retail space for far longer. The company may be restructured in bankruptcy and remain as a vestige of its once-greater self; alternatively, it will liquidate and be put out of its misery.

Worst Fall from Grace of an American Powerhouse…

General Electric, over a century old and once among our most revered companies, repeatedly bought high and sold low its business portfolio, mis-managed its core businesses, acted as a financial-services hedge fund in disguise, over-paid its management team, hired its second chief executive in a little over a year, cut its quarterly dividend to a miserly one-cent per share, and saw its stock drop nearly 90 percent since its peak in the year 2000.

Best Idea from Washington in a Long Time…

The corporate tax cut of late-2017 reduced incentives to locate business overseas, while boosting corporate profits to record levels. The bounty led to rising dividend payments, share repurchases, and capital spending, with growth accelerating and unemployment falling to a five-decade low. It also restored America's status as the most competitive economy in the world.

Tidbits…

US Federal Government shuts down for third time in a year.
Does anyone care?

US Treasury projects debt issuance of 1.3 trillion dollars in 2019 as deficits widen.
US student loan debt reaches 1.5 trillion dollars.
Borrow today, worry about it whenever.

Venezuela inflation likely to reach 10 million percent in 2019, says International Monetary Fund.

Pie in the Sky? Volkswagen hopes to sell electric vehicles for under 23,000 dollars.

Russia joins Saudi Arabia, rest of OPEC, in oil production cuts.
Qatar announces its intention to withdraw from OPEC.
International Energy Agency warns of mid-2020s oil shortage, says US shale oil production must add equivalent to Russia's total output in next seven years to meet global demand needs.
US briefly becomes net exporter of oil.
With mixed messages from oil markets, expect wild price swings.

US Postal Service sees package deliveries rise 10 percent in 2018, still manages to lose 3.9 billion dollars.
No easy feat, losing so much money with a billion-dollar monopoly.

Food and Drug Administration announces plan to restrict sales of flavored e-cigarettes, ban sale of menthol cigarettes.

Black Friday retail sales at US brick-and-mortar stores fall mid-single-digit percent, while online sales rise 23 percent.
Cyber Monday retail sales top Black Friday's, making it the largest shopping day in the US.
No slowing down for e-commerce.

European Central Bank ends its multi-year Quantitative Easing program, after mixed results.
France threatens 'digital tax' on large internet companies, prodding European Union to join in.

Federal Court judge rules Affordable Care Act, aka 'Obamacare', unconstitutional.
Far from the last word on this issue.

Facebook is sued by Washington, DC over providing user data to Cambridge Analytica.

Virgin Galactic aircraft flies to outer space, returns safely, as dawn of space tourism era nears.
London's Gatwick Airport is closed due to overhead drone activity compromising flight safety.
The wonders and dangers of technology.

Source:
Bloomberg
The Wall Street Journal

Equities

S&P 500 Index

US large cap equities broke their uptrend, suffering two setbacks in the past year, with the recent bear market decline unresolved.

Russell 2000 Index

US small cap stocks suffered a sharper decline than their large-cap brethren.

MSCI EAFE Index

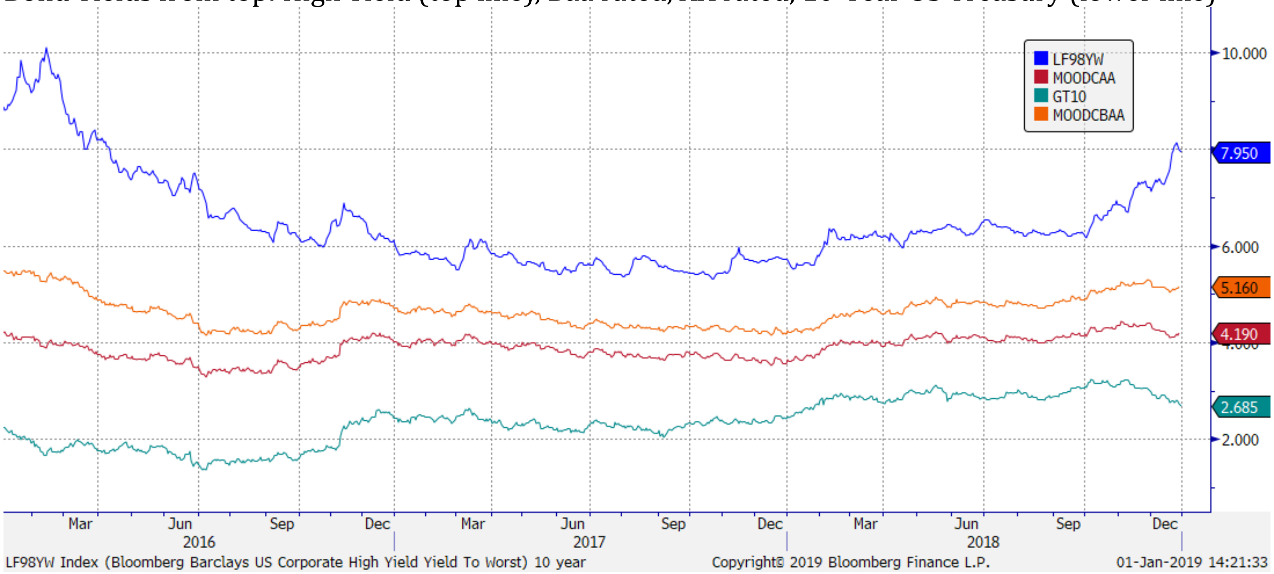
Developed international markets peaked early in the year, before rolling over into a bear market.

MSCI Emerging Markets Index

Emerging markets followed the pattern of developed markets, while showing recent signs of stability.

Bonds

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



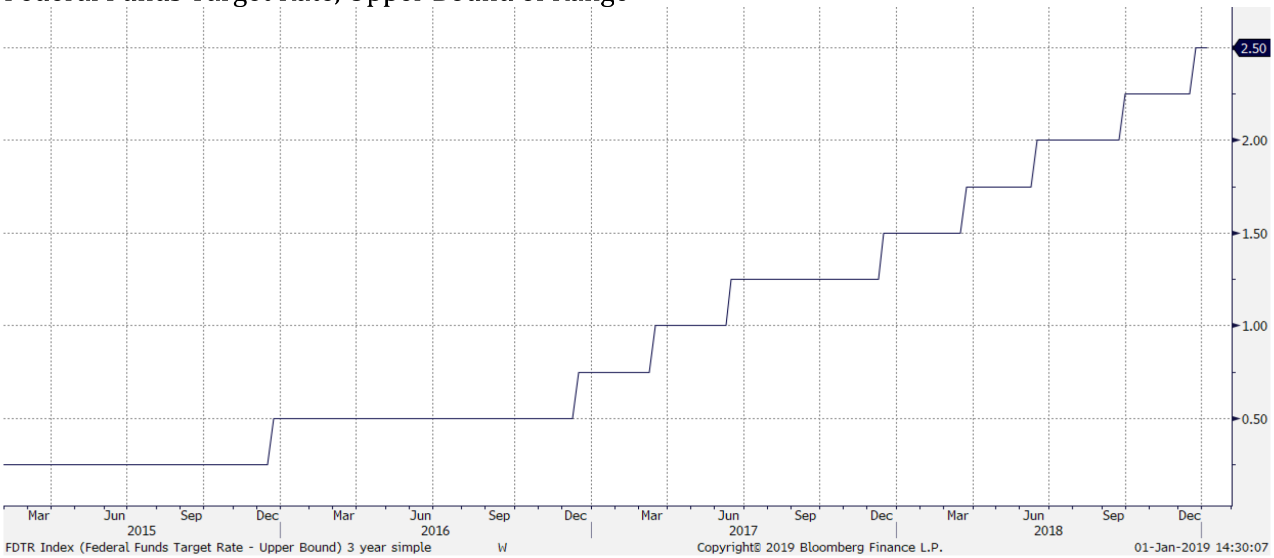
The US bond market finally began to reflect normalization, with rising yields and widening spreads. Global bond markets did not follow the US lead, with yields remaining extraordinarily low.

US Treasury 10-year note yield

From a long-term perspective, bond yields have barely nudged higher, and seem in no hurry to do so.

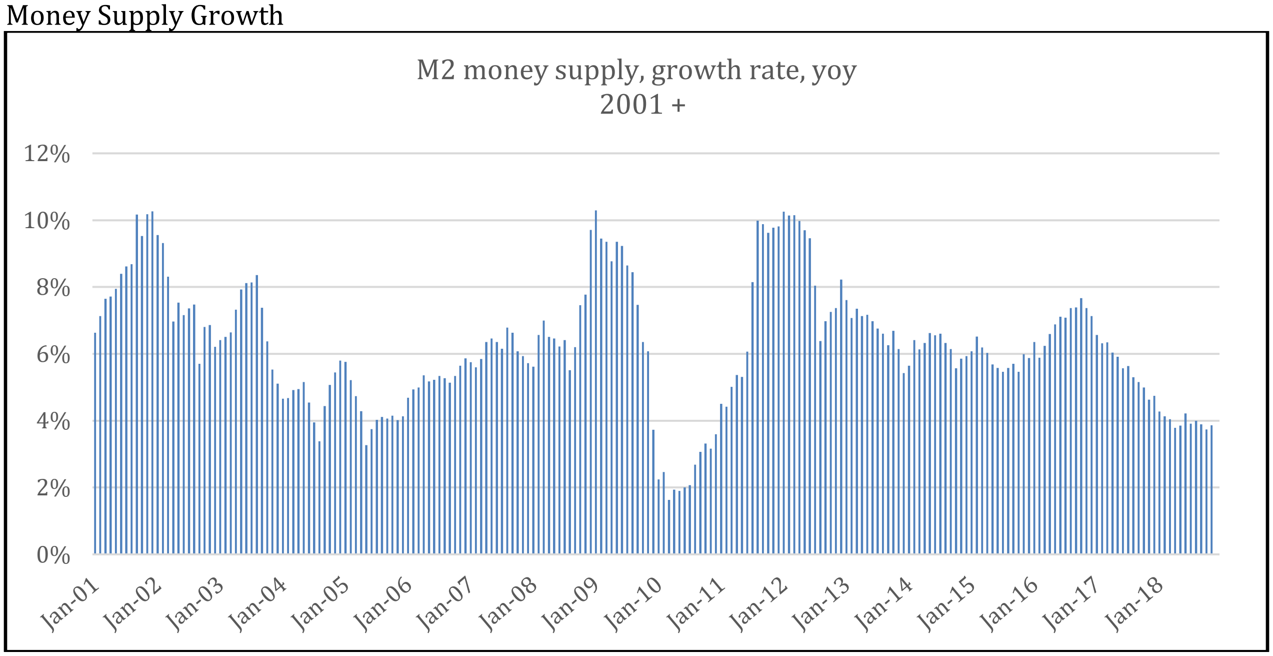
Monetary Policy

Federal Funds Target Rate, Upper Bound of Range



The Federal Reserve has raised interest rates nine times this cycle, for a total of 225 basis points. The steady path of rate increases is behind us, with more modest and less predictable hikes expected.

Money Supply Growth



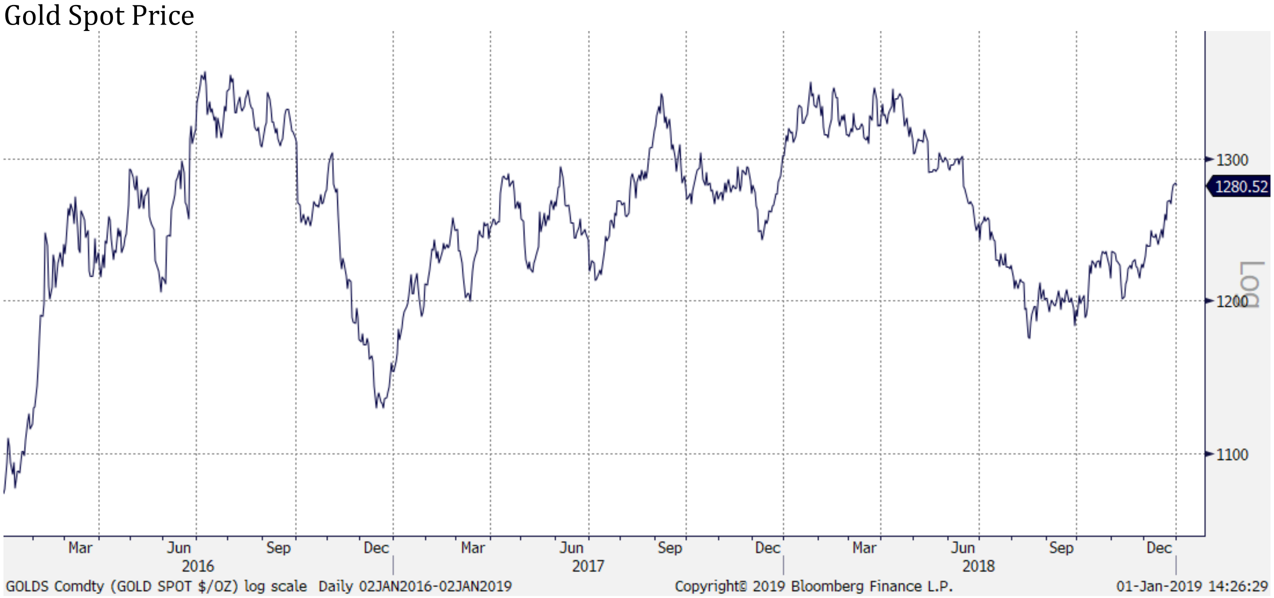
Sluggish money supply growth suggests financial conditions have tightened more than implied by Federal Reserve interest rate policy; which in turn means the Fed should hit the pause button.

Commodities

Continuous Commodity Index

Commodity prices fell again, fitting for what is typically the worst of all asset classes.

Gold Spot Price



Gold continued its trading-range meandering, but is showing some renewed interest.

West Texas Intermediate Oil Price

Oil prices rallied through September before a sharp sell-off, as a global supply glut developed.

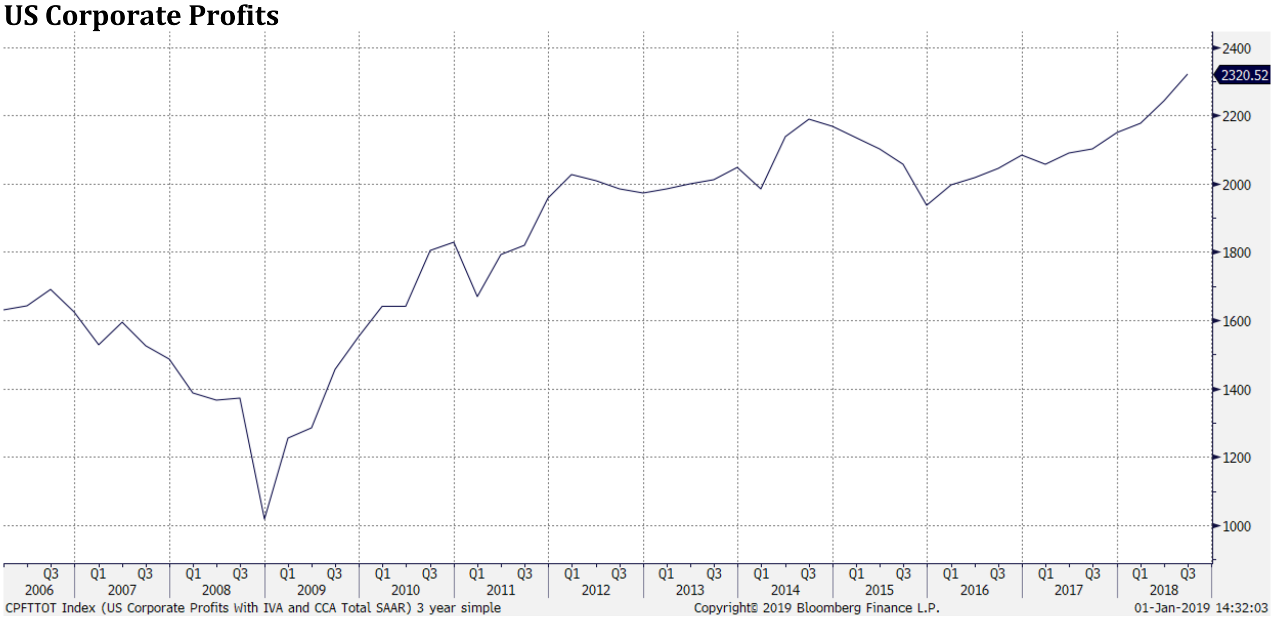
Natural Gas Price

Natural gas spiked on early signs of winter, then settled back to familiar levels.

US Dollar Index

The US Dollar was surprisingly strong in 2018, to the chagrin of most investors.

US Corporate Profits

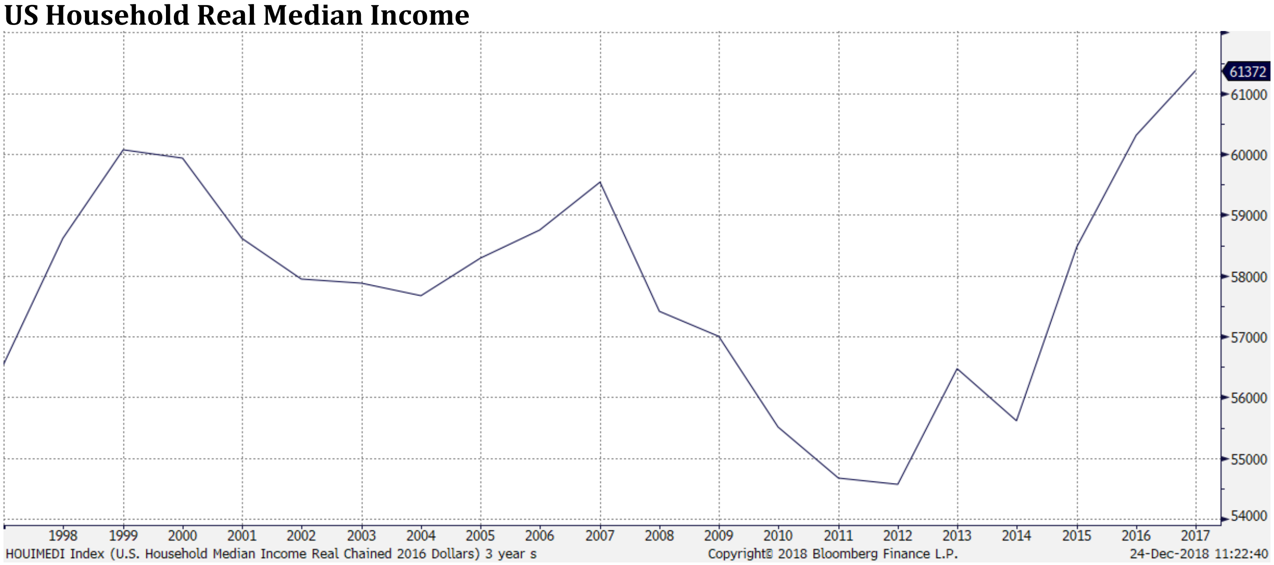


US corporate profits, on a pre-tax basis, attained record levels. The tax cut was icing on the cake.

US Private Housing Building Permits

The housing market is showing some strain, reflecting years of healthy price gains and rising mortgage rates. A slowdown in new builds will only exacerbate our housing shortage.

US Household Real Median Income



Household median income, inflation adjusted, is moving sharply higher, though only slightly above its 1999 peak.

US Unemployment Rate

The jobless rate, under four percent, is approaching 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.