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BALANCE IN A CHANGING WORLD
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FIRST QUARTER 2018 INVESTMENT ADVISORY REPORT

Should I Stay or Should I Go – the Clash

The markets got off to a strong start in January hitting new highs and following through on the strong rally of last year. However, it came to an abrupt end, gapping lower towards the end of the month and never looking back. While some sectors fared better than others (such as technology and small-cap stocks), the broader markets definitely faltered and the S&P 500 Index turned in its first quarterly loss since 2015[1]. Last year, it seemed that absolutely nothing could rattle the market. Conflict with North Korea, the ever-simmering Middle East, tensions over trade, domestic political squabbles, foreign political squabbles, Fed rate hikes…the market ignored them all. According to Barry Ritholz, "The Standard & Poor's 500 Index was within 3 percent of its all-time highs for 202 consecutive days. The next closest streak was 1995-96, at 116 days, a little more than half as long."[2]

Ironically, it was the so-called "defensive" stocks that pulled the indexes down the most. According to data from Morningstar, year to date, household names such as Procter & Gamble and Pepsi are down by nearly 20% and 15% respectively! It should be noted that Pepsi's revenue growth and growth in earnings per share, on average, has been ***negative*** for the past 3 and 5 year periods! Yet the stock still trades at a heady growth multiple of 29.8 x earnings (P/E) and 18.1 x expected future earnings.[3] ***This is higher than the P/E of Apple or Intel***! Similar stories can be seen in other "safe", "blue chip" names like Con Edison, Phillip Morris, Walmart, Colgate Palmolive and so on.

It should be noted that one big reason for the inflated valuations of these slow growing companies is their inclusion in many of the popular stock indexes. While investing in non-actively managed "passive" indexes has its uses and benefits, we have never been huge fans. In our opinion, the above issue is one of the more significant drawbacks because an index manager must buy all of the stocks in that index, regardless of whether they are expensively priced or not! This seems to be unwinding now. As the Fed raises rates and reduces its balance sheet, there will no longer be the same sea of liquidity that previously existed and floated all boats.

The market correction was global, affecting overseas markets as well as ours. However, the January rally in Emerging Markets was strong enough to push them into the plus column for the quarter. According to Capital Group, "emerging markets stocks rose for a fifth consecutive quarter, helped by steady economic growth in China and other developing countries, higher oil prices and a weaker dollar. The MSCI Emerging Markets Investable Markets Index advanced 1%, the only major index to finish in positive territory."[4]

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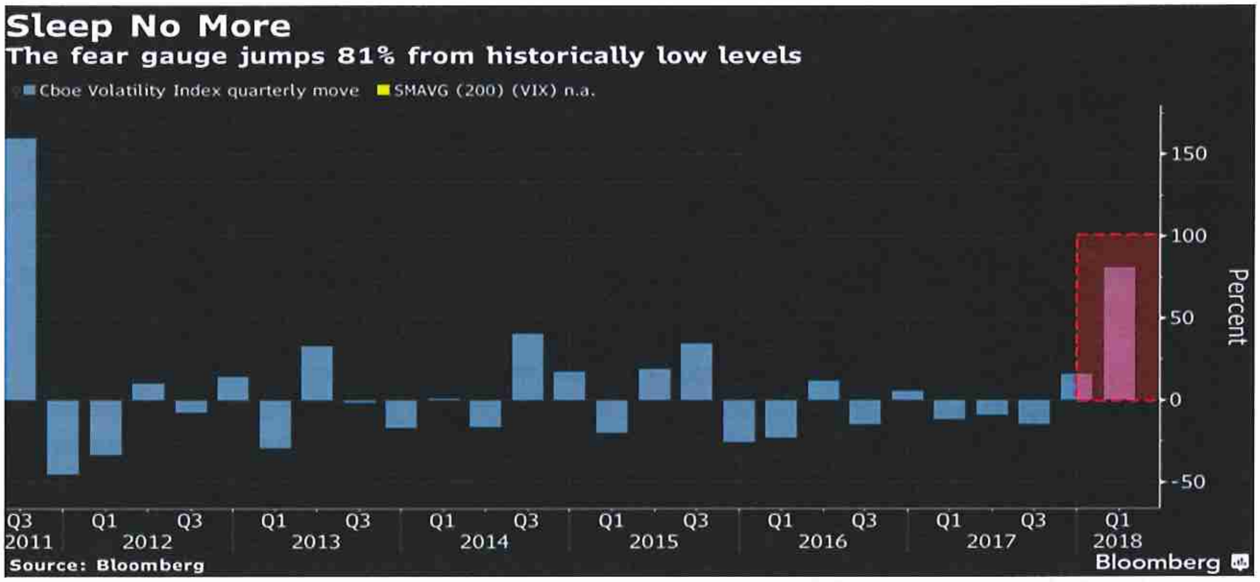
[1] T. Rowe Price; Quarterly Market Review, First Quarter 2018. https://www3.troweprice.com/usis/personal-investing/planning-and-research/t-rowe-price-insights/markets/quarterly-market-review.html
[2] http://ritholtz.com/2018/03/q1-2018-volatility/
[3] http://www.morningstar.com/stocks/xnas/pep/quote.html
[4] https://www.capitalgroup.com/content/dam/cgc/shared-content/documents/reports/WMR_CG_0318.pdf

As always, it's hard to pinpoint the exact catalyst for the change in sentiment, although as David Kotok observed, "The stock market peaked within days of President Trump's State of the Union Message in which he claimed credit for the stock market high."[5] Along with the market selloff came an end to the calm. Morningstar noted that "volatility returned with a vengeance, with the markets making some of their biggest moves in months. After going all of 2017 without a move of 2% or more in absolute terms, the S&P 500 had six such moves in the first three months of 2018, capped by a 4% decline on Feb. 5."[6]

The market gyrations caused a severe spike in the VIX (the CBOE Volatility Index, a/k/a the "fear index"). The spike is shown below in a Bloomberg graph titled "Sleep No More".[7]



The Bloomberg article states that "The 81 percent jump in the Cboe Volatility Index tells the story of a quarter when stocks went from euphoria to correction in a matter of weeks... (causing) a 10 percent correction that wiped $2 trillion from U.S. stocks." There are funds that trade the VIX and several, such as the VelocityShares Daily Inverse VIX Short-Term ETN and the ProShares Short VIX Short-Term Futures ETF respectively lost 84% and 79% of their entire value ***overnight***! These funds were "short" the VIX – i.e. a bet that the VIX would decline in price, or at least remain unchanged – which is essentially a view that benign market conditions would persist. Blomberg further notes that "The two largest exchange-traded products that wager on low volatility took in $1.7 billion in January, a record. And why not? Plowing cash into them has been a license to print money since roughly 2015. "[8]

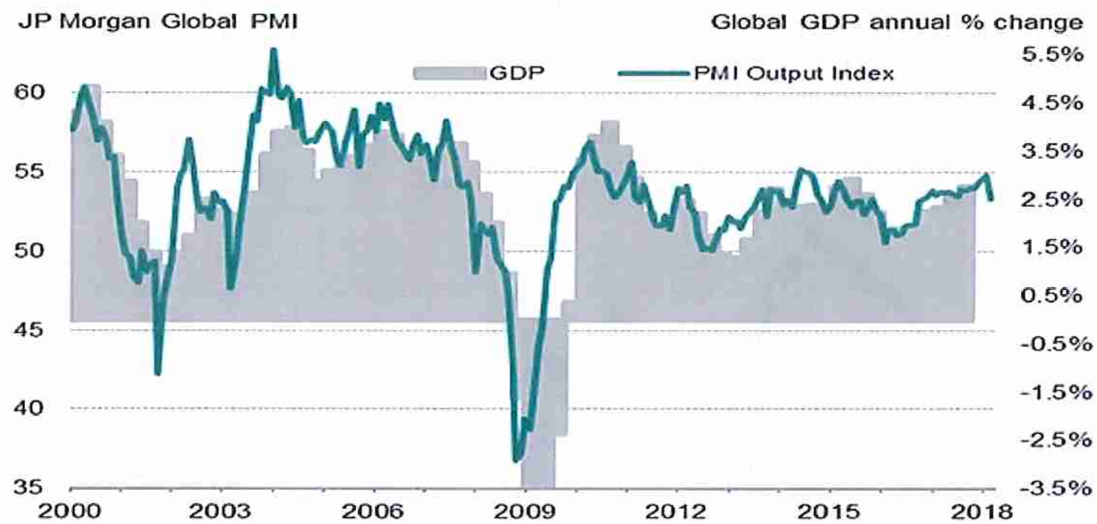
The good news in all this is that some of the "euphoria" and confidence in the market has receded. In last quarter's report we looked at the Citigroup Panic/Euphoria Model as reported in Barron's which, at .47, pushed the index into the "euphoria" range showing high levels of positive investor sentiment (typically a

[5] https://seekingalpha.com/article/4156272-u-s-stock-market-first-quarter-2018
[6] http://www.morningstar.com/articles/857667/first-quarter-in-us-stock-funds-the-return-of-vola.html
[7] https://www.bloomberg.com/news/articles/2018-03-29/vix-up-81-shows-extent-of-stock-market-pain-in-jarring-quarter
[8] Ibid. # 5

While the technical picture is constructive, the fundamental outlook is beginning to cloud. Global growth is showing signs of peaking. At the same time, the long awaited arrival of inflation is finally showing signs of life. This could set the stage for a period of "stagflation" where we have slow(ing) growth and rising prices – the worst of both worlds.

IHS Markit compiles many data series, one being a broad survey of purchasing managers – the PMI series, now known as the JP Morgan Global PMI. According to IHS Markit, "Global economic growth slowed sharply to the weakest for over a year in March, according to the latest PMI surveys. Although some of the slowdown may prove temporary, the broad-based nature of the weakening suggests growth has peaked. Price pressures meanwhile remained elevated, in part due to supply constraints giving pricing power to sellers."[11] The sharp slowdown can be seen in the chart below. The degree of the downtick is obscured because there is nearly 20 years of data shown. Further, any print over the 50 level represents expansion. Nevertheless, since the 2008 financial crisis, every time the index has gotten up to these levels it has stalled out.

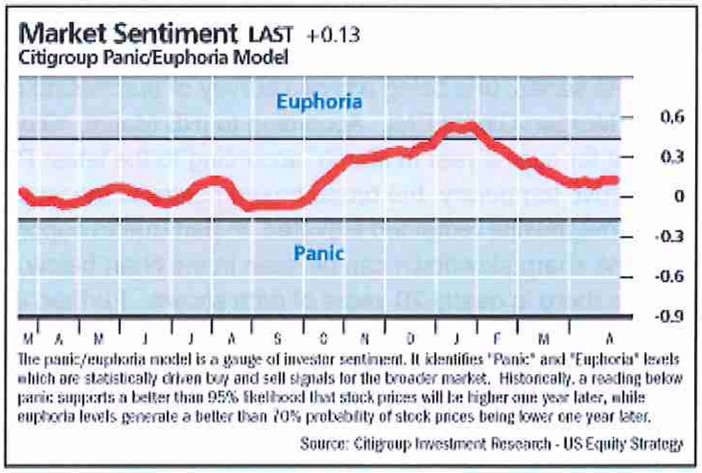
We discussed the PMI index in last quarter's report focusing in particular on the manufacturing component which was just exploding and showing coordinated growth among nearly every country that reported. However, we wrote, "the question, as always, is can this continue and how much is already reflected in asset prices? As mentioned...this growth is due in some significant degree to the trillions in liquidity pumped in to the financial system over the past decade by the major central banks. Global debt has expanded to a whopping 327% of global GDP – far exceeding the levels reached in 2007 just prior to the '08 financial crisis... So, the trillion dollar question now becomes can the global economies withstand an eventual unwind and removal of this accommodation?



It should be noted that the 2011-2012 and 2015-2016 periods – also periods of decreasing PMI output – were choppy, volatile times for the stock markets. The big difference then was that bonds still offered some refuge. That may be changing now as inflation starts to rear its head (more on this below).

[10] http://www.marketinout.com/chart/market.php?breadth=advance-decline-line
[11] https://ihsmarkit.com/research-analysis/global-pmi-slides-to-16month-low-in-broadbased-slowdown.html

contrary indicator). More recently, as fear has reentered the market, this index has dropped back to more neutral levels as seen below.[9]



In addition to the reintroduction of some fear back into the markets (a positive), the "technical condition" has remained solid. There are many technical indicators, but one that has a good track record of forecasting impending strength or weakness in the markets is the "Advance/Decline ratio". This is calculated by simply taking the difference between the number of advancing issues and declining issues and then adding the result to the previous value. It is useful because, as discussed at length in previous reports, the popular indexes such as the Dow Jones Industrials or the S&P 500 are disproportionately influenced by the movement of a few very large stocks such as Facebook, Apple, Amazon, Google and so on. However, as seen in the chart below, while the S&P 500 index itself shows a sideways price movement so far this year, the broader market consisting of many more stocks has been making new highs, as depicted by the Advance/Decline line (in red). This is consistent with an overall market environment of accumulation (as opposed to distribution).

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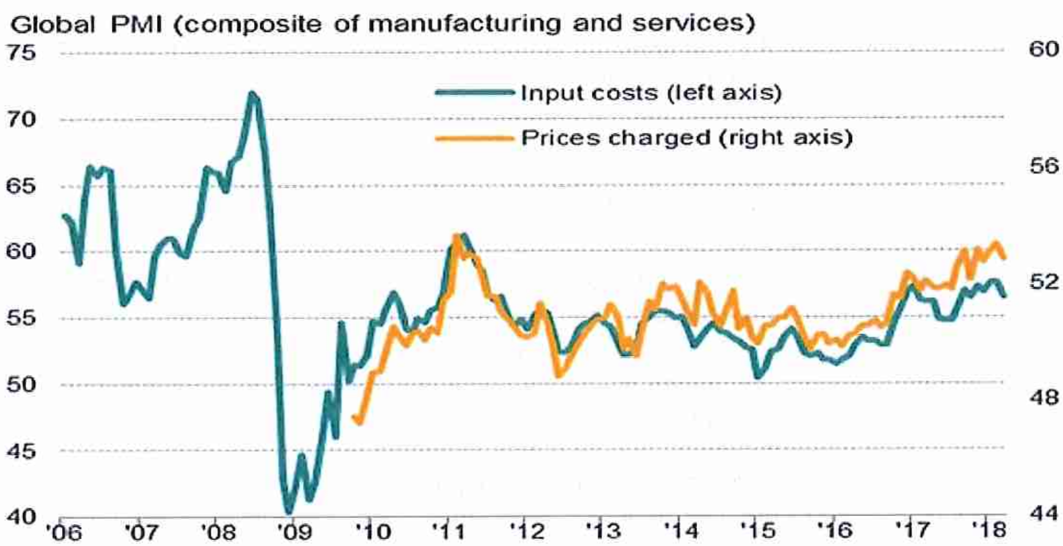
[9] http://www.barrons.com/public/page/9_0210-investorsentimentreadings.html

It should also be noted that there has been a persistent seasonal problem with measuring US growth for the first quarter and it appears to have been consistently under-estimated. According to Steve Liesman at CNBC, "A detailed review by CNBC of 30 years of the government's gross domestic product data, the most followed measure of U.S. growth, suggests a longstanding problem of under-reporting Q1 expansion…(Over this period) first quarter growth has been by far the weakest of the four, averaging just 1.87 percent while the economy has grown 2.7 percent…First quarter data since 2010 has been especially depressed, averaging a paltry 0.62 percent while the economy grew 2.3 percent."[12] So, perhaps this most recent decline is just another case of Q1 reporting bias and economic growth will shortly return back up to trend.

What is more certain is that price pressures are increasing. According to the FT, "US private sector pay grew at the quickest pace since before the recovery started". They cite Bureau of Labor statistics showing 2.9% growth in wages and salaries for the first three months of the year vs. last year – the fastest pace since 2008.[13] Nor is it just wage pressures. Danielle DiMartino Booth recently noted that "By all metrics, inflation is heating up…According to producers, input costs have risen for six of the past eight months. And it's not just big companies that are feeling the pressure. One in four small businesses say they plan to raise prices, a 10-year high, according to the National Federation of Independent Business. Inflation's persistence will finally begin to trickle through to consumers."[14]

Additional evidence is offered by the Global PMI Price data series from IHS Markit. Note the upward trend in prices since 2015. Also note that the Prices Charged (orange line) is breaking higher and exceeding increases in input costs. This supports DiMartino Booth's assertion that price increases are filtering through to consumers.



Sources: IHS Markit, JPMorgan. [15]

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[12] https://www.cnbc.com/2015/04/21/the-mysterious-case-of-weak-1q-gdp-for-30-years.html
[13] US Wages in Steepest Climb Since 2008; FT; April 28/29, 2018; pg. 2
[14] https://seekingalpha.com/article/4166763-markets-better-prepare-stagflation?li_source=LI&li_medium=liftigniter-widget
[15] https://ihsmarkit.com/research-analysis/global-pmi-slides-to-16month-low-in-broadbased-slowdown.html

Regarding the US specifically, DiMartino Booth reports that "In April, Delivery Time - defined as how stretched vendors are in getting input products to manufacturers - jumped to the highest level since record-keeping began in May 1968...In formulaic fashion, Prices Paid rose to the highest in seven years. But here's the clincher - Prices Received increased to the highest in almost a decade. It's one thing if manufacturers are absorbing higher costs, but it's much more pertinent to Fed policy if these higher costs are passed along to end users."[16]

This puts the Fed in a serious dillema, where they must consider further interest rate hikes to stave off inflation, just at the moment when growth might be slowing. As the FT reported, "US prices climbed closer to the Federal Reserve's target in March, leaving policymakers on track for further rises in short-term interest rates, after the central bank's preferred inflation measure reached its quickest pace in over a year."[17]

This dilema was aptly captured by a recent piece by Guggenheim's CIO, Scott Minerd, who wrote:

> "Markets should prepare for a collision course with disaster: Over the course of the next two years the effects of fiscal stimulus will wear off and monetary policy will get more restrictive.
>
> The collision course is being brought about by strong fiscal stimulus in the late stage of the business cycle...The U.S. economy is beyond full employment. The labor market is beginning to reach capacity constraints in a number of areas, which is resulting in a pickup in wage pressures. At this stage of the business cycle monetary and fiscal policy would normally be utilized to cool off the economy, but with the huge fiscal stimulus coming online, the Federal Open Market Committee (FOMC) will feel obliged to play the role of creating economic headwinds...
>
> During the financial crisis and the Great Recession, the FOMC played the opposite role...The fiscal headwinds of the economy made it necessary for the Fed to maintain a very low interest rate policy through the use of quantitative easing to help the economy expand and offset fiscal headwinds.
>
> Now, as newly installed Fed Chairman Jerome Powell has testified, the headwinds of fiscal policy are gone and have turned into tailwinds. We are seeing some market estimates for economic growth upgraded to 3.5 percent...Thus (the Fed will feel obliged to raise the overnight Fed funds rate so that) a year from now it will be 2.5–2.75 percent, and a year later it will be between 3.25–3.5 percent. When the overnight rate gets to 3 percent ***the amount of free cash flow in corporate America will be reduced to a level which is consistent with what we have seen in prior recessions*** (emphasis added)...
>
> When you consider where we are today, things look pretty rosy as corporate earnings rise. But what happens in 2019? Corporate debt as a percentage of gross domestic product (GDP) is sitting at a record high. By the time we get to the end of 2019, when the overnight rate is between 3.25–3.5 percent, corporate America will be in worse shape than it is today. It will be in worse shape than it was last year. It will be in worse shape than in 2007.

[16] Op. cit. #14
[17] Fed Ponders More Rate Rises as Inflation Gathers Pace; FT, May 1, 2018; pg.4

This is the collision course. The collision will take place when the effects of fiscal stimulus begin to wear off and monetary policy keeps getting more and more restrictive.

We will enter the next recession with the highest debt load on record for corporate balance sheets (emphasis added)...The next recession is going to emanate from the corporate sector. There is likely to be a sharp decline in employment and a sharp decline in profitability, followed by widening credit spreads as the market discounts the expectation of higher corporate defaults.[18]

Minerd offers the following chart to illustrate his concerns:

Long time readers of these reports are well aware of our concern over the levels of debt in our society and indeed globally. Our past reporting has focused more on sovereign (government) debt relative to their countries GDP, but Minerd's focus on corporate debt as the weakest link in this current cycle is probably spot on. Without going into too much detail, suffice it to say that the outstanding levels are currently far in excess of those existing prior to the "Great Financial Crisis" of 2008. This would be okay if economic growth had kept apace. It has not!

Despite the ominous longer term ramifications of this, the timing remains problematic. Often, the greatest gains are generated in the final phases of a bull market and we continue to feel that there are areas that offer potential for strong performance. These are particularly in the sectors that benefit from a "late-cycle" inflationary environment, such as Energy and Basic Materials. These areas have been beaten down over the past years. Productive capacity has been shut down and taken off-line and little new investment has

[18] https://www.guggenheiminvestments.com/perspectives/global-cio-outlook/when-fiscal-and-monetary-policy-collide

occurred. Further, as discussed in earlier reports, Commodities in general have only been this cheap relative to stocks twice in the past 50 years! We began overweighting those sectors late last year and are happy with the allocations so far.

This was definitely the winter of the Nor'easters this year! However, we remain bullish on the tulips, daffodils and warm weather that look to finally be arriving in the Northeast. We hope you are able to enjoy a few days of spring this year now that it's nearly summer!

Thanks for Reading,

Jason Waxler

Quarterly Market Review First Quarter 2018[19]

U.S. STOCKS

	4Q 2017	*Year-to-Date*
Dow Jones Industrial Average	-1.96%	-1.96%
S&P 500 Index	-0.76	-0.76
Nasdaq Composite Index	+2.32	+2.32
S&P MidCap 400 Index	-0.77	-0.77
Russell 2000 Index	-0.08	-0.08

INTERNATIONAL INDEXES

MSCI Index	*4Q 2017*	*Year-to-Date*
EAFE (Europe, Australasia, Far East)	-1.41%	-1.41%
All Country World ex-U.S.A.	-1.08	-1.08
EM (Emerging Markets)	+1.47	+1.47

GLOBAL BONDS

Index	*4Q 2017*	**YTD**
Bloomberg Barclays U.S. Aggregate Bond Index	-1.46%	-1.46%
J.P. Morgan Global High Yield Index	-0.69	-0.69
Bloomberg Barclays Municipal Bond Index	-1.11	-1.11
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	+3.62	+3.62
J.P. Morgan Emerging Markets Bond Index Global Diversified	-1.74	-1.74

[19] https://www3.troweprice.com/usis/personal-investing/planning-and-research/t-rowe-price-insights/markets/quarterly-market-review.html