Katonah Capital Group, LLC
BALANCE IN A CHANGING WORLD
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SECOND QUARTER 2018 ADVISORY INVESTMENT REPORT

~ Funny how the Fed did not call it "Balance Sheet Abnormalization" when they were creating trillions of dollars to give to their banker pals.[1]

There was plenty of volatility once again during the second quarter. Prices on average though, made only small progress as the markets continued to consolidate and digest their gains from 2017. There was certainly cause for the volatility given concerns over trade, tariffs on our trading partners and their retaliatory tariffs on our goods, Federal Reserve interest rate hikes and balance sheet unwinding. This was counterbalanced by truly stellar earnings reports in the US. According to T. Rowe Price, "April and May brought evidence that corporate earnings had accelerated even more than expected following the December 2017 tax cut and further stimulus provided by federal spending increases in March. According to data and analytics firm FactSet, earnings for the S&P 500 as a whole rose by 24.6% in the first quarter relative to a year earlier, marking the best increase since profits rebounded following the Great Recession nearly a decade ago. Steep cuts in the corporate tax rate deserved part of the credit, but top-line revenue growth also surprised on the upside. Indeed, more than three-quarters of firms reported higher-than-expected increases in both earnings and revenues."[2]

This tug of war is depicted in the charts below showing the sideways to up price performance of the S&P 500 versus the downward sloping bias to the FTSE All World Index.

[1] Borrowed from a tweet by Saurez, Jul 6, 2018 at 7:47 pm
[2] https://www4.troweprice.com/gis/fai/us/en/insights/articles/2018/q3/quarterly-market-review.html

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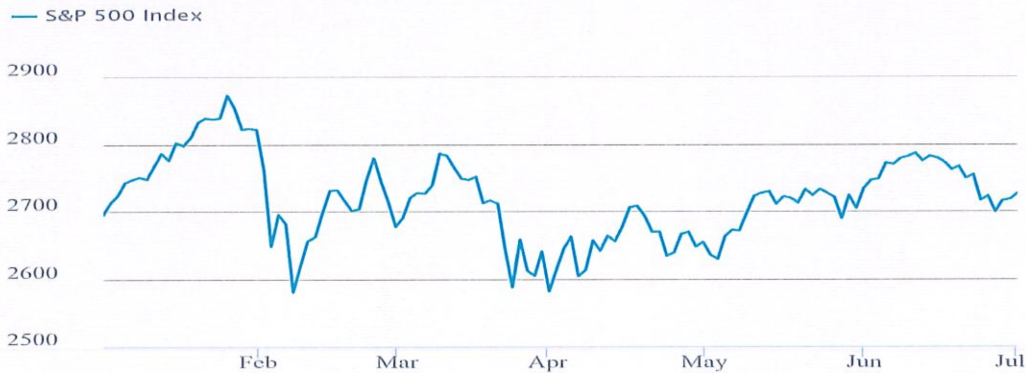

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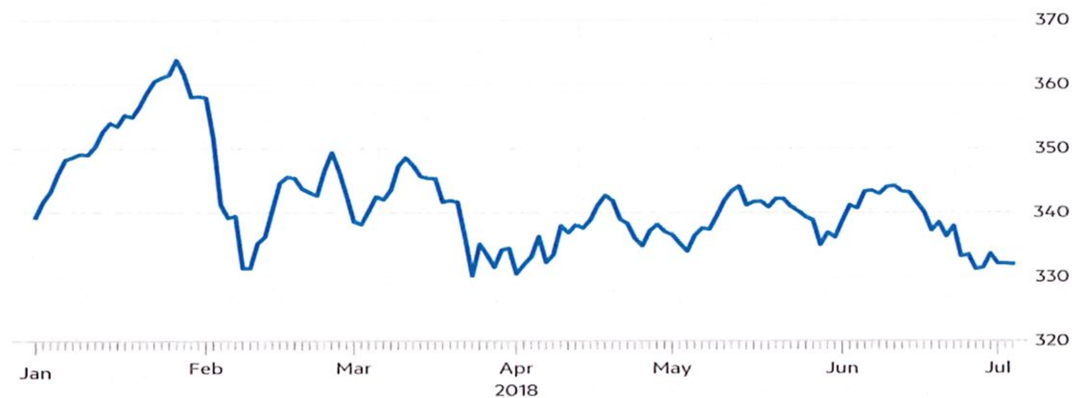

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In addition to the divergences between US and foreign stocks, energy stocks were up 13% amid global concerns about supply constraints, according to Capital Group.[5] Technology was once again a leader, supported by strong earnings from the tech giants Apple, Microsoft and Facebook. Smaller stocks, which tend to be less affected by global trade and more impacted by the tax reductions, were big winners with the Russell 2000 Index gaining 7.75% (see Index

[3] https://www.barrons.com/articles/after-the-bell-dont-read-too-much-into-the-dows-35-point-gain-1530568410?mod=djem_b_Weekly%20Barrons%20feed%20for%20last%2024%20hours

[4] https://www.ft.com/content/a9f9327a-7f5f-11e8-8e67-1e1a0846c475

[5] https://www.capitalgroup.com/us/insights/market-commentary/world-markets-2q-2018.html

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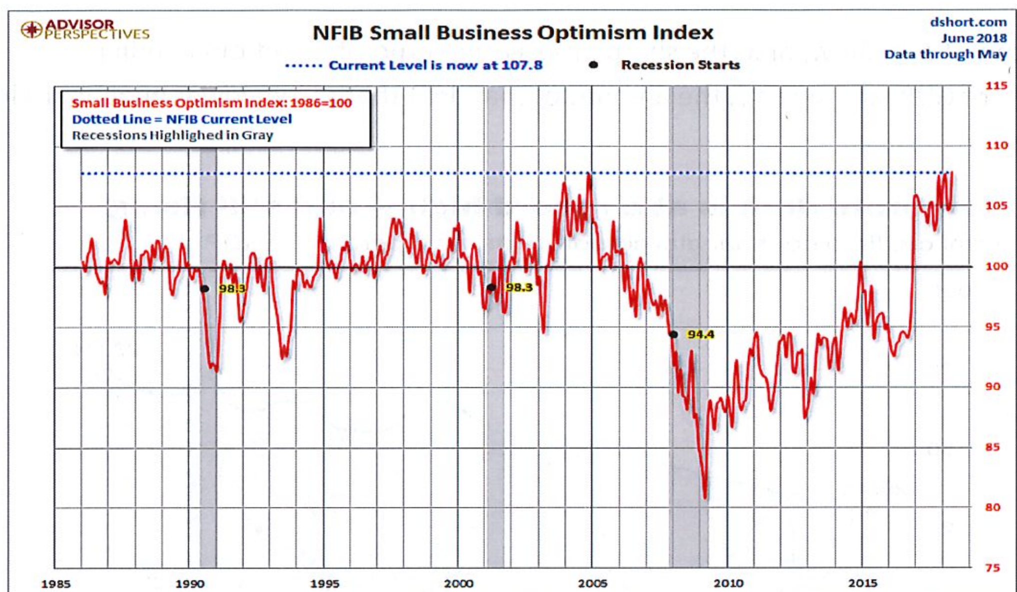
returns below). Whether you agree with the policies of the current administration or not, it's hard to argue that paring back regulations and tax burdens would not benefit businesses. This can be seen in sentiment measures of small business owners as seen below, showing small business optimism is at the highest levels seen in well over a decade!



[6]

However, there are perhaps other factors at work that are boosting this sector - one that is traditionally known as a more volatile "risk on" trade. A recent article about a Bloomberg story states "There is an odd quirk occurring in the Russell 2000 this year. ***A third of the index doesn't have any profits, yet those companies are rallying 50% faster than the rest of the index. Money losing small cap stocks are up 14.5% this year versus 9.2% in profitable ones*** (emphasis added)**.** The big question is why. Bloomberg offers no clear answers, but does say that ultra low rates have historically boosted the proportion of money losing companies." [7] Another factor is the rise of "passive investing" where money going into an index purchases all components of that index, whether profitable or not.

We have commented in the past about "zombie companies" that should have been put into liquidation – and historically would have – if not for the fact that they are having capital hurled at them from the credit markets which are swimming in central bank induced liquidity. In an article entitled "Beware the 'mother of all credit bubbles'", Steven Pearlstein of the Washington

[6] https://seekingalpha.com/article/4181325-nfib-small-business-survey-small-business-optimism-index-soars-continuing-historic-run
[7] https://finsum.com/index.php/markets/equities/item/7062-the-big-quirk-in-small-caps

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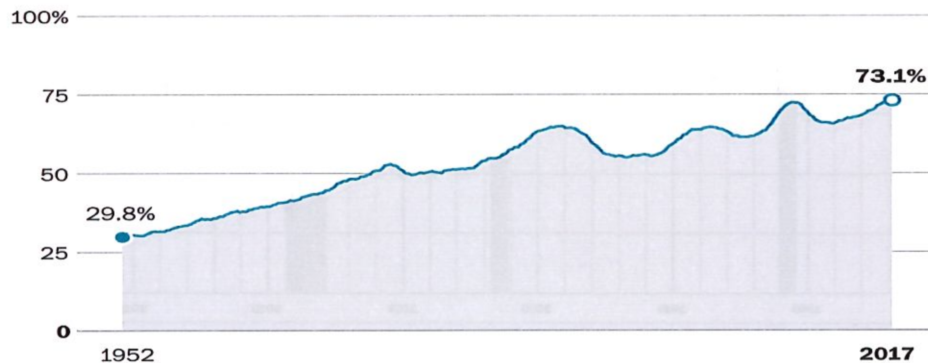
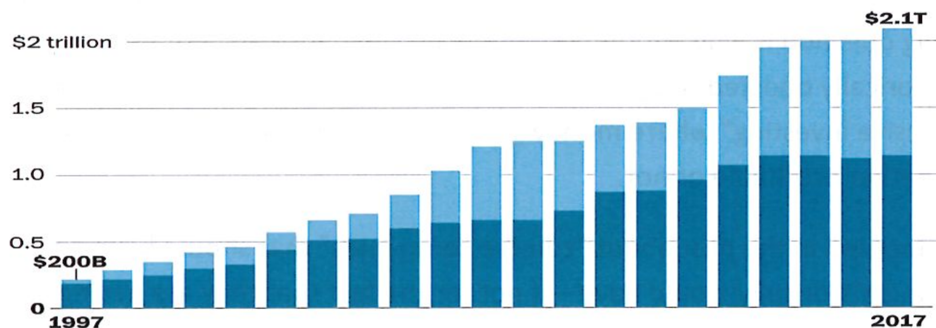
Post writes "It used to be that issuing bonds was the most common way for corporations to borrow money. A decade ago, in 2008, there was $2.8 trillion in outstanding bonds from U.S. corporations. Today, it's $5.3 trillion, after the record $1.7 trillion of new bonds issued last year, according to Dealogic, and $500 billion more issued this year. In recent years, at least half of those new bonds have been either "junk" bonds, the riskiest, or BBB, the lowest rating for "investment-grade" bonds."[8]

The next two charts show, first, the sharp increase in Corporate debt outstanding as a percentage of GDP, and second, the amount of that debt that's from lower quality, riskier borrowers.





[8] https://www.washingtonpost.com/business/economy/beware-the-mother-of-all-credit-bubbles/2018/06/08/940f467c-69af-11e8-9e38-24e693b38637_story.html?noredirect=on&utm_term=.d6f2596b61ac

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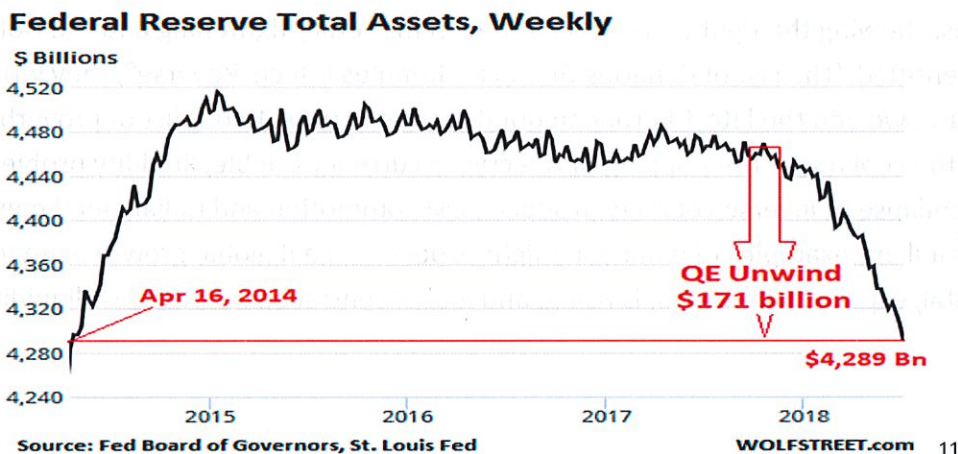
Pearlstein continues, "As a result of all this corporate borrowing, Daniel Arbess of Xerion Investments calculates that more than a third of the largest global companies now are highly leveraged — that is, they have at least $5 of debt for every $1 in earnings — which makes them vulnerable to any downturn in profits or increase in interest rates. And 1 in 5 companies have debt-service obligations that already exceed cash flow — "zombies," in the felicitous argot of Wall Street."[9]

Nor is this just a US based phenomena. Bloomberg recently reported that "Global debt rose to a record $237 trillion in the fourth quarter of 2017, more than $70 trillion higher from a decade earlier, according to an analysis by the Institute of International Finance."[10] Of course, this is occurring as the central banks – in a move called Quantitative Tightening (QT as opposed to Quantitative Easing) - are reversing course and reducing the liquidity they created to address the financial crisis in 2008. This is occurring both in the US...



[11]

...and globally, as the FT notes in an article entitled "The Retreat From Easy Money That Markets Cannot Escape".[12] They further note that "Thin summer trading conditions risk amplifying the pressure facing risk assets".

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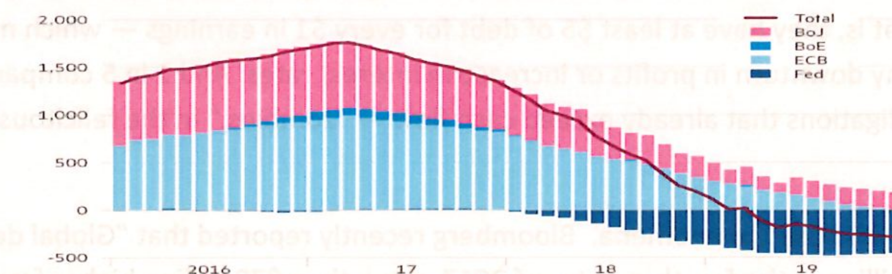
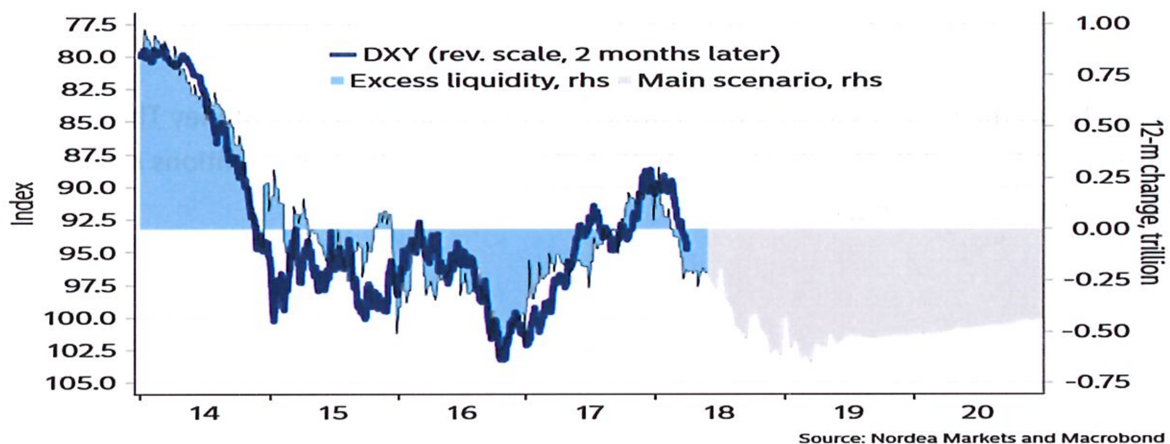
[9] Ibid. # 8
[10] https://www.bloomberg.com/news/articles/2018-04-10/global-debt-jumped-to-record-237-trillion-last-year
[11] https://wolfstreet.com/2018/07/06/update-on-the-feds-qe-unwind/
[12] https://www.ft.com/content/a9f9327a-7f5f-11e8-8e67-1e1a0846c475



Our favorite barometer of global liquidity has long been the US Dollar which has risen sharply in the second quarter (a stronger "more expensive" USD implies a "shortage of dollars" relative to demand). Note in the chart below from Nordea, the dollar index is inverted, and pushed ahead by 2 months, showing the tight correlation between monetary tightening and the Dollar index. In a report entitled "The List of Canaries Grows as Stimulus Effects Reverse", they write "In the bigger picture, we add the latest European bond market turmoil to our list of proverbial canaries in the coal mine. The popping of the crypto currency bubble, liquidity problems in China, the collapse of inverse volatility products, EM commotion and Italian and Spanish bond market turmoil are examples of what you might expect to see if global growth is slowing, the cost of capital, especially in the US, is rising, and global central banks offer less liquidity support.



[13]

[13] https://e-markets.nordea.com/#!/article/44651/week-ahead-pasta-la-vista-world-trade

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Another example of a fallen canary is given by the performance of "century bonds" – bonds with a maturity of 100 years – recently issued by Argentina. In a piece entitled "Chasing Yield during ZIRP & NIRP (ed. note; zero interest rate policy and negative interest rate policy) Evidently Starved Human Brains of Oxygen. Now the Price Is Due", Wolf Richter notes that "Argentina sold these 'century bonds,' which mature in 2117, at 90 cents on the dollar – and investors thought they'd gotten a sweet deal. And they sure had if they sold the bond when it peaked on October 30 at 103.94... Those that didn't sell or that bought at the time are ruing the day. The bond has since plunged 23% to 79.98 cents on the dollar... and is down 11% from the price when issued."[14]

Other fallout can be seen by the recent plunge in commodity prices such as copper and other industrial metals. However, the market still chooses to ignore this and there are no real signs of financial stress yet. So, perhaps credit is not as tight as it would appear. This is a position taken by Scott Grannis, the former chief economist of Western Asset Management, who writes under the name Califia Beach Pundit. He states "the Fed 'tightening' cycle looks very different today than in the past, mainly because bank reserves are still quite plentiful and real borrowing costs are still very low... We are now 2½ years into a Fed rate-hiking cycle: the Fed started raising short-term rates in late 2015 from a low of 0.25% to now 2.0%. Real yields have risen from -1.5% to now about zero - still very low from an historical perspective. Not surprisingly...there are still no signs of rising systemic risk or deteriorating credit conditions. Credit spreads remain low... Although the Fed has been draining bank reserves, they are still magnificently abundant, totaling about $1.9 trillion."[15] He offers a chart of 2 year "Swap spreads" (suffice it to say that they are an indicator of financial conditions, widening during periods of stress as in '08-'09) which are notably subdued at present.

[14] https://wolfstreet.com/2018/06/18/chasing-yield-during-zirp-nirp-evidently-starved-human-brains-of-oxygen/
[15] https://seekingalpha.com/article/4182469-key-credit-indicators-still-green?app=1&isDirectRoadblock=false

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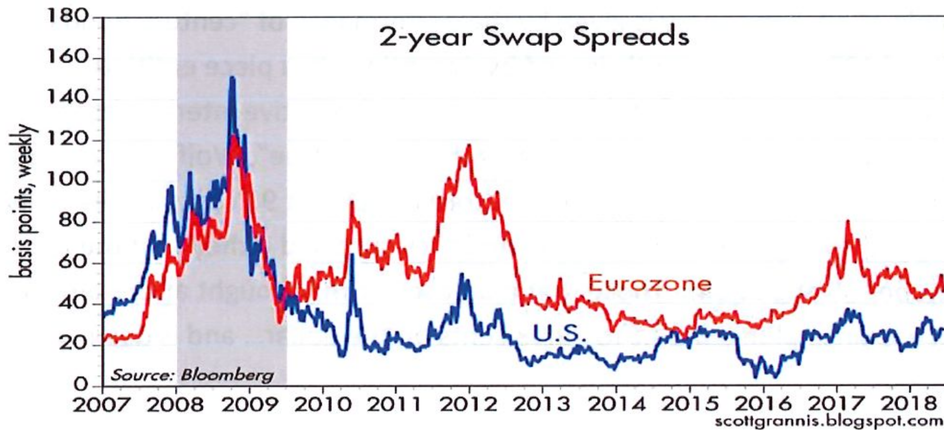
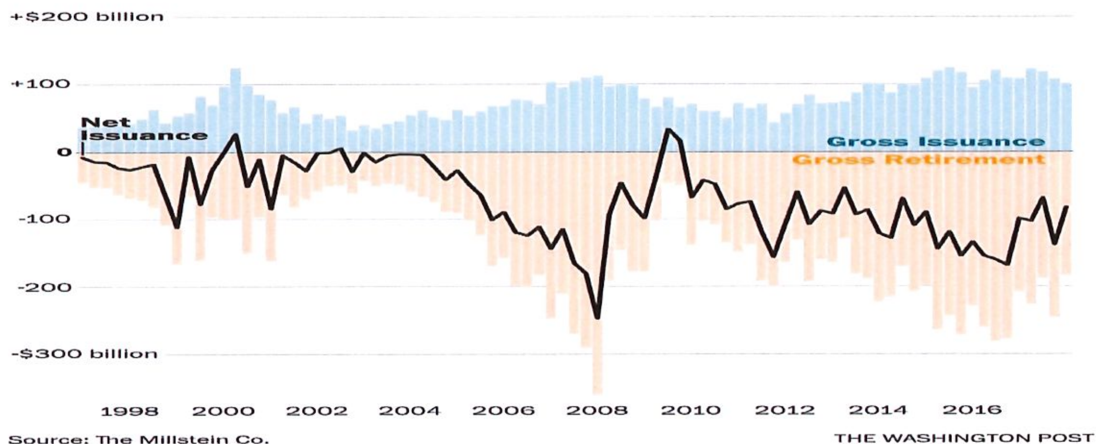


Further, there are other structural factors supporting equity prices now. In the Washington Post article discussed above concerning the growth of Corporate debt, Pearlstein notes that much of the new debt issuance was going, not towards investment in new productive plant & equipment or research & development, but rather towards the repurchase of shares of outstanding stock of the company. He states "As the accompanying chart indicates, over the past decade, net issuance of public stock — new issues minus buybacks — has been a negative $3 trillion. This reduction in the supply of public shares in American companies, coupled with an increased global demand for them, goes a long way toward explaining why stocks are now priced at 25 times earnings, well above their historical average."[16]



[16] Op. cit. # 8

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So, here we are. There is every reason in the world for the markets to be much lower than where they are. But, perhaps exactly because of that – i.e. the "wall of worry" that the market has upon which to climb – prices continue to grind higher. Perhaps the world just blinks at the current trade tariff bluster; perhaps central banks cease their QT just in time without overshooting and causing financial stress; and perhaps underlying earnings growth eventually carries the day. In Q IV of last year and Q I of 2018 we over-weighted later cycle sectors, such as energy, commodities and basic materials in the belief that global growth was real and would continue apace. Energy has worked out due to its own unique supply and demand dynamics, however, after a promising start, commodities and basic materials while arguably cheap, have continued to remain cheap! If the US dollar continues to strengthen here (and commodities remain under pressure), we will be forced to reevaluate our entire asset allocation and very likely begin raising cash. As of this writing though, the trend of the market remains up and we are respecting that.

The trend of the weather here in the Northeast remains soupy, and it looks like it will be raining for 40 days and 40 nights. We hope you're enjoying your summer in any case and hopefully finding time to relax.

Thanks for reading,

Jason

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Quarterly Market Review

Second Quarter 2018[17]

U.S. STOCKS

	2Q 2018	**Year-to-Date**
Dow Jones Industrial Average	+1.26%	-0.73%
S&P 500 Index	+3.43	+2.65
Nasdaq Composite Index	+6.33	+8.79
S&P Mid-Cap 400 Index	+4.29	+3.49
Russell 2000 Index	+7.75	+7.66

INTERNATIONAL INDEXES

MSCI Index	***2Q 2018***	***Year-to-Date***
EAFE (Europe, Australasia, Far East)	-0.97%	-2.37%
All Country World ex-U.S.A.	-2.39	-3.44
EM (Emerging Markets)	-7.86	-6.51

GLOBAL BONDS

Index	***2Q 2018***	**YTD**
Bloomberg Barclays U.S. Aggregate Bond Index	-3.16%	-1.62%
J.P. Morgan Global High Yield Index	+0.17	-0.53
Bloomberg Barclays Municipal Bond Index	+0.87	-0.25
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	-4.76	-1.31
J.P. Morgan Emerging Markets Bond Index Global Diversified	-3.54	-5.23

[17] https://www4.troweprice.com/gis/fai/us/en/insights/articles/2018/q3/quarterly-market-review.html

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