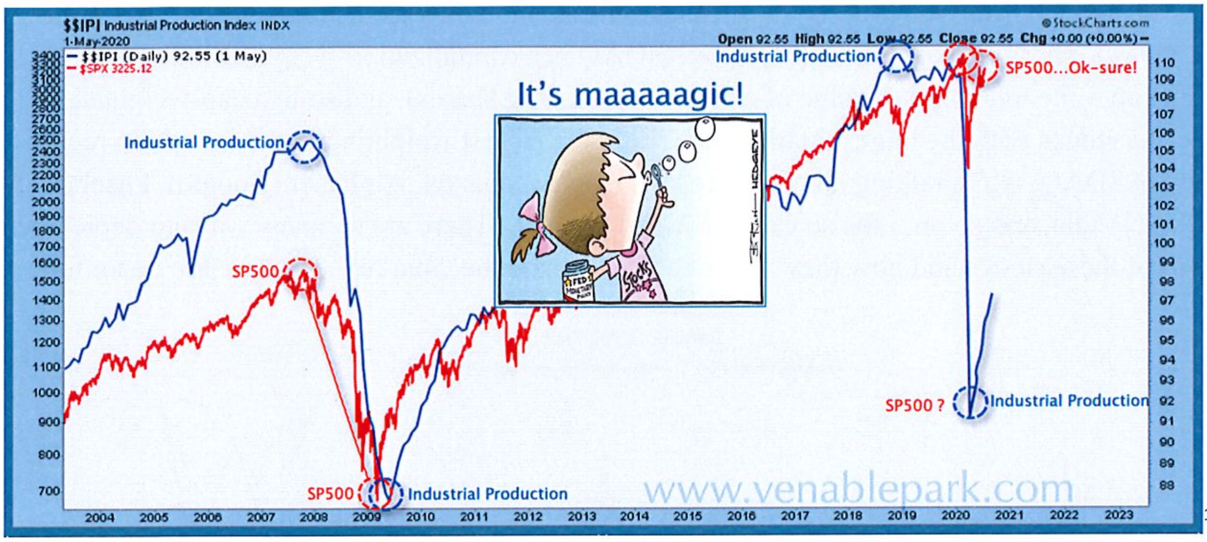
Katonah Capital Group, LLC

BALANCE IN A CHANGING WORLD

Jason@KatonahCapitalGroup.com

80 Business Park Drive, Suite 304 • Armonk, NY 10504

p (914) 219-5880 • f (914) 273-6806



[1]

SECOND QUARTER 2020 INVESTMENT ADVISORY REPORT

~ A Mania First Carries Out Those Who Bet Against It, And Then Those That Bet With It![2]

"Well, that was historic" notes Russel Investments in their recent Global Market Outlook[3]. "The fastest 30% drawdown in the history of global equities in the first quarter was followed by the largest 50-day advance in market history in the second quarter. The S&P 500® was back above 3,100 on June 3 and the NASDAQ hit a record high on June 10. Meanwhile, commentators have been lining up to claim that markets are detached from fundamentals."

In case the cartoon above didn't give it away, you can count us as firmly ensconced in that camp of skeptical commentators "lining up to claim that markets are detached from fundamentals." The detachment of financial asset values from the real economy are astounding, but what's more striking is just how many of these "disparities" exist, across the board – whether looking at incomes, inflation, or just the performance of the stock markets themselves.

Regarding the stock indexes, everyone was a winner during Q2, but the expression "it's easy to see green shoots when you're looking at scorched earth" comes to mind. According to T. Rowe

[1] https://jugglingdynamite.com/2020/07/15/the-real-economy-has-a-message-for-stocks-and-its-not-bullish/

[2] Attributed to Jim Rogers, in a Tweet by La nuit sera calme, @NuitSeraCalme; 2:29 AM · Jun 9, 2020

[3] https://russellinvestments.com/us/global-market-outlook#ColorBoxesRoot_b8fda17e-a2a8-4716-be82-0e57bee24097

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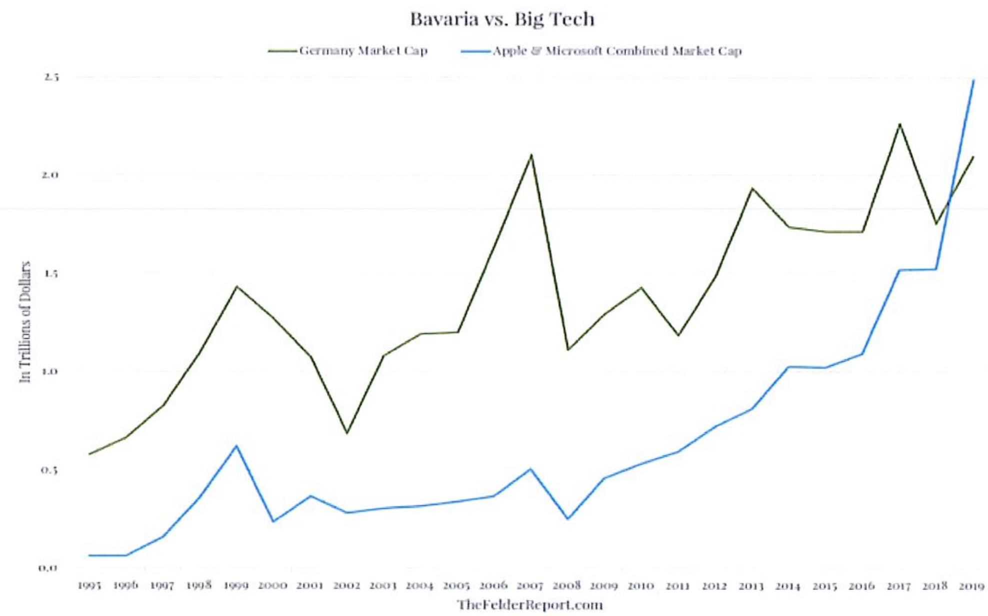
Price, the returns ranged from the Dow's gain of 18.51% to the NASDAQ's gain of 30.63%. However, the year-to-date returns are more telling, as the Dow remained down - 8.43% on the year, along with small stocks (-12.98%), international stocks (-12.43%), emerging markets (-9.37%), and the S&P 500 (- 3.08%). In stark contrast though, was the tech-heavy NASDAQ (+12.11%).[4] As discussed in the past, the NASDAQ is a capitalization-weighted index (i.e. market cap = the total market value of a firm's outstanding shares), and so in a cap-weighted index, the stocks with the largest market values get the largest weighting in the index. In regard to the NASDAQ, we're talking about Microsoft, Apple, Amazon, Alphabet (Google), Facebook, Netflix, NVidia, and so on…the so called FAANG stocks. There are so many ways to depict the growth of these stocks and how they've come to dominate the "market", but here are just a few:



Above: the market cap of just two companies - Apple and Microsoft - are larger than the entire German stock market.[5] Below: the total market cap of the 7 largest components of the Nasdaq index is currently around $7trillion – roughly 1/3 of our entire economy, *pre-covid*![6] And, the concentration of just those few stocks in the indexes dwarf the concentration we saw in the 2000 NASDAQ bubble.

[4] https://www.troweprice.com/financial-intermediary/us/en/insights/articles/2020/q3/global-markets-quarterly-update.html?action=notification&notificationid=1596197689117&PlacementGUID=emFAI_2020_q3_global-markets-quarterly-update

[5] https://seekingalpha.com/article/4354439-dangerous-gap-opened-up-for-u-s-equities

[6] https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=US

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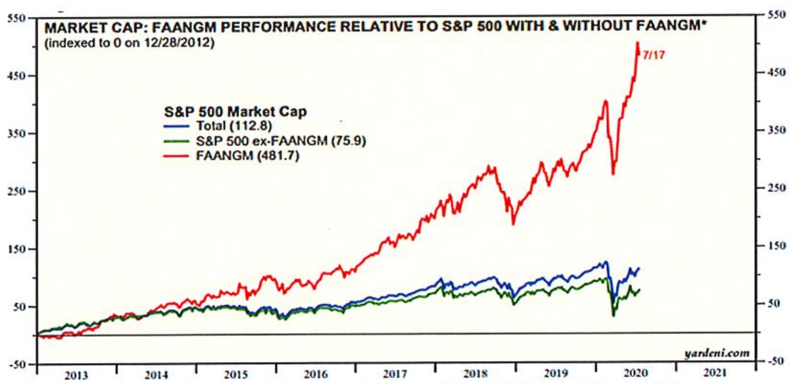
Chart 2: S&P500 now more concentrated in the 5 largest stocks than ever

Source: BofA Global Investment Strategy, Bloomberg [8]



* FAANGM stocks include Facebook, Amazon, Apple, Netflix, Google (Alphabet), and Microsoft. Both classes of Alphabet are included.
Source: Standard & Poor's and Yardeni Research Inc. [9]

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[7] https://wolfstreet.com/2020/07/19/reversal-of-divergence-in-stocks-my-giant-5-index-sagged-all-week-wilshire-5000-minus-giant-5-rose-still-2-5-year-wild-ride-to-nowhere/

[8] https://www.macrobusiness.com.au/2020/04/goldman-were-all-faang-stocks-now/

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Finally, this one below from Yardeni research showing the performance of these stocks (red line) vs. the S&P 500 ex the FAANGM (green line) and vs. the total market (blue line):

The charts above are clearly reminiscent of the NASDAQ bubble in 2000, albeit with one extremely significant difference – today's tech stocks actually have earnings, if not actual profits, and those earnings are often growing rapidly. Tesla, for example, has yet to turn a profit, but their earnings are growing on average by 52% a year over the past 3 years.[10] Zoom (ZM) does have earnings of 18 cents a share on a trailing twelve month basis. At its current price of around $240 a share, ZM trades at a multiple of only 1,428 times those earnings (for reference, the S&P500 currently trades at a multiple of around 22 x earnings – and that level itself is at the very top end of historical ranges going back to 1870!).[11] At least ZM is currently growing their revenues at over 100% per year on average for the past three years![12] If they keep that up for 50 more years, they might even justify today's valuations!

The growth that is occurring is truly remarkable and should not be underestimated. There is absolutely no doubt that innovation in areas such as artificial intelligence, 3D printing, blockchain technology, DNA sequencing, robotics…are going to deeply transform our world and this makes us very optimistic about the longer run. We are optimistic in particular about driverless vehicles, which will mean that my generation will be the first one whose kids won't have to take the car keys away from us at some point! However, it could be a very deep valley indeed to traverse before we get to the other side of where we are currently. And, ultimately *growth in and of itself is not enough without profits*…profits to reward shareholders who provide capital; profits to reward employees who provide labor; and profits to fund research and development and drive future growth. Concerning profits, the profit cycle peaked in 2014 and in simpler times" would have ultimately had consequences for equity values.

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[9] https://www.yardeni.com/pub/faangms.pdf

[10] https://www.morningstar.com/stocks/xnas/tsla/financials

[11] https://www.longtermtrends.net/price-earnings-ratio/

[12] https://www.morningstar.com/stocks/xnas/zm/financials

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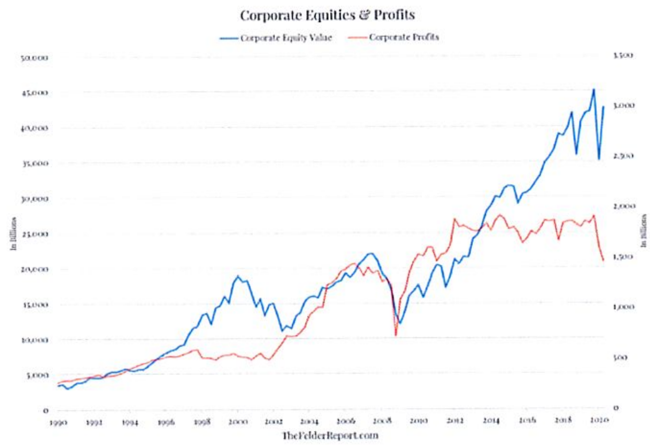

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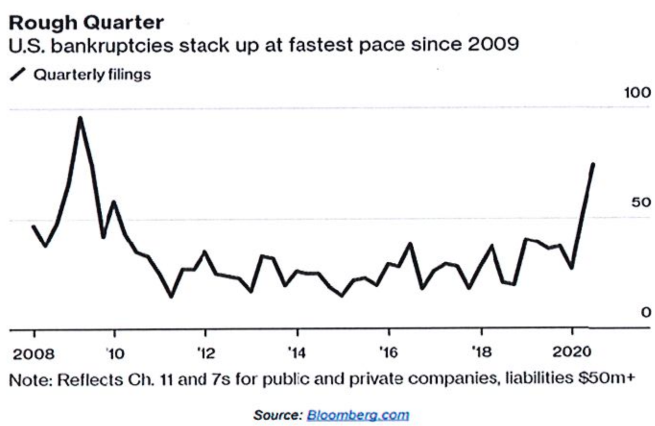
So far though, the stock market has remained blissfully unaware of the decline in profits. But consequences are clearly visible in the business sector itself, where bankruptcies are soaring. According to the Wall Street Journal, "Chapter 11 business bankruptcy filings increased 26% in the first half of this year…U.S. courts recorded a total of 3,604 businesses filing for chapter 11 protection in the first six months of 2020, up from 2,855 in the first half of 2019."[14] Many of these are smaller businesses, but the trend is evident in the below chart of companies with at least $50 million in liabilities:



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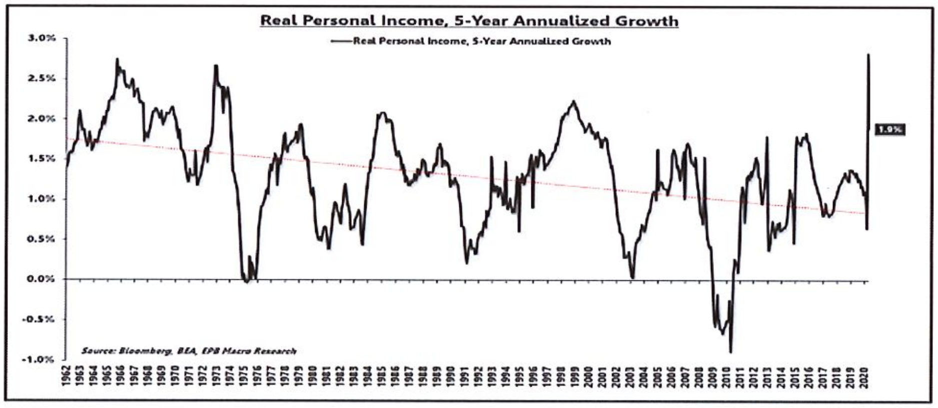
And again, while not visible in the stock market, the effects on corporate profits are very visible on the pockets of workers. The following three charts analyze long term trends in personal

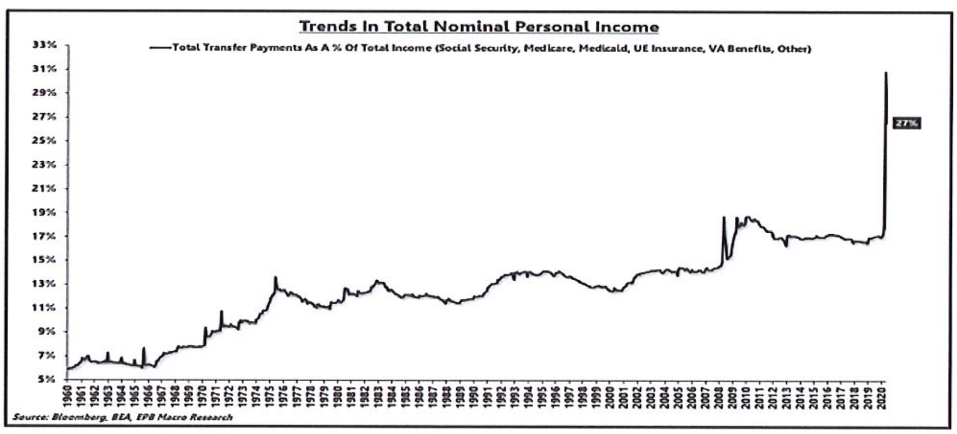
[13] https://seekingalpha.com/article/4355790-biggest-disconnect-prices-and-profits-in-stock-market-history?utm_medium=email&utm_source=seeking_alpha&mail_subject=jesse-felder-the-biggest-disconnect-between-prices-and-profits-in-stock-market-history&utm_campaign=rta-author-article&utm_content=link-0
[14] https://www.wsj.com/articles/chapter-11-business-bankruptcies-rose-26-in-first-half-of-2020-11593722250
[15] https://ggc-mauldin-images.s3.amazonaws.com/uploads/pdf/CTM_Jul_08_2020.pdf

income going back to 1962.[16] The first one shows a smoothed, 5-year annualized rate of growth in real, inflation adjusted income. Note the downward sloping red line showing the gradual but inexorable decline in purchasing power over the past 6 decades. Also note the major spike in the last data point.



The next chart depicts a stunning and depressing story. At the same time that real incomes have been grinding lower and lower, government transfer payments have been climbing higher and higher and equaled roughly one fifth of all income – again, *pre-covid*! The transfers have come from traditional programs like Social Security and Medicare. The sharp spike in 2020 largely represents the category of "Other Transfers". These comprise recently adopted programs such as Pandemic Unemployment Assistance (PUA) and Pandemic Emergency Unemployment Compensation (PEUC). In all, Total Transfer Payments have surged, accounting for nearly a quarter to a third of all income today!

The last chart shows how employee compensation from sources like wages and salaries have been declining over the last half century and just recently fell off a cliff due to the pandemic.



[16] https://seekingalpha.com/article/4356756-stimulus-not-yields-are-still-headed-lower

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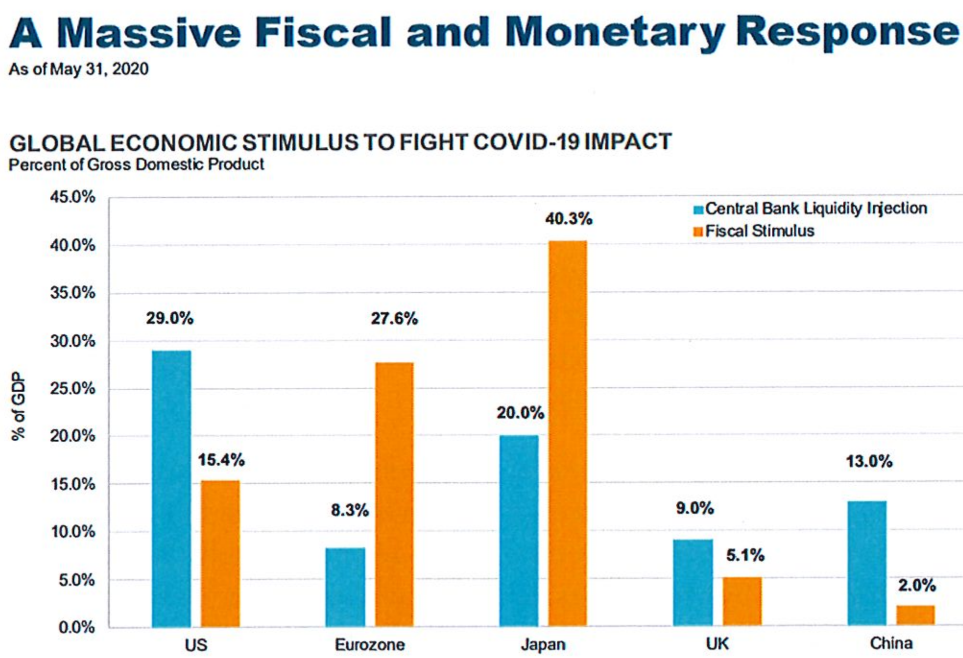
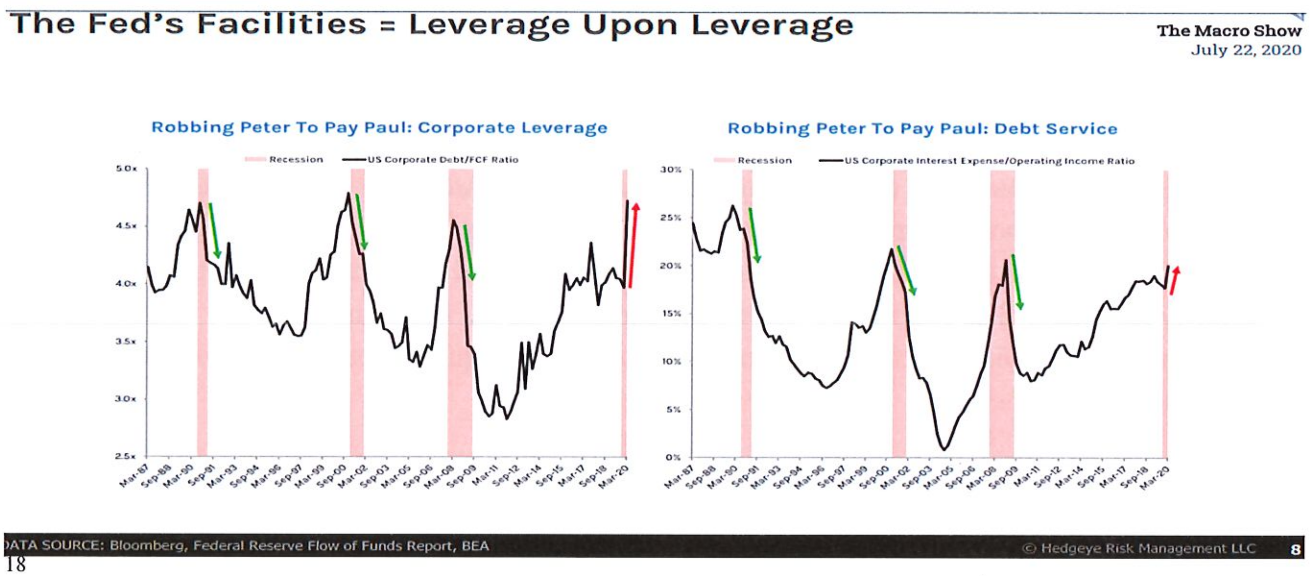
In times of crisis like we're experiencing now, governments are doing what they do best – namely spending money that they do not have. We would argue that this strategy has been a major factor behind the economic predicament we find ourselves in currently. But that is not a priority for today. The chart below shows the enormity of the fiscal and monetary response to the current crisis, with the US and Japan injecting stimulus equal to roughly 50% of their entire economies![17]



[17] Data from Cornerstone Macro; used in T.Rowe Price's 2020 Midyear Market Outlook

Trillions are being thrown at the crisis, and truthfully, it's not clear what else *should* be done other than attempting to keep things afloat until an effective medical response is developed. However, as seen above, these transfers to individuals have not addressed the underlying declines in real wages and income. Nor, as the next chart from Hedgeye brilliantly shows, is attempting to save over-indebted companies by increasing the supply of debt an effective long term solution for them either.



[18]

The chart on the left shows how debt is swamping the amount of free cash flow needed to ultimately service that debt. And the chart on the right shows that for the first time in at least the past 4 recessions, corporations have taken on so much debt that their interest expenses are actually *increasing* relative to their operating income.

For years, Lacy Hunt at Hoisington Investment Management has consistently been on the right side of understanding the deflationary forces at work in the world and was one of the few lone voices predicting lower and lower interest rates. In his recent Quarterly Outlook he wrote "…additional debt incurred by all countries, and many private entities, to mitigate the worst consequences of the pandemic, while humane, politically popular and in many cases essential, has moved debt to GDP ratios to uncharted territory. This insures that a persistent misallocation

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[18] Hedgeye Macro Show; July 22, 2020

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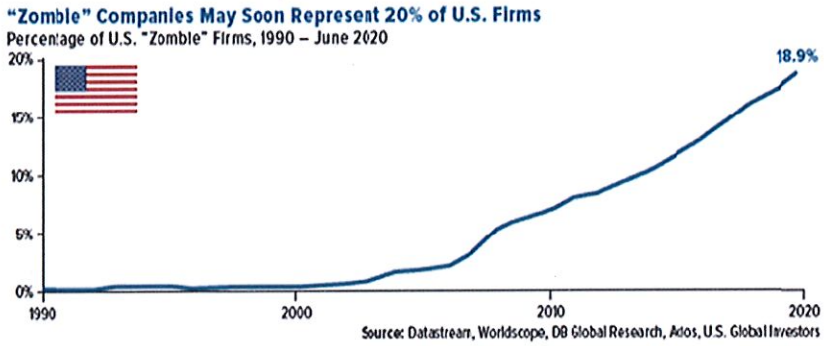
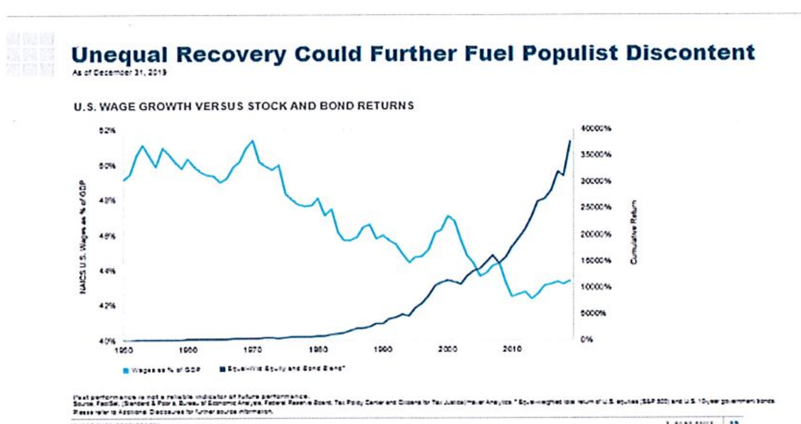
of resources will be reinforced, constraining growth as productive resources needed for sustained growth will be unavailable."[19]

The effects of this can be seen below in a chart showing the growth of "zombie companies". As discussed in past reports, these are companies whose earnings are less than needed to satisfy their debt-servicing costs.[20]



Source: [U.S. Global Investors]

To be clear, we believe that the disparities discussed here are direct consequences of the government/central bank policies of solving over-indebtedness and excess leverage with ever more debt and leverage. And we believe these disparities are ultimately unsustainable for a society. The final "disparity" we'd like to address is captured perfectly in the next chart from T.Rowe Price.[21]



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[19] Hoisington Investment Management; Quarterly Review and Outlook; Second Quarter 2020; pg.1

[20] https://ggc-mauldin-images.s3.amazonaws.com/uploads/pdf/CTM_Jun_24_2020_2.pdf

[21] https://on24static.akamaized.net/event/23/42/05/0/rt/1/documents/resourceList1591740875339/trp2020midyearmarketoutlook1591740856444.pdf ; pg.19

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So there you have it. To keep this going, you need to add evermore debt to the system which is ultimately unsustainable. You can institute policies that redistribute wealth from rich to poor, but that has its own set of unintended consequences and is also ultimately unsustainable as seen above in the ever increasing percentage of transfer payments as a component of income.

It is not typically the focus of these reports to delve into existential issues in this manner. We'll blame it on the virus which has affected all of us and is definitely beginning to wear on everyone. These are all themes that have been touched on in past reports, but the global scope of the pandemic and consequent draconian shutting down of entire economies, have accelerated many of these themes and laid bare many structural weaknesses that already existed. Despite their existence we've somehow muddled through so far. Perhaps an effective vaccine is just around the corner and we will continue to muddle through for the foreseeable future.

The primary effect this all has had on our investing has been to tend towards having larger than usual cash balances in most of the models. We've remained US and growth centric – although we recently took some profits in some of the very high growth tech, along with some of our exposure to gold. We've often cited the US dollar as our barometer of global liquidity. The USD has been showing definite signs of weakness of late. It is very likely that our next shift will be towards international markets which remain deeply undervalued relative to large-cap US growth and commodities including more precious metal exposure.

We do hope that all of you are safe and healthy, and remain in good spirits as we weather this storm. Hopefully you're able to indulge in some "safely distanced" barbeques, beach time, and summer fun!

Thanks for reading,

Jason

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