

Katonah Capital Group, LLC

BALANCE IN A CHANGING WORLD

Jason@KatonahCapitalGroup.com

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

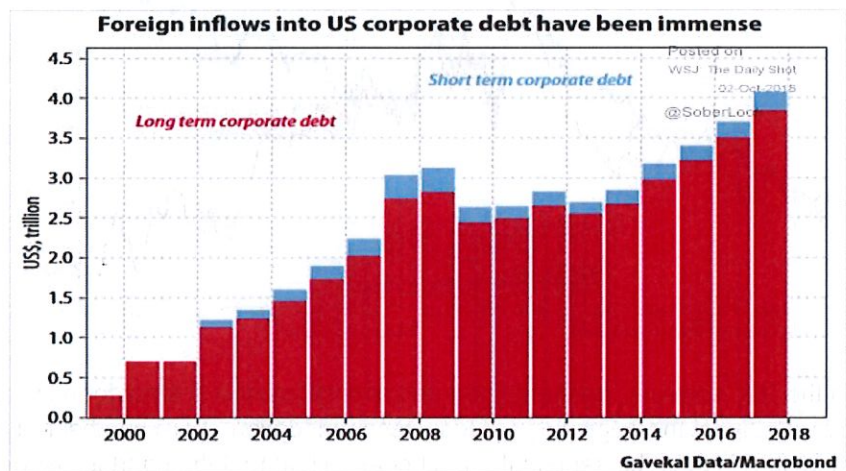
p (914) 219-5880 • f (914) 273-6806

THIRD QUARTER 2018 ADVISORY INVESTMENT REPORT

~ *"The Basic Thing That Starts the Game of Musical Chairs is When Somebody Doesn't Pay Somebody Back and it's Bigger Than Somebody Thinks it's Going to be"*¹

Any commentary concerning the 3rd quarter has already been rendered fairly irrelevant given the very recent market volatility, and of much greater interest is where do we go from here. Solid economic growth and corporate profits in the US fueled a sort of "melt-up" into large cap US growth stocks in the third quarter. Aided by the recent tax cuts and deregulation, the S&P 500 and Nasdaq Composite Index rose 7.71% and 7.14% respectively.² Small cap stocks were up, but by much less and the good news pretty much ends there. Foreign markets are down on the year as Fed rate hikes and a stronger US dollar (USD) sucked capital away from the rest of the world. The carnage in the emerging markets (EM) has been striking. According to Barron's, from their peak in January, Brazil is down -16.6% (even after a strong rally recently due to election results), China is down -34.6%, India down -17% and Mexico down -10.8% and Turkey down a whopping -47.1%!³

Despite the recent lack of accommodation and rising interest rate policy of the Fed, or perhaps because of them, the USD has strengthened and capital is flowing into the US. This can be seen in the chart below showing foreign inflows into our Corporate Bond market.



¹ The Human Cost of the Crisis; Barron's; 10/10/2018 pg. 5; [Quoting a Barron's reader, Richard Weinroth]

² <https://www4.troweprice.com/gis/fai/us/en/insights/articles/2018/q3/quarterly-market-review.html>

³ Bargain Hunting in Emerging Markets; Barron's, October 22, 2018; pg. 24

⁴ Twitter; 10/1/2018; Foreign flows into US corporate debt: <https://blogs.wsj.com/dailyshot/2018/10/02/the-daily-shot-growth-in-private-construction-spending-now-lags-government-projects/> ... via @SoberLook

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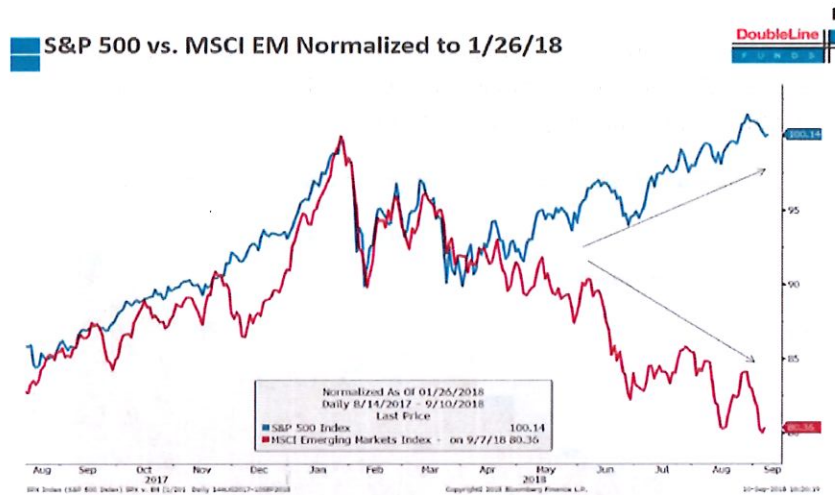
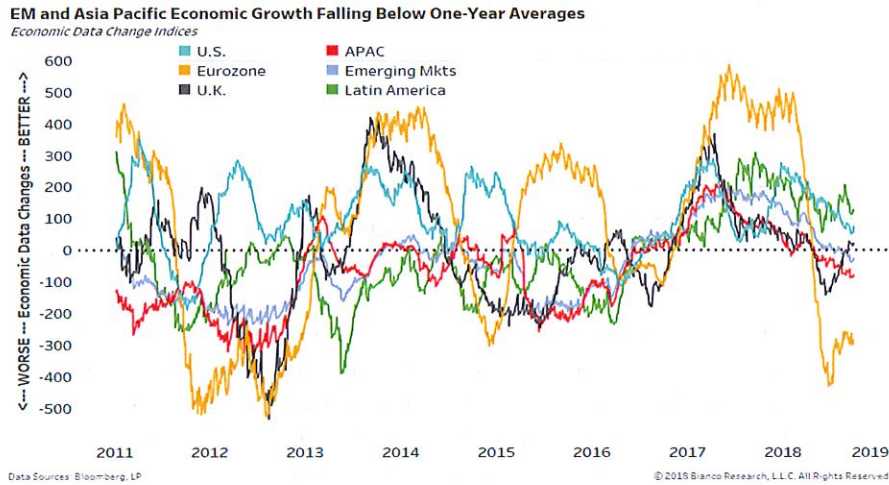
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The results so far have been a marked slowdown in global growth, along with the consequent divergence in market returns. The next two charts show various measures of this. The first is a compilation of Citigroup Economic Data Change indices for major regions and they “measure the distance of incoming economic data releases to one-year average growth rates.”⁵ Note the marked downturn in 2017, particularly in the Eurozone. The next chart shows the dramatic divergence between US and foreign stock market returns.⁶



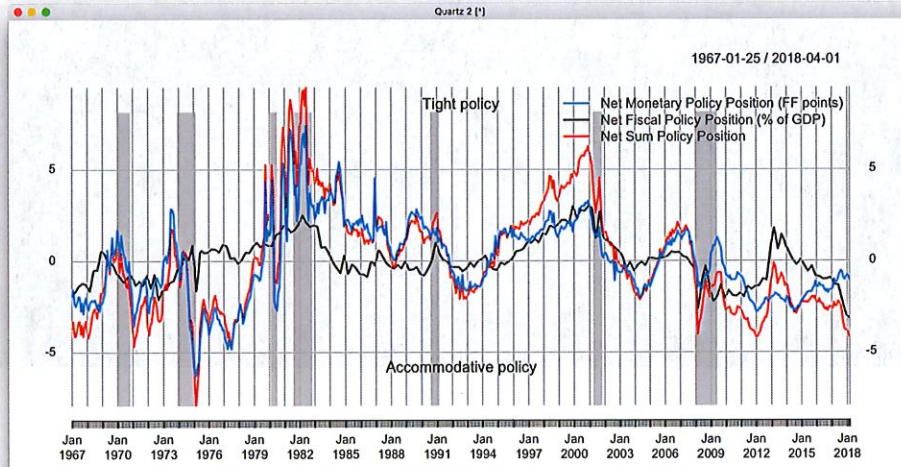
The environment in the US, however, has remained uniquely different – at least for now. Despite the monetary tightening, or at least the beginnings of less accommodation, there has been a tremendous fiscal impulse to offset it. This can be seen in the next chart. Note that the chart is inverted so that a declining line shows easy financial conditions, but focus on the red line which shows the sum of both

⁵ <https://www.biancoresearch.com/?cat=27>

⁶ <https://www.forextraders.com/forex-news/current-narrative-is-shifting-all-eyes-focused-on-the-direction-of-the-usd/>

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fiscal and monetary conditions. According to Matt Busigin, the author, "The degree of both fiscal and monetary policy accommodation verges on unbelievable. This is close to as loose as we've ever seen."⁷



This assessment is confirmed by the next chart which shows the S&P 500 (blue line) and the Goldman Financial Conditions Index (FCI, white line).⁸ Note, again that the FCI (white line) is inverted. The author states "One of the interesting things about the current Fed hiking cycle is that financial conditions have remained relatively loose throughout. In fact, Goldman's Financial Conditions Index (hereafter "FCI") hit a record low (i.e., record easy) in January of this year just as the S&P hit a record high..."

⁷ <https://twitter.com/mbusigin>

Matt Busigin @mbusigin 11h11 hours ago 9-28-18

⁸ <https://seekingalpha.com/article/4213000-stocks-soon-imperil-u-s-gdp-growth?ifp=0>

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However, the FCI is comprised of various financial metrics such as the target Fed Funds Rate, bond yields, corporate credit spreads, USD exchange rates and, of course, the stock market! The author continues; "As illustrated above, rising stock prices were largely responsible for Goldman's U.S. FCI hitting its easiest levels on record in January. As the bank (Goldman Sachs) writes in a note dated Friday, 'the run-up in the equity component of the FCI drove most of the 185bp easing from the start of 2017 till late January, the FCI all-time low'. On the flip side, falling stock prices have been the largest contributor to tightening financial conditions since late September."

So, while financial conditions are overall still favorable, the trend is heading the wrong way at the moment. First, as just noted, stock prices have a large impact on financial condition measures. And, monetary conditions have a large impact on equities. As longtime veteran market observer Richard Suttmeier notes, "In my opinion, the main event is that the Federal Reserve is unwinding its balance sheet, taking away the punch bowl of many years of quantitative easing. QE ballooned the Federal Reserve balance sheet to \$4.5 trillion. The unwinding of this balance sheet began in October 2017. Since then, the Fed has flushed \$325 billion down the drain.

As October 2018 began, the monthly drain was raised to \$50 billion, which I say is the "canary in the coal mine" and investors have smelled the stench of the popping stock bubbles that intensified during the first three days of October when the Fed drained \$18 billion."⁹

In past reports, we've frequently called attention to the massive buildup of debt, to levels now surpassing those that existed prior to the 2008 financial collapse. We agree with Suttmeier that the vaporizing debt is indeed what the "canary" is smelling, and it permeates all asset valuations. Barron's recently quoted Danielle DiMartino Booth who stated "In the last five years, U.S. corporations have taken advantage of

⁹ <https://seekingalpha.com/article/4212956-5-equity-etfs-negative-weekly-charts-fed-unwinds-balance-sheet?ifp=0>

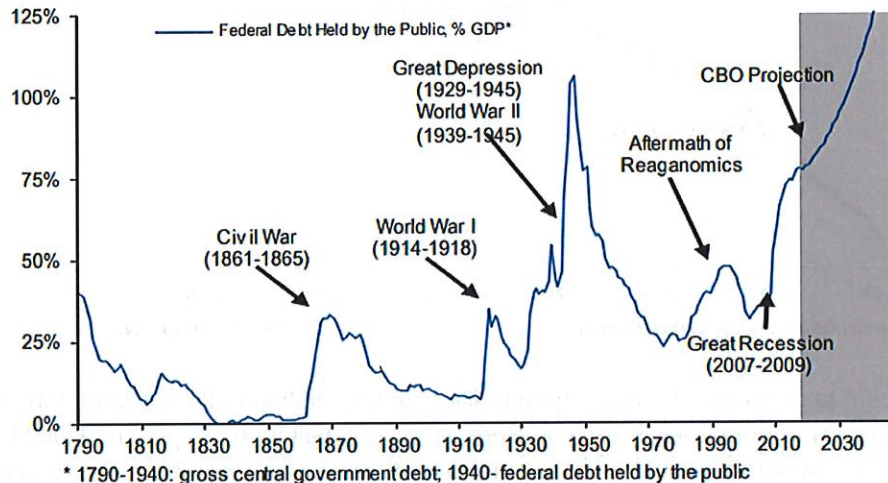
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low yields to sell \$9.2 trillion of bonds, which have helped fund \$3.5 trillion in (stock) repurchases and are on pace for a record \$850 billion in stock buybacks in 2018.”¹⁰

More important than the absolute levels (which are astounding in their own right) is the question of leverage, and specifically what areas of financial growth was fueled by the use of leverage. Well, an argument can be made that leverage is actually everywhere and that all assets - from stocks and bonds to multi-million dollar apartments and works of art – have been artificially inflated. The Barron’s article continues, “Leverage has permeated the economy. Booth cites Bank of America Merrill Lynch chief investment strategist Michael Hartnett who ticks off a litany: ‘share buybacks with borrowed money is leverage, private equity is leveraged equity portfolios, tax cuts financed with Treasuries (sic) is leverage.’”¹¹

Regarding Treasuries, the charts below illustrate just “how far we’ve come”! The first is from a DoubleLine presentation by Jeff Gundlach, and shows over 200 years of data for the US, along with projected growth from the CBO.

Chart 4: US Federal debt as % GDP



Source: BofA Merrill Lynch Global Investment Strategy, Reinhart & Rogoff (2010), Haver

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The next chart is from Wolf Richter who writes “So far in this fiscal year, which just started on October 1, the US gross national debt – the total debt issued by the US government – has jumped by \$138 billion in just 11 business days, fueled by a stupendous spending binge and big-fat tax cuts, to a breath-taking \$21.654 trillion, after having jumped \$1.27 trillion in fiscal 2018. And these are the good times!”¹³

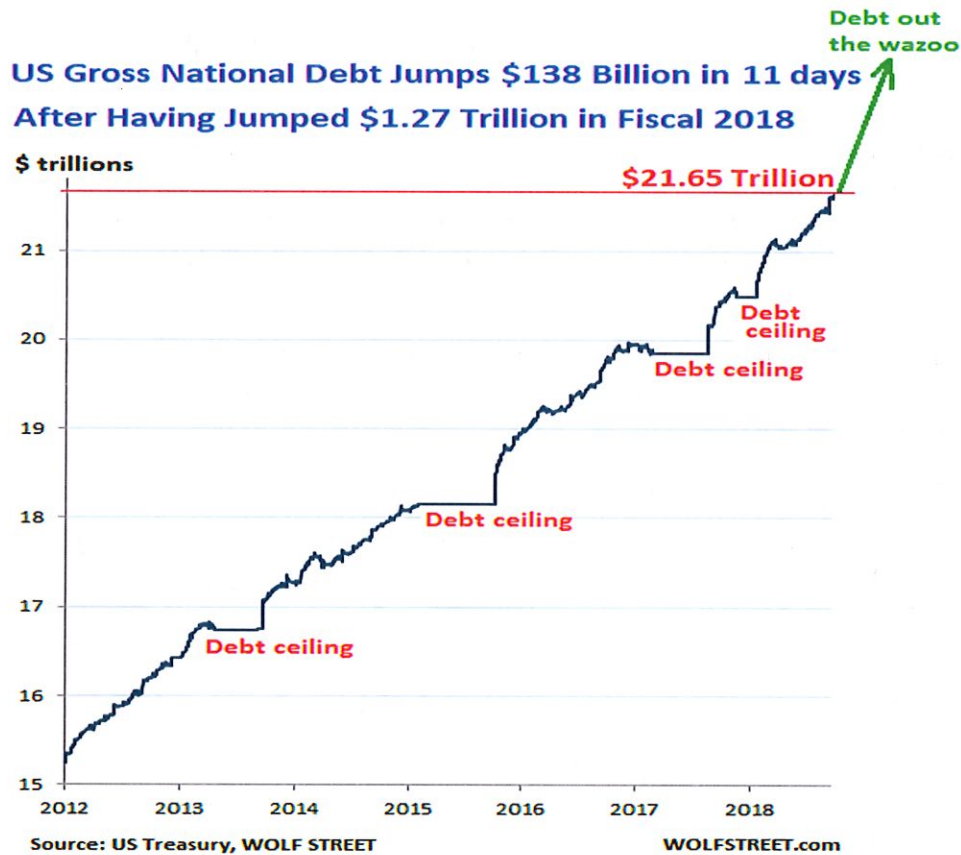
¹⁰ Up & Down Wall Street; Barron’s; September 10, 2018

¹¹ Ibid. # 10

¹² https://www.advisorperspectives.com/pdfs/2018-Slides/6-12-18_TR_Webcast-FINAL.pdf

¹³ <https://wolfstreet.com/2018/10/16/who-bought-the-1-6-trillion-of-new-us-national-debt-treasury-securities-foreign-domestic/>

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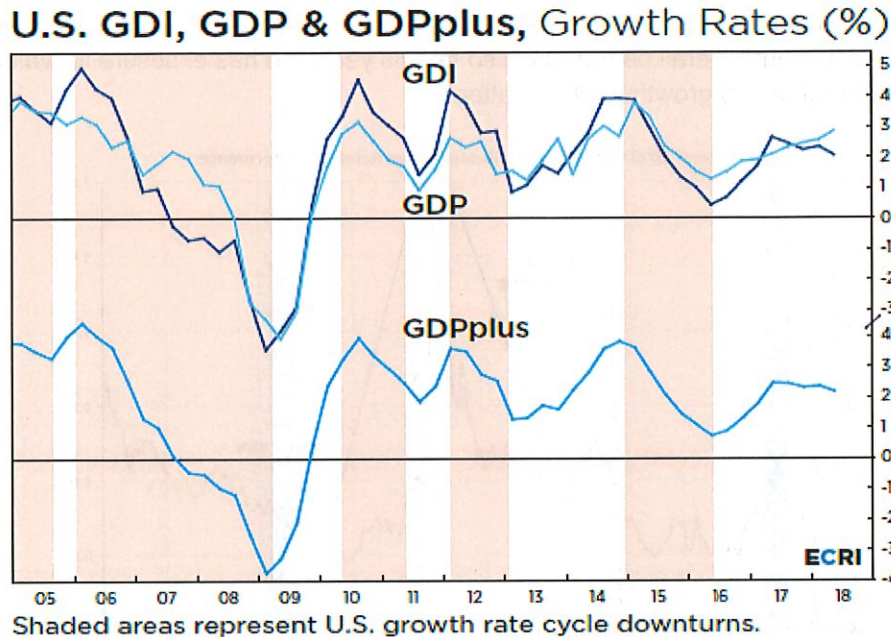
Regarding the recent tax cuts and the consequent trillion dollar addition to the Federal debt, venture capitalist (and a director of the Federal Reserve Bank of NY, as well as AT&T) Glenn Hutchins observes that conventional wisdom attributes recent economic growth, strong employment data and corporate earnings to “a powerful mix of tax cuts, regulatory relief and standing up to China... This argument confuses the sugar-high that accompanies short-run fiscal stimulus with the blend of fiscal prudence and durable investments essential to assure future generations of sustained prosperity... Tax cuts should not be mistaken for tax reform, which would increase both efficiency and competitiveness. The corporate tax cuts will goose earnings for two years, but compel future generations to shoulder the resulting interest and principal payments — transferring wealth from taxpayers to shareholders.”¹⁴

Perhaps the global equity markets are agreeing with Hutchins and reacting to a weakening of global growth that lies ahead. Mauldin Economics recently reported on work done by Lakshman Achuthan, head of the Economic Cycle Research Institute (ECRI) who has been more restrained on his assessment of the economy. In an article entitled “Damned Lies and Statistics”, Mauldin notes that the GDP measure of the economy is “likely to be exaggerating the economy’s strength. Indeed, since GDP tends to be substantially revised years after the fact, it’s useful to cross-check it with the data on Gross Domestic Income (GDI), an equivalent measure of output growth, based on income rather than purchases.

¹⁴ <https://www.ft.com/content/6796b820-d3a7-11e8-9a3c-5d5eac8f1ab4>

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Importantly, one study showed that initial GDP growth estimates tend to get revised toward initial GDI growth estimates, but not vice versa. So it's surely worth noting that, in the second quarter of 2018, GDI grew at a scant 1.6% pace, far below the 4.2% GDP growth rate.¹⁵ This is shown in the below chart from ECRI.



Mauldin writes “Indeed, while year-over year (yoy) real GDP growth has been rising steadily, and has climbed to a three-year high (upper panel, light blue line in chart), yoy real GDI growth has been in a yearlong slowing trend, declining to a 1¼-year low (dark blue line).” And, the Philadelphia Fed, noting shortcomings in both measures, developed their own series called “GDPplus”, which combines both measures of the economy. Mauldin notes that “Like yoy real GDI growth, yoy GDPplus growth has been in a shallow cyclical downswing for a year, and has just touched a 1¼-year low (lower panel). This narrative stands in stark contrast to headlines heralding accelerating GDP growth.”¹⁶

Other indications of slowing growth abound such as home sales. According to ETF Trends, “Existing home sales languished in September, falling to its lowest level since 2015 as mortgage rates continue to move higher, according to the most recent data from the National Association of Realtors (NAR)...contract closings fell from the prior month to a 5.15m annual rate, the median sales price rose 4.2% year-over-year to \$258,100 and housing inventory of available properties moved up 1.1% year-over-year to 1.88m.”¹⁷

So where does this leave the investor? We’re reluctant to dramatically change course at this point in time. First, we don’t think we’re entering a recession but neither do we see signs of overheating in any sectors of the economy. Thus, there’s a very strong possibility that the Fed stops their tightening. In

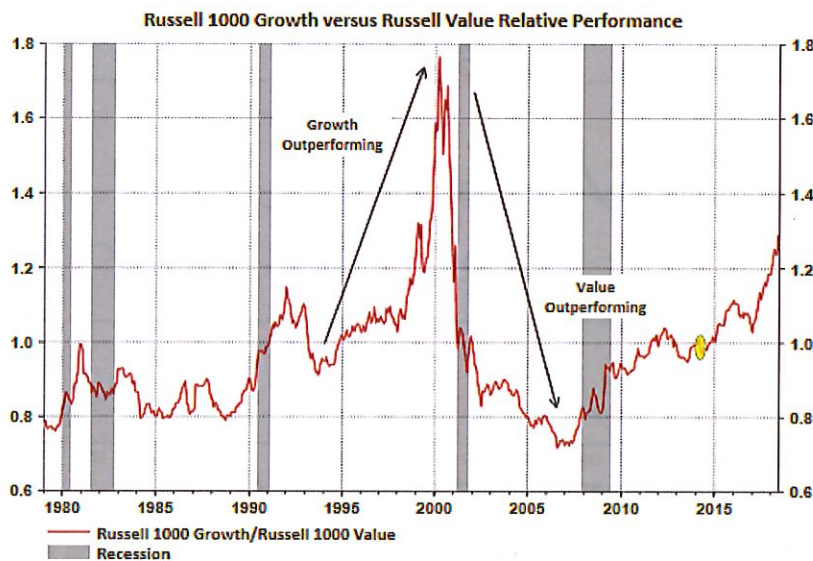
¹⁵ <https://www.businesscycle.com/ecri-news-events/news-details/economic-cycle-research-ecri-lakshman-achuthan-business-cycle-damned-lies-and-statistics>

¹⁶ Ibid. # 15

¹⁷ https://www.etftrends.com/rising-rates-channel/jim-cramer-fed-chair-will-raise-rates-stop-and-then-blink/?utm_source=Salesforce&utm_medium=email&utm_campaign=etf-newsletters

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addition, China's markets have been hit very hard and their economy appears to be slowing. At some point the People Bank of China (PBOC) might decide to ease, as they did in 2015-16. Either actions could stem the declines, lengthen the economic cycle, and pave the way for another leg up in the markets. It's also hard to bet against the large cap US growth stocks that have driven this rally for the past 10 years or so, but it's hard to ignore the disparities in valuation now between this sector and the overseas developed and emerging markets. Since most of our portfolios are diversified, our exposure to international stocks has hurt overall performance so far this year. So has exposure to "value" stocks, or to anything else other than US growth for that matter.



Source: Thomson Reuters Datastream & HORAN Capital Advisors 18

It's hard to know when trends like this will turn, but if we were to change portfolios at all, in most cases it would be to rebalance the allocations back towards international and emerging markets. If it appears that interest rates continue to rise, the USD strengthens, and that we're wrong on the economy slowing, we would likely begin to increase holdings of cash and short term bonds, as that would imply that capital is flowing out of "paper" financial assets.

Otherwise, we are flowing into autumn in the Northeast. Pumpkins are adorning houses, apple picking has been great, and we've been eating pies from both in order to store up our energy for the winter. We hope you are doing the same.

Thanks for reading,

Jason

¹⁸ <https://seekingalpha.com/article/4180641-another-look-growth-versus-value>

Quarterly Market Review

Third Quarter 2018¹⁹

U.S. STOCKS

	<i>3Q 2018</i>	<i>Year-to-Date</i>
Dow Jones Industrial Average	+9.63%	+8.83%
S&P 500 Index	+7.71	+10.56
Nasdaq Composite Index	+7.14	+16.56
S&P Mid-Cap 400 Index	+3.86	+7.49
Russell 2000 Index	+3.58	+11.51

INTERNATIONAL INDEXES

<i>MSCI Index</i>	<i>3Q 2018</i>	<i>Year-to-Date</i>
EAFE (Europe, Australasia, Far East)	+1.42% 0.98%	-
All Country World ex-U.S.A.	+0.80 2.67	-
EM (Emerging Markets)	-0.95 7.39	-

GLOBAL BONDS

Index	3Q 2018	YTD
Bloomberg Barclays U.S. Aggregate Bond Index	-0.02%	-1.60%
J.P. Morgan Global High Yield Index	+2.19	+1.65
Bloomberg Barclays Municipal Bond Index	-0.15	-0.40
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	-1.74	-3.03
J.P. Morgan Emerging Markets Bond Index Global Diversified	+2.30	-3.04

¹⁹ <https://www4.troweprice.com/gis/fai/us/en/insights/articles/2018/q3/quarterly-market-review.html>

