Katonah Capital Group, LLC
BALANCE IN A CHANGING WORLD
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FIRST QUARTER 2017 ADVISORY INVESTMENT REPORT

Finding "Value in a Faith-Based Rally"[1]

Overall, markets performed well last quarter, although there was a clear bias back to growth (vs. value). According to Morningstar, the broad US Market gained 5.91% over this period, with growth stocks contributing an 8.58% gain, whereas value stocks rose by only 2.58%.[2] This was the reverse of the past few quarters where small value consistently outperformed.[3] The overall Macroeconomic picture was good. According to Schroders, data on unemployment, non-farm payrolls, the Institute for Supply Management's manufacturing purchasing managers' index (the PMI) and the Conference Board consumer confidence index (which hit a 16 year high) were all supportive.[4]

The other big shift was that overseas markets dramatically outperformed the US. President Trump seemed to back away from his earlier protectionist rhetoric, the US dollar (USD) softened, and as recently noted by The Economist, "Today, almost ten years after the most severe financial crisis since the Depression, a broad-based economic upswing is at last under way... In America, Europe, Asia and the emerging markets, for the first time since a brief rebound in 2010, all the burners are firing at once."[5] If this proves to be a lasting event, then overseas markets, after dramatically underperforming the US markets for many years, are arguably truly undervalued – at least relative to the US. There is still plenty of risk in these sectors, but it appears to be more political risk such as the uncertainty surrounding the upcoming French elections or the 5-year Communist party leadership shuffle that occurs this year. This past quarter, we increased our international exposure and, for the first time in several years, began investing again in the Emerging Markets.

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[1] Guggenheim; First Quarter 2017 Fixed-Income Outlook [The title of this quarters report was inspired by the Q I 2017 Fixed Income Outlook recently put out by Guggenheim, and we found it too good to pass up.]
[2] http://news.morningstar.com/articlenet/article.aspx?id=801979
[3] Ibid. #2
[4] http://www.schroders.com/en/sysglobalassets/digital/insights/2017/pdf/market-reviews/quarterly/quarterly-markets-review-q1-2017.pdf
[5] http://www.economist.com/news/leaders/21718868-past-decade-has-been-marked-series-false-economic-dawns-time-really-does-feel

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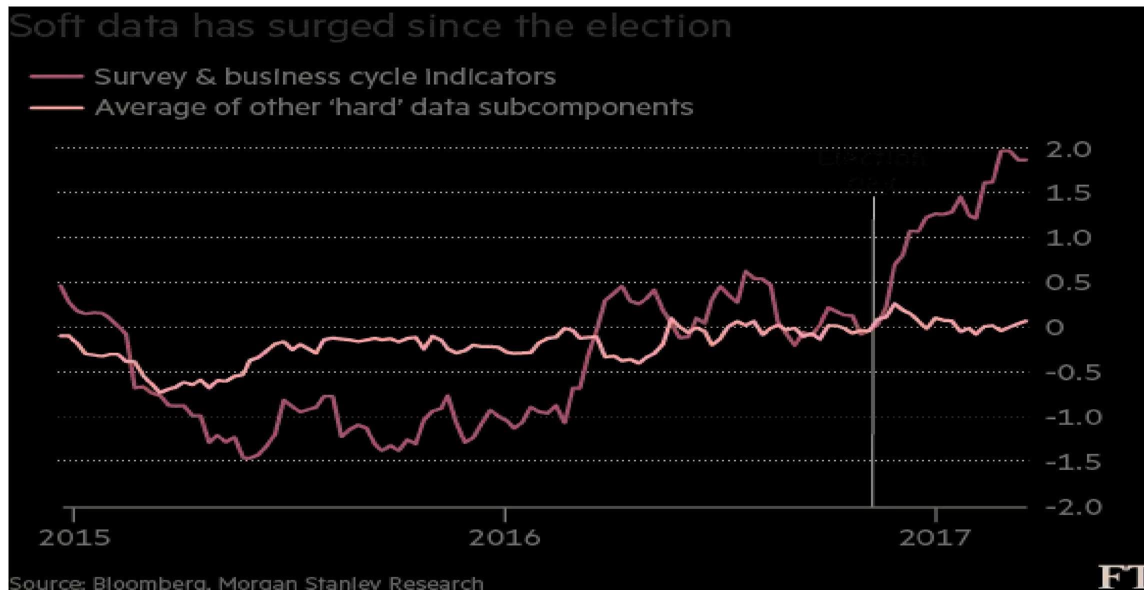
Nevertheless, as of this writing, equity markets are showing shorter term signs of fatigue, and recent economic data also appear to be easing. There's been a lot of focus on the disparity between "soft economic data" such as consumer sentiment or the Small Business Optimism index which, as noted above are soaring, and actual "hard data" such as retail spending or capital expenditures, which have yet to show sustained growth. A recent FT headline states "Doubts Grow over Strength of 'Trump Bounce'", and they offer the below graph. The darker line measures the "soft data" which has clearly expanded sharply. However the lighter pink line is still trending sideways, barely above zero.[6]



Morningstar notes that "Households, businesses and investors started the year riding a wave of rising expectations for growth with a new, business-friendly president in the White House, but the euphoria hasn't translated quickly into broad economic gains."[7] Recent data show that US retail sales at stores, restaurants and online sellers dropped 0.2% in March. February's numbers were revised downward to a 0.3% decrease from an initially estimated 0.1% gain – the first back to back declines in retail spending in over two years.[8]

Because the US is farther along than the rest of the world in the economic cycle, there are certainly areas for concern – the US consumer being one of them. A particular area of concern is auto sales, and as always, one needs only to follow the credit trail to understand the situation. Just like the housing boom/bust of a decade ago, auto sales have been fueled by a surge of available credit. As with the mortgage debacle, there's been tremendous demand on the part of institutional investors for "securitized" or "asset-backed" loans – in this case, instead of a mortgage loan backed by an actual dwelling, these are

[6] "Doubts Grow Over Strength of 'Trump Bounce'"; FT; April 18, 2017; pg.2
[7] http://www.morningstar.com/news/dow-jones/TDJNDN_201704143717/confidence-is-high-but-economic-gains-are-elusive.html
[8] Ibid. #6

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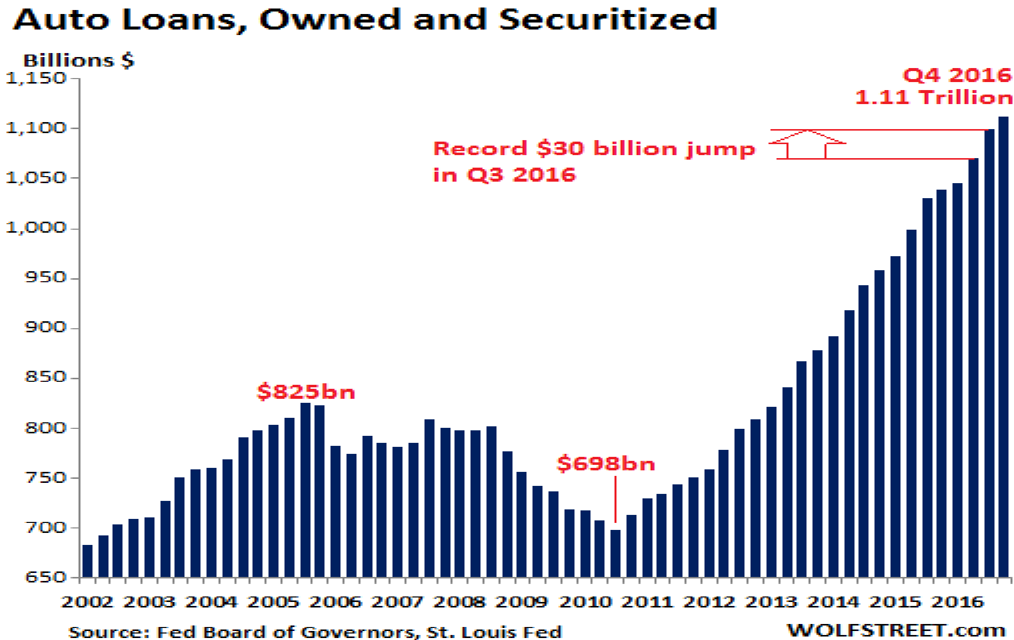
auto loans backed by an automobile as collateral. The chart below, from Wolf Richter, shows the rapid recent growth in this market;[9]



As with the mortgage debacle, auto lending also has its subprime loan sector (no self-respecting credit boom would be without one) where, of course, the rubber is hitting the road. Danielle DiMartino Booth recently wrote, "Subprime auto lending is a booming business. Of the $1 trillion in all such loans outstanding, some $300 billion are considered non-prime. According to S&P Global Ratings, subprime auto loans that are 60 days or more delinquent rose to 4.76 percent in November, almost double 2011's rate. Net losses of 8.48 percent are also almost double that of five years ago."[10] She points out that these levels, while "alarming", are not at the stress levels of the financial crisis in '08/'09. However, the subprime market is driven by used car pricing – in a downturn, the loans are ultimately only as good as the value of the collateral that secures them - and here the portent is challenging. According to DiMartino Booth, 4 million cars are coming off leases this year, roughly 1 million more than in 2015. And, as Richter points out, "… auto loans…have boomed on higher prices, higher unit sales, longer maturities (the average hit a new record of 66.5 months in Q4), and higher loan-to-value ratios (negative equity)"[11] Richter failed to mention an additional driver which is (was?) lower short term interest rates and various central bank QE's! None of these are good signs for future sales.

As with all credit excesses, once the unwinding begins it causes a negatively reinforced downward spiral as financing dries up and thus new demand is stifled. Autos are, of course, one of the major sectors of the economy. The good news is that other sectors, such as housing, are not yet extended and can act to some degree as a shock absorber. And, while on the topic of debt and credit, we recently learned that the single largest asset type on the balance sheet of the US Federal Government are student loans!

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[9] http://wolfstreet.com/2017/03/21/used-vehicle-wholesale-prices-fall-bottom-falling-out-of-auto-industry/
[10] https://www.bloomberg.com/view/articles/2017-02-14/consumers-are-too-giddy-when-it-comes-to-borrowing
[11] Op. cit. #9

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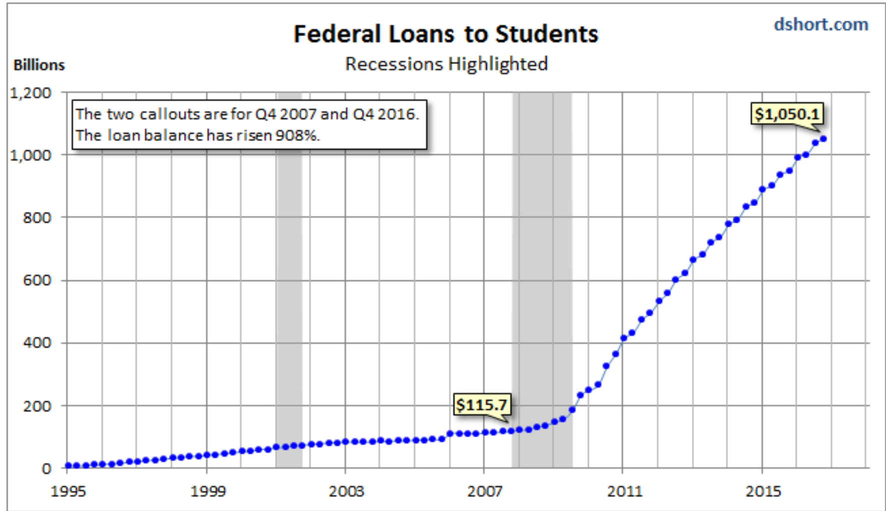
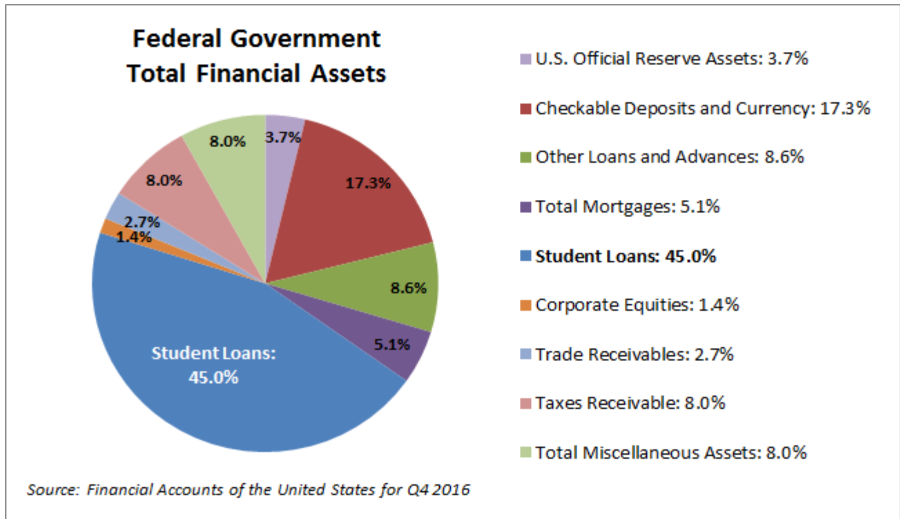
According to an article from Jill Mislinski of Advisor Perspectives, while down from their peak in 2015, Student Loans comprise almost ***one half*** of Uncle Sam's balance sheet:[12]





Mislinski notes ironically that, "Of course, assets are, sadly, the trivial side of Uncle Sam's Financial Accounts balance sheet — about 2.33 Trillion. The liability side totaled 18.53 Trillion at the end of Q4 2016." However, none of this really matters as long as credit remains plentiful and global growth continues. Here though, we're back to signs – albeit possibly very early signs – that the party might be beginning to wind down.

[12] https://www.advisorperspectives.com/dshort/commentaries/2017/03/14/the-fed-s-financial-accounts-what-is-uncle-sam-s-largest-asset

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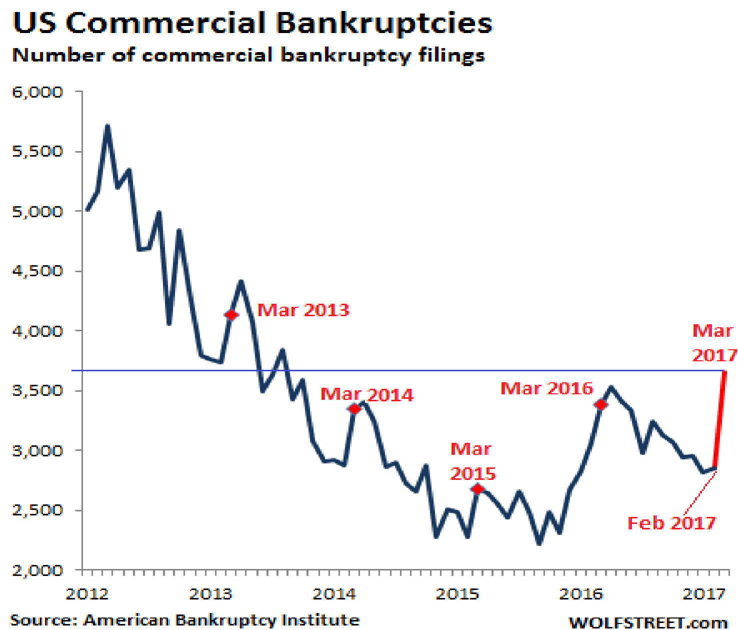
One such sign is the number of US commercial enterprises filing for bankruptcy. According to another posting by Wolf Richter, "Commercial bankruptcy filings, from corporations to sole proprietorships, spiked 28% in March from February, the largest month-to-month move in the data series of the American Bankruptcy Institute going back to 2012. They're up 8% year-over-year. Over the past 24 months, they soared 37%! At 3,658, they're at the highest level for any March since 2013."[13]



Total US bankruptcies, which include US consumers, tell the same story. Not surprisingly given this scenario, banks are becoming more cautious in their lending. In a recent article entitled "US banks hit brakes on lending after Trump election - Credit contraction casts doubt on revival of 'animal spirits' in economy" the FT offers the following chart of US bank lending[14]:

[13] http://wolfstreet.com/2017/04/08/commercial-bankruptcies-rise-consumer-bankruptcies-up/
[14] https://www.ft.com/content/c34b2d30-f9ed-11e6-bd4e-68d53499ed71

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In the broader macro picture, the backdrop for all this - in terms of the golbal financial and credit environment - has really not changed much at all aside from the fact that it's no longer front and center headline news. Complacency, however, certainly abounds. In recent days/weeks, the US bombed Syria, dropped a MOAB on Afghanistan, and sent a warship (supposedly) heading towards North Korea, and the markets remained basically unfazed. Or, as Katie Martin recently wrote in the FT, "…take South Africa. Its president has unceremoniously dumped his widely respected finance minister, and his hangers-on laugh in the face of the country's double junking from rating agencies. In response, the rand has wobbled, not tanked, and government bonds just keep on drawing in and retaining buyers after every dip. In between scratches of their heads, seasoned investors are putting this down to passive flows and a glib reliance on hope for a decent outcome. What can possibly go wrong?" she asks rhetorically. "The Bank for International Settlements, the central bank for central banks…strikes an exasperated note in saying markets are at risk of 'complacency' and 'self-delusion' in appearing upbeat in the face of potential trade wars and crumbling international co-operation." [15]

The article also references Michael Hartnett of BAML who is a keen observer of global markets and history. In a recent missive to his Bank of America clients, reprinted via Zero Hedge, Hartnett marvels at just how "delusional" the markets have truly been in their assumption that this is a "normal" recovery. He points out (building on the seminal work "A History of Interest Rates" by Sidney Homer and Richard Sylla) that interest rates were recently at 5000 year lows![16]

[15] "The Good Old (Finance) Days are so Hot Right Now"; Katie Martin, FTfm; FT.com; April 15, 2017
[16] http://www.zerohedge.com/news/2017-03-31/bank-america-unexpectedly-warns-coming-manias-panics-and-crashes

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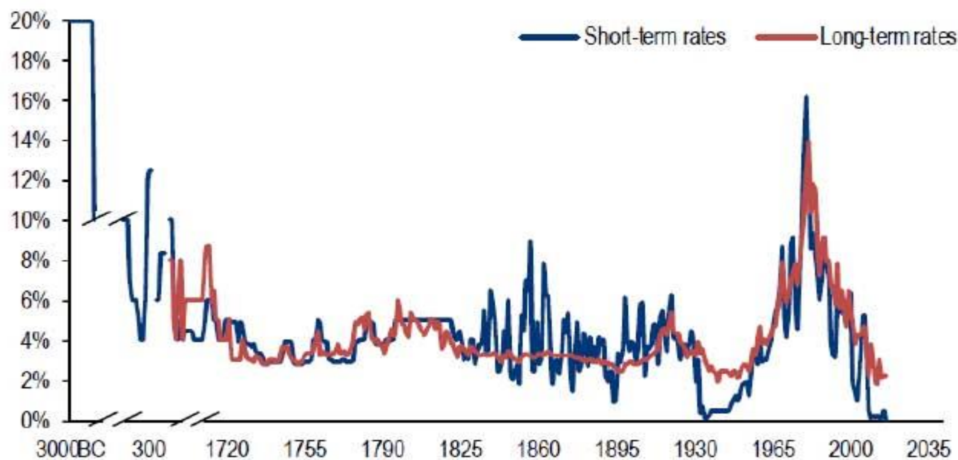

Comparing this to other "manias, panics and delusions", Hartnett writes:

> * On July 11th 20-16 Swiss authorities could have issued 50- year debt out to 2076 at a negative yield (of -0.035%)…
> * …and in 1989 the Imperial Palace in Tokyo worth more than all real estate in California…
> * … and in March'2000 the market-cap of Yahoo! was 25X higher than the market-cap of Chinese equity market (MSCI)…
> * … and in 2008 the combined assets of Iceland's three biggest banks were 14 times the size of the nation's GDP…
> * **…all manias, all over now."**[17]

Hartnett notes that the primary driver of the bull market since the '08/'09 Great Financial crisis was the 'revolutionary monetary policy of central banks' who, …'have cut rates 679 times and bought $14.2tn of financial assets.'[18] He offers many other insightful comments and charts, but we will share one more with our readers. The first shows the tsunami of credit the Fed created, which now sits on their balance sheet. Getting to those levels was fairly easy. It's unlikely that the reverse will be true. A key issue here, that's only recently getting some press, is the dilemma the Fed now faces of how to unwind this. If, as Fed Chairwoman Janet Yellen has suggested, the economy is now healthy enough to begin raising interest rates, then there's no reason to maintain these huge balances. However, even doing nothing is a de facto tightening, because the bonds are maturing and running off and by definition, a central bank tightens monetary policy by shrinking their balance sheet. Yellen alluded to this in a recent speech where, according to Bloomberg, she "said a shortening in the average maturity of the central bank's bond holdings and the approach of an eventual reduction in its balance sheet could increase the yield on the

[17] Op. cit. #16
[18] Ibid. #17

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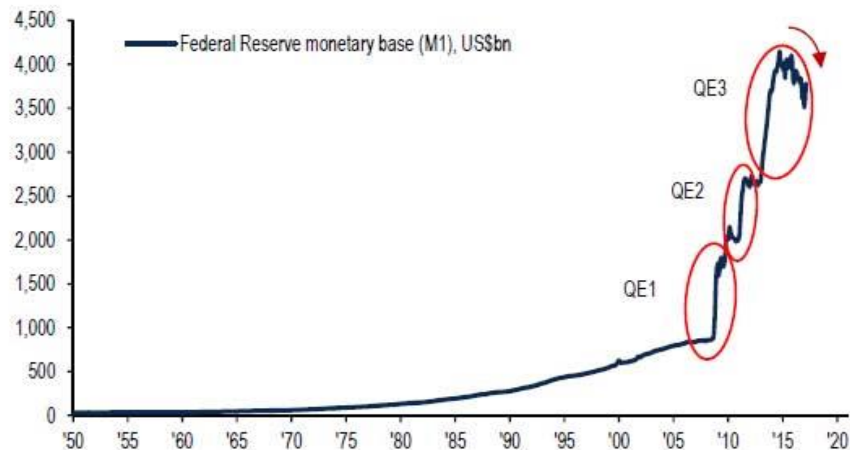
10-year Treasury note by 15 basis points this year. That would be roughly equivalent to two 25 basis point increase in the inter-bank federal funds rate.[19]

Yellen gave no hint as to when such a reduction might occur, but according to USA Today, $164 billion of securities mature on the Fed's balance sheet in 2017, $425 billion in 2018 and $352 billion in 2019.[20] This is equal to almost 25% of their total assets.



Our regular readers know that we've long been discussing this and, admittedly in hindsight, it's kept us far too risk averse. We were rattled by a near unravelling in China last year as they scrambled to staunch the outflow of capital from their economy, thereby causing severe dislocation to our markets. In his report, Hartnett makes mention of this noting "While the current mania almost ended in early 2016, it was once again China that was responsible for the latest leg higher", refering to the nearly $1 trillion in FX reserves that China had to draw down to address it's situation.[21] It is our bet that China will in fact do everything in its power to keep things stable at least until its twice-a-decade National Congress is over this fall. In fact, the FT just reported that "China's ecnomy has started the year with its strongest quarterly performance in 18 months, on the back of a surge in industrial activity, property investment and credit growth."[22] They note that the data comes amidst "a year of expected consolidation of power by Presient Xi Jinping, whose second term as head of the ruling Communist party will begin later this year following the country's 19th national congress." However, the article also quotes Eswar Prasad, a China finance expert at Cornell University who observes "'The apparent strength of Chinese GDP growth belies rising macroeconomic tensions and financial system stresses, exemplified by high and rising levels of corporate

[19] https://www.bloomberg.com/news/articles/2017-01-20/yellen-says-fed-not-behind-the-curve-backs-gradual-rate-rises
[20] https://www.usnews.com/opinion/economic-intelligence/articles/2017-04-03/unwinding-the-federal-reserves-balance-sheet-will-be-a-challenge
[21] Op. cit. #16
[22] "China Boosted By Factory Output and Credit"; FT; April 18, 2017; pg. 2

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leverage…'" And, "'This level of growth cannot be sustained…'" according to Wang Xinling, lead analyst at China Policy, a think-tank.[23]

It is entirely possible that there is a brighter side to all this – mainly that many of these risks are no longer "unknown unknowns". They are being discussed. The bond markets, at least, seem to be recognizing them as global rates continue to remain subdued. And, despite all the risks, the global cyclical recovery seems to be overcoming them. As the Economist notes in an article entitled "From Deprivation to Daffodils – All around the world, the economy is picking up", recoveries from severe debt crises such as the 2008 Great Financial Crisis are "painfully slow" and take time.[24] Furthermore, it was not one debt crisis but three – the subprime mortgage collapse in the US; Sovereign debt in Europe; and a collapse in Emerging Market corporate debt borrowing. We experienced Grexit and the downgrading of US debt in 2011; the US government shutdown and the Fed "taper tantrum" in 2013; and the collapse in oil prices in 2014 with its consequent severe global dislocations, among others.

However, as the article points out, there are indeed "green shoots of global recovery". The Emerging Markets are healing. Their current account defecits have narrowed so they're less reliant on foreign borrowing. China has in fact stabilized. Japanese business spending rose at an annualized rate of 8% in Q IV 2016, and in the US, labor and employment data seem firm. We very much would like to believe in all of this and "embrace the faith". For now, we remain fairly fully invested and, as mentioned, with an increased weighting towards overseas markets.

Nevertheless, as Harnett observes, "Longer-term, we continue to remind ourselves it's not a normal cycle. 'Normalization' from 5,000-year low in rates, 70-year low in G7 fiscal stimulus, 35-year high in US-German rate differential, all-time high US stocks vs. EAFE, 75-year low in bank stocks is unlikely to be peaceful." To which, we must say "Amen". For now though, we are enjoying the Daffodils – both those referenced by the Economist as well as those flourishing in our back yard and along the Northeast. We hope you're doing the same.

Thanks for reading,

Jason

[23] Ibid. #22

[24] "From Deprivation to Daffodils"; The Economist; March 18, 2017; pg. 19

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Quarterly Market Review First Quarter 2017[25]

U.S. STOCKS

	1Q 2017	Year-to-Date
Dow Jones Industrial Average	5.19%	5.19%
S&P 500 Index	6.07	6.07
Nasdaq Composite Index	9.82	9.82
S&P MidCap 400 Index	3.94	3.94
Russell 2000 Index	2.47	2.47

INTERNATIONAL INDEXES

MSCI Index	*1Q 2017*	*Year-to-Date*
EAFE (Europe, Australasia, Far East)	7.39%	7.39%
All Country World ex-U.S.A.	7.98	7.98
EM (Emerging Markets)	11.49	11.49

GLOBAL BONDS

Index	Q1 2017	YTD
Bloomberg Barclays U.S. Aggregate Bond Index	0.82%	0.82%
J.P. Morgan Global High Yield Index	2.87	2.87
Bloomberg Barclays Municipal Bond Index	1.58	1.58
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	2.48	2.48
J.P. Morgan Emerging Markets Bond Index Global Diversified	3.87	3.87

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

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