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

Get Your Facts First, Then You Can Distort Them as You Please

– Mark Twain

Market action in the third quarter saw a continuation of the trends that have been in place since the beginning of the year, and which have been discussed in our previous reports. As economic data continues to point to an expanding global economy, world stock indexes all rose and US equity markets were propelled to their 8th consecutive quarterly gain. According to data from JPMorgan, “In the US, job vacancies hit the highest level since 2000. In Japan, there are now more jobs available per applicant than at any point since 1974. In the UK, the unemployment rate is the lowest since 1975 and Eurozone consumer confidence is at its highest since 2001”.[1] The improving growth outside of the US, along with a softer US dollar, helped Emerging Markets (EM) continue to deliver strong returns this quarter. In Japan, 18% growth in their exports drove markets higher there. And in Europe, improving labor markets have boosted consumption, driving sales, margin expansion and corporate profits.[2]

This all flies in the face of seemingly glaring paradoxes which have been explored at length in past reports:

1. Despite the robust labor and employment conditions noted above, there have been no signs of consumer inflation (certainly not wage inflation) and, in fact, deflation or disinflation is still a concern for central bankers.

2. Despite the massive buildup of global debt driven by central bank monetary policies, there have been no signs of inflation as reflected in overall price levels. Although the US dollar has softened by perhaps 10% since the beginning of the year (after an equivalent increase in 2016), paper fiat currencies more or less continue to maintain their relative values.

3. Despite seemingly preposterous levels of ongoing geo-political risks, volatility in financial markets has remained incredibly quiescent.

[1] https://am.jpmorgan.com/gb/en/asset-management/gim/adv/insights/market-insights-monthly-market-review-september-2017
[2] Op. sit. #1

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With regard to the 3rd point, Europe appears to be falling to pieces in slow motion, yet its markets were stellar performers last quarter. As George Friedman wrote in a recent post entitled "The Odd Calm of EU Officials";

> "Imagine the following scenario: Texas votes to secede from the United States, sparking bitter negotiations between Austin and Washington. A neo-Nazi party wins seats in the California legislature. Cook County, home to Chicago, threatens to break away from Illinois to form its own state, while government officials, worried about losing such an economically vibrant region, furiously try to prevent the election from taking place. The federal government, meanwhile, vows to suspend North Carolina's voting rights in Congress simply because it didn't approve of its behavior. It considers doing likewise for Arizona.
>
> In such a scenario, one might rightly conclude that something is terribly wrong with the United States.
>
> The thing is, this is pretty much what is happening in Europe. The United Kingdom has voted to leave the European Union, and the negotiations over its departure are unpleasant, to put it mildly. Alternative for Germany, a party whose members have been compared to neo-Nazis, has won a surprising number of seats in Germany's parliament. Catalonia, which is home to Barcelona, a large and economically vital city in Spain, held an independence referendum Oct. 1, something the government in Madrid has tried to stop. (Early reports indicate physical altercations between regional and national forces.) And the European Commission has threated to suspend Poland's voting rights over actions taken by the Polish government, and has previously attacked the Hungarian government."[3]

Friedman is quick to point out that while "The EU is a treaty organization, the US is a closely knit federation" and so the analogy can only be taken so far. But John Mauldin recently presented a research piece from Tom Holland of Gavekal Research, expressing the same concern. Holland reports:

> "As a result, (of the heavy handed response from Spain's prime minister, Mariano Rajoy) the face-off between Catalonia's government and Madrid will persist, with little chance of any externally-brokered reconciliation. The Catalan question will become one more unsolved problem on Europe's to-do list, along with the unchecked influx of illegal migrants from the Middle East and Africa, the "Article 7" legal dispute between Brussels and Poland, the upcoming negotiations with Athens ahead of the expiry next year of Greece's current bailout program, Brexit, and the seeming impossibility of overcoming constitutional obstacles to the implementation of much-needed structural reforms in the eurozone's third largest economy: Italy.
>
> This matters, because another item on the list of unsolved, and possibly insoluable, EU problems makes even less likely the sort of progress towards deeper integration the eurozone badly needs if it is to successfully ride out the next cyclical economic downswing. In France Macron has sketched out a plan that includes the first pan-European taxes …and a common eurozone budget. But although German politicians have made encouraging noises, the Free Democrats,

[3] "The Odd Calm of EU Officials"; George Friedman; This Week in Geopolitics; October 2; 2017

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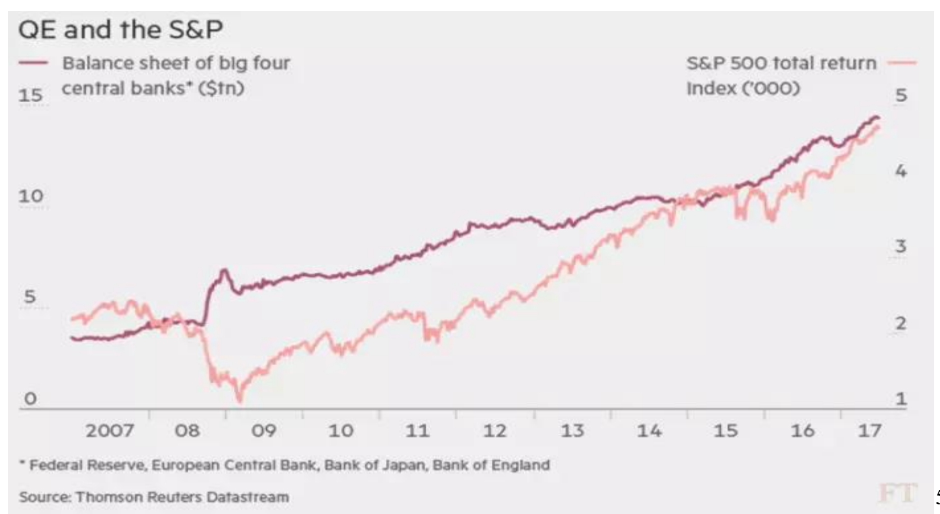
> chancellor Angela Merkel's likely new partners in a "Jamaica coalition" have so far spoken coolly about any possible steps towards a fiscal transfer union.
>
> … A fiscal transfer union would stand far more chance of averting an existential crisis for the eurozone. But with the Catalan question unresolved, achieving such a fiscal union will be even more difficult, and very likely impossible."[4]

We've focused here on the European situation merely as one example of the many seismic dislocations roiling the world right now. We could have chosen any number of conflicts – each with potential dire consequences for global stability and financial markets. Yet in each case, the complacency and lack of concern – at least as displayed by the markets – is almost deafening!

Perhaps this is just the "wall of worry" that's kept the rallies intact. Other equally problematic headwinds confronting the markets would include the stated desire by several of the major central banks to unwind their QE (sometimes referred to as QT, or Quantitative Tightening) and begin normalizing their inflated balance sheets. This has ramifications not only in terms of the liquidity that has been a tailwind for asset prices, but also for the real economy and corporate profits in the event that the normalization causes an economic slowdown.

Regarding the effects of QE on asset prices, correlation of course does not have to mean causation, but the correlation (see below chart from the FT) between the plunge in the S&P 500 during the 2008-09 financial crisis, the surge in central bank balance sheets, and the subsequent turnaround in the S&P, is striking.



[5]

[4] The Catalan Question and the Future of Europe, by Tom Holland, Gavekal Research, Oct. 2, 2017; as provided by John Mauldin in his Outside the Box report, Oct. 4, 2017

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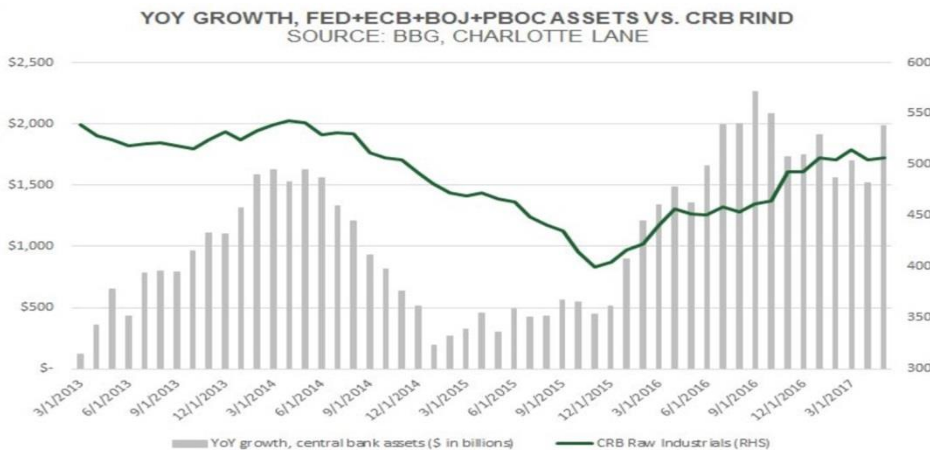
This next graph charts the growth of individual central bank balance sheets relative to the growth and size of their economy. It then offers a projection of future balance sheet growth based on the stated bank policy intentions. Of note is the black line which projects total assets to peak sometime in early 2018 and begin to trend downwards.

[6]

As mentioned, correlation does not imply causation, yet it is instructive to look at what the impact of past reductions in just the *growth rate* of central bank assets has been on asset prices. A good example is the 2013-2015 period which saw a continued gradual decline in the assets of the PBoC (Peoples Bank of China) and a sharp drawdown of the ECB's assets. Interestingly, the effects were hard to detect in the overall broad equity indexes due to massive outperformance by a few large technology companies such as Facebook, Amazon, Netflix and Google (the infamous "FANG" stocks) during that period which masked an otherwise negative stock market performance. However, the effects can be starkly seen in the collapse in commodity prices (see below).

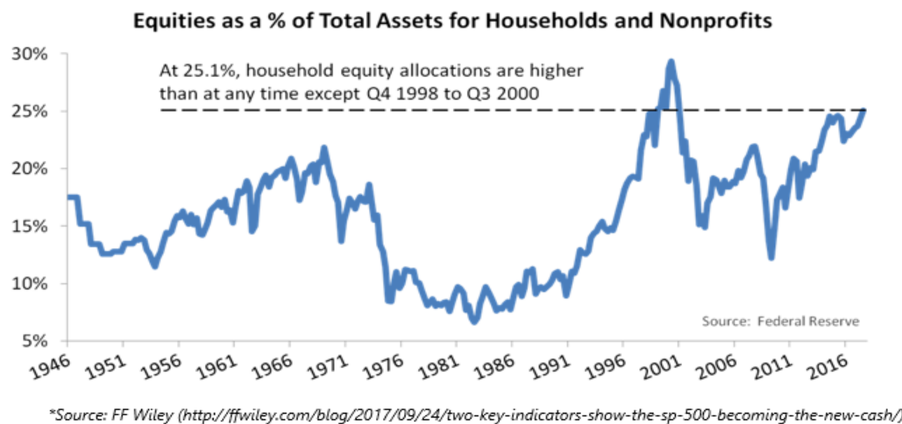


[7]

[5] https://www.ft.com/content/fe71505c-474e-3204-803d-fb085794c82c
[6] https://timemoney.com/bull-market-ending-with-balance-sheet-unwind/

Even if we assume the central banks are able to execute their normalization without roiling the markets, another unavoidable headwind remains market valuation. There are numerous ways of measuring valuation and there are, of course, lies, damn lies and statistics! Nevertheless, we look below at two valuation measures – Equity as a Percentage of Household Financial Assets and Total U.S. stock market capitalization as a percentage of gross domestic product (market cap to GDP). Neither of these measure are good short term predictors of the market. However, they have been strong historical predictors of market returns over longer rolling 10 year time horizons. The outlook here is for dramatically reduced returns going forward.

Regarding the first data series, equity as a percentage of household financial assets are not quite as high as in the period leading up to the 1999-2000 dot.com bubble, but they are higher than any period before or after. Steve Blumenthal's recent newsletter, using research from Ned Davis, shows this clearly;[8]



*Source: FF Wiley (http://ffwiley.com/blog/2017/09/24/two-key-indicators-show-the-sp-500-becoming-the-new-cash/)

As he goes on to show in the next two charts below, subsequent returns over the next 10 years are just barely around + 1%. Note that in the second chart below showing stock market holdings as a percentage of total Household financial assets, the right axis showing subsequent 10-year returns is inverted, so a higher blue line means lower expected returns over the next 10 years. According to the study, there is a 91% corellation – not perfect, but certainly close to 1.0 (perfect correlation).

[7] https://timemoney.com/bull-market-ending-with-balance-sheet-unwind/
[8] https://www.cmgwealth.com/ri/on-my-radar-upside-down/

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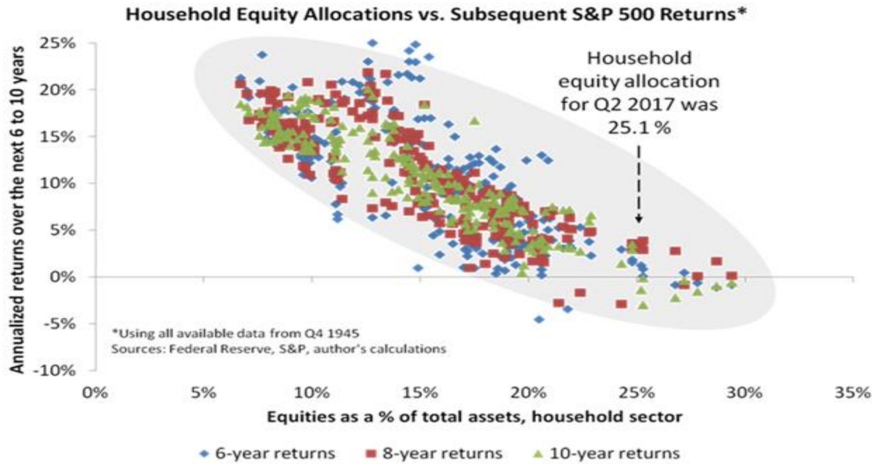
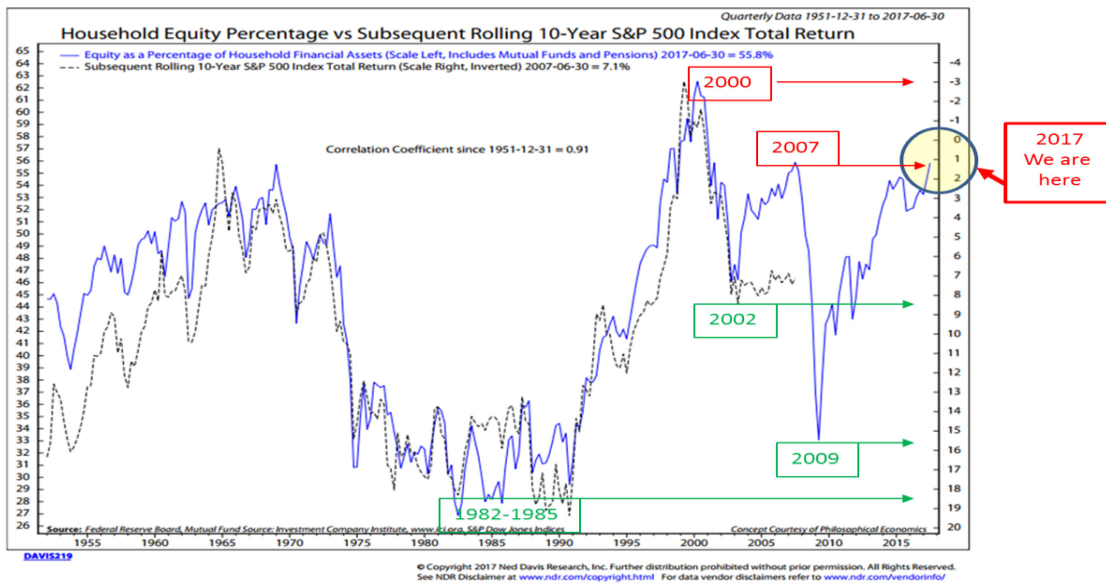


*Source: FF Wiley (http://ffwiley.com/blog/2017/09/24/two-key-indicators-show-the-sp-500-becoming-the-new-cash/)



Another way of measuring this is "market cap" to GDP – sometimes called the "Buffett Indicator" because of an article Buffett wrote for Fortune back in 2001. "Market capitalization" is simply the number of shares outstanding times the price of those shares – whether for an individual stock, or for an index of many stocks such as the S&P 500, etc. Essentially Buffett posited that when the market cap percentage falls

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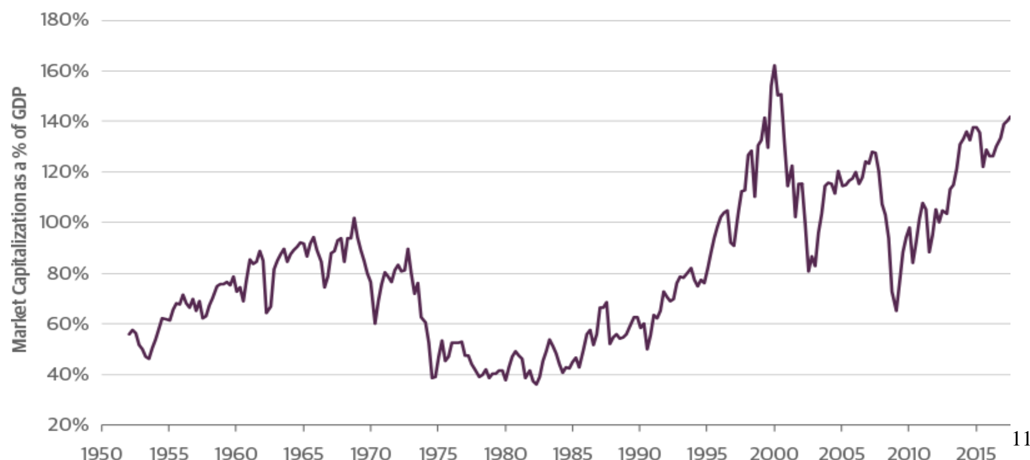
below GDP, to "…the 70% or 80% area, buying stocks is likely to work very well for you". By 1999, the ratio had approached 200%, at which point Buffett felt you were "playing with fire".[9]

It's important to note, as Consuelo Mack observes in a recent Wealthtrack newsletter, "The number of publicly traded stocks available to buy has shrunk dramatically. Twenty years ago there were nearly 9,000 publicly traded companies on U.S. stock exchanges. That number has declined more than 40% to just over 5,000 today."[10] So, while a change in either variable can affect the overall valuation measure, the chart below from Guggenheim is even more striking because of the massive trend towards corporate stock repurchases as companies have utilized cheap debt to buy back their shares. This means that all of the increase has been due to increases in stock prices.



[11]

In this case, Guggenheim used data for the entire US stock market. Partially offsetting the reduction in the number of stocks is the fact that GDP growth itself has recently been below its historical trendline. Nevertheless, this measure shows that at 142%, we've surpassed the 2006-2007 peak and are approaching the "playing with fire" levels of the 2000 NASDAQ bubble! The next chart shows the expected returns over the next 10 years for the S&P 500 when the ratio is at these elevated levels. If history does indeed rhyme, then this is not a promising picture.

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[9] http://archive.fortune.com/magazines/fortune/fortune_archive/2001/12/10/314691/index.htm
[10] http://mailchi.mp/wealthtrack/money-saving-advice-a-message-from-consuelo-april-20-282305?e=ef7145fc48
[11] https://www.guggenheimpartners.com/perspectives/macroeconomic-research/stocks-for-the-long-run-not-now

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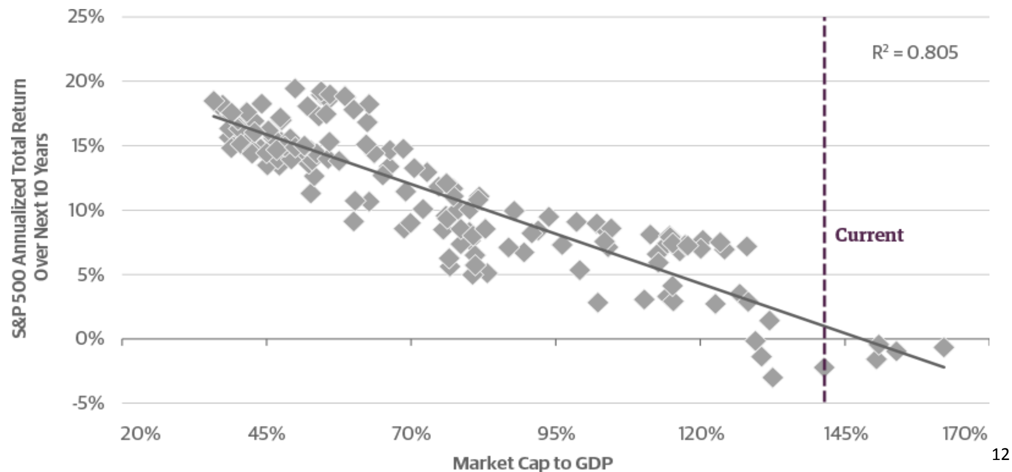

[12]

It must be stressed that this is ***expected average returns over the next 10 year period. It says nothing about the next month, quarter or year(s).*** It's also instructive to remember the words of the late Sir John Templeton who said "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria". It's truly hard to say that there's euphoria, and there's certainly a boatload of skepticism. Our sense is that we're "maturing into optimism".

Part of the optimisim no doubt will stem from behavioral economics and the FOMO trade – the fear of missing out trade – as stock prices continue their upward climb. However, other sources of optimism will stem from the fact that the economic news is legitimately good. We discussed the daunting geopolitical adversity facing Europe, yet the economic data is extremely encouraging. According to Trading Economics, "The IHS Markit Eurozone Manufacturing PMI rose to 58.6 in October 2017 from 58.1 in September and above market expectations of 58.2, a flash estimate showed. The reading pointed to the strongest pace of expansion in the manufacturing sector since February 2011, as new export orders rose at faster pace and employment increased the most since data collection began in June 1997… Businesses remained strongly confident regarding the 12-month outlook for business activity."[13] Further, as Michael Shaoul of Marketfield astutely noted,

> "The Q3 2017 survey of ECB Eurozone Lending Standards shows the largest move towards Easing in the 14 year history of the survey… Overall the survey suggests that mortgage lending is starting to accelerate within the Eurozone. This is significant since it is strong evidence that years of quantitative easing are finally starting to be coupled with lending growth. As we have seen before it is the transformation of 'liquidity' into 'credit' that really matters in an economic cycle and it would seem clear that the Eurozone is starting to experience a broad improvement of housing related lending which has obvious bullish implications for the region's economy."[14]

Looking globally, beyond just Europe, a report from IHS Markit titled "Worldwide PMI Surveys Indicate Fastest Economic Growth In Over 2 Years" states that "The data therefore suggest that an increasingly broad-based global upturn has gained momentum over the summer and should have further to run.

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[12] Ibid. # 11
[13] https://tradingeconomics.com/euro-area/manufacturing-pmi
[14] The Daily Speculator, by Michael Shaoul, PhD.; Marketfield Asset Management; October 24, 2017

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Rising demand has boosted firms' pricing power, while higher employment should meanwhile help boost consumer spending."[15]

And finally, in the US:

- Durable-goods orders rose 2.2% in September, beating the MarketWatch forecast of a 0.7% gain.[16]

- "Business investment advanced 1.3% for the third month in a row, based on a closely followed measure known as core capital-goods orders. These orders have climbed 7.8% in the past year, the fastest pace since early 2012."[17]

- "Sales of newly-constructed homes surged to the strongest pace in a decade in September as robust demand buoyed builders. New-home sales ran at a 667,000 annual pace, the Commerce Department said Wednesday. That was a 18.9% increase compared to August, and a 17% increase compared to a year ago. It crushed the MarketWatch consensus forecast of a 555,000 annual rate."[18]

- Corporate earnings seem to be strong and, more importantly, sales growth looks strong. According to early data from FactSet, as of 10/20 "For Q3 2017 (with 17% of the companies in the S&P 500 reporting actual results for the quarter), 76% of S&P 500 companies have reported positive EPS surprises and 72% have reported positive sales surprises."[19]

Thus, the "most hated rally" in history continues. It is increasingly supported by positive economic data. Perhaps this will eventually overcome the political discord. And, further acceptance of the better data might eventually bring the markets into the final "euphoria" stage. At this point, however, the markets are showing no sign of this and the intermediate trend in our view remains up! We continue to find little value in bonds. After increasing our exposure to overseas markets earlier in the year, we continue to maintain this balance. In more tactical accounts we have been increasing exposure to more cyclical, later stage sectors such as basic materials and energy (although after a promising start, energy has recently performed miserably and we are closely monitoring that sector).

We hope you've been enjoying fresh apples and cider donuts along with the remarkably warm and beautiful autumn weather we've been experiencing in the North East, and are staying in shape for the upcoming onslaught of turkey and pumpkin pie!

Thanks for reading,

Jason

[15] https://seekingalpha.com/article/4104696-worldwide-pmi-surveys-indicate-fastest-economic-growth-2-years

[16] http://www.marketwatch.com/story/business-investment-surges-again-in-september-durable-goods-report-shows-2017-10-25
[17] Ibid. # 16
[18] http://www.marketwatch.com/story/new-home-sales-roar-to-a-10-year-high-in-september-2017-10-25
[19] https://insight.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_102017.pdf

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Quarterly Market Review Second Quarter 2017[20]

U.S. STOCKS

	2Q 2017	*Year-to-Date*
Dow Jones Industrial Average	5.58%	15.45%
S&P 500 Index	4.48	14.24
Nasdaq Composite Index	5.79	20.67
S&P MidCap 400 Index	3.22	9.40
Russell 2000 Index	5.67	10.94

INTERNATIONAL INDEXES

MSCI Index	*2Q 2017*	*Year-to-Date*
EAFE (Europe, Australasia, Far East)	5.47	20.47%
All Country World ex-U.S.A.	6.25	21.61
EM (Emerging Markets)	8.04	28.14

GLOBAL BONDS

Index	**Q2 2017**	**YTD**
Bloomberg Barclays U.S. Aggregate Bond Index	0.85%	3.14%
J.P. Morgan Global High Yield Index	2.24	7.35
Bloomberg Barclays Municipal Bond Index	1.06	4.66
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	2.48	8.74
J.P. Morgan Emerging Markets Bond Index Global Diversified	2.63	8.99

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

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