Katonah Capital Group, LLC
BALANCE IN A CHANGING WORLD
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THIRD QUARTER 2019 INVESTMENT ADVISORY REPORT

As the current bull market enters its 10th year making it the longest bull market in history, we thought an image of Fauja Singh, the oldest marathon runner in the world, was appropriate. Purportedly now 108 years old,[1] he's pictured above at a sprightly 100 years old. Interviewed after that race, he attributed his success to the ability to avoid stress![2]

Unlike the Mr. Singh, however, the stock market has been nothing but stress – probably a key factor underpinning the longevity of the bull market and lending proof to the old saw that "a bull market climbs a wall of worry!" The chart below presents some of the more significant events that drove market movements over these past 10 years.[3]

[1] https://religionnews.com/2019/04/22/worlds-oldest-marathoner-at-108-is-a-model-of-more-than-simply-stamina/
[2] https://www.theguardian.com/uk/2011/oct/19/secret-worlds-oldest-marathon-runner-100
[3] https://www.investopedia.com/market-milestones-as-the-bull-market-turns-10-4588903

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The chart is only updated through early 2019, and doesn't capture some of the more recent progress the markets have made (the S&P 500 has been flirting around the 3000 level as of this writing). Nevertheless, the fact remains that since January of 2018 as the markets were rocked by hedge funds making large (and wrong-sided) bets on the direction of volatility (see 'Volmageddon' in the chart above), the market has made precious little headway albeit with some wild price swings along the way. On August 5th, the CBOE Volatility Index (VIX; a/k/a/ the "Fear Index") hit its highest level of the year as the "Wall of Worry" was fed by a deep well of geopolitical events.[4]

Trade tensions were certainly front and center on the list of worries. The President announced that the U.S. would impose a new 10% tariff on the roughly USD 300 billion in Chinese imports not currently facing duties and on August 1st, the market experienced its largest intraday decline since May.[5] Recently, a record $7.5 billion of tariffs were imposed on European goods due to a dispute over EU subsidies to Airbus. The FT recently noted that "The IMF warned that global growth will fall this year to its slowest rate since the financial crisis, with 'precarious' economic conditions created by the US-China trade war". They predict growth of only 3%, down from 3.8% as recently as 2017.[6]

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[4] https://www.troweprice.com/financial-intermediary/us/en/insights/articles/2019/q4/quarterly-market-review.html?action=notification¬ificationid=1570748654655&PlacementGUID=emFAI_2019_q4_quarterly-market-review

[5] Ibid. # 4

[6] "IMF Slashes Global Growth Forecast After Trade War Batters Confidence"; FT; 10/16/19; pg.1

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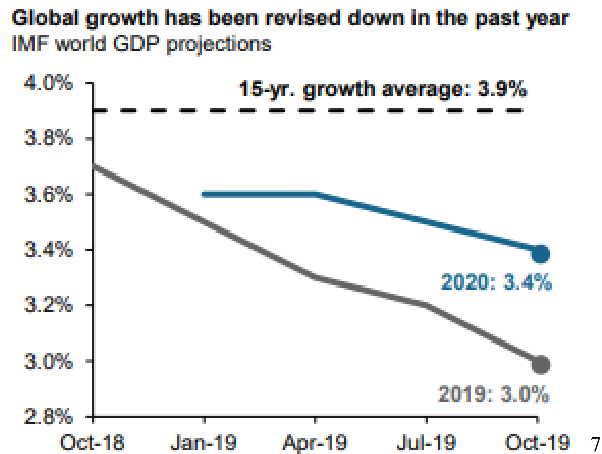

[7]

Although we're far less exposed to exports here in the US, a Reuters report recently quoted Christopher Cabaldon, the mayor of West Sacramento, California, who noted that "…bids for a $100 million infrastructure project in the city came in 80% higher than expected in part because of construction firms' need to factor in higher costs and the risk of additional tariffs in the future. Even in small cities like my own, we see the impacts of trade. ***We have come to realize the deep integration of our local economies in the global system*** (emphasis added)".[8]

Of course, global trade is hardly the only issue afflicting world economies and markets. There's Brexit, the impeachment inquiry and the 2020 election, a weakening trend in US earnings, Turkey's attack on the Kurds in Syria, Iran's alleged attacks on Saudi Arabia's oil facilities, North Korea's firing of missiles, tensions between Japan and South Korea…what could possibly go wrong?

Well, first it must be noted that, in our opinion, the IMF has never been a beacon of forecasting accuracy. They've been fine at describing what is unfolding currently but far less useful in predicting future trends. In fairness, they are not alone here. In an Article entitled "IMF shows poor track record at forecasting recessions" the FT quoted Paul Donovan, chief economist at UBS Wealth Management who stated "Economic models are 'not precise and they are based on lots of assumptions that may not turn out to be true…Having decimal points in the forecasts is 'purely to prove that economists have a sense of humor'."[9] And, as Yogi Berra purportedly said, "It's tough to make predictions, especially about the future."

[7] https://am.jpmorgan.com/blob-gim/1383452890099/83456/weekly_market_recap.pdf
[8] https://www.reuters.com/article/us-imf-worldbank-trade/fallout-from-trumps-trade-wars-felt-by-economies-around-the-world-idUSKBN1WY0PZ
[9] https://www.ft.com/content/60581224-3335-11e8-b5bf-23cb17fd1498

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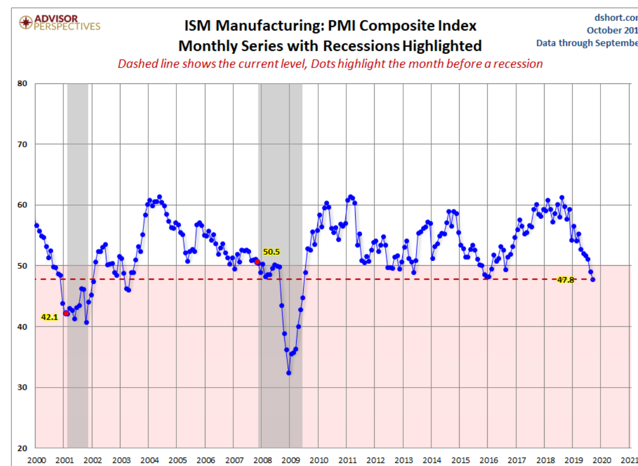
However, the IMF is not alone. The FT reported that the OECD expects world growth to decline to 2.9% in 2019, prompting fears of a 'synchronized slowdown'.[10] This is the lowest rate of growth since the 2008 Great Financial Crisis.[11] Research from the Brookings Institution claims the global economy has entered a period of 'synchronized stagnation'.[12]

There's no doubt that manufacturing is contracting sharply. As seen below, the ISM PMI Manufacturing index is at multi-year lows (note: this is a diffusion index so readings below 50 mean contraction)[13]



On the other hand the US consumer, riding the tailwinds of record low unemployment levels, has been a major source of global strength. In a piece captioned "All Eyes Turn Toward the Consumer as Manufacturing Sector Weakens" T. Rowe Price notes that "Meanwhile, the U.S. consumer appeared to be the stalwart of the global economy. Monthly payroll gains remained generally healthy, keeping unemployment near five-decade lows and resulting in a long-anticipated pickup in wage growth." Nevertheless, they note that "Signs emerged late in the period that consumers might be growing more cautious, however. Gauges of consumer confidence fell back, and personal spending rose only slightly in August despite healthy income gains."[14]

There are other signs of fraying as well. A Bloomberg article recently showed that credit card delinquencies at smaller banks are up sharply. They note that "At 3.9 percentage points, the

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[10] "World Week in Review"; FT; 10/12-13/2019; pg.2
[11] https://www.marketwatch.com/story/developed-central-banks-expected-to-see-biggest-synchronised-easing-since-2000-2019-09-30
[12] "Global Indicators his Lowest in 3 Years"; FT; 10/14/19; pg.4
[13] https://www.advisorperspectives.com/dshort/updates/2019/10/01/ism-manufacturing-index-down-in-september
[14] Op. Cit. #4

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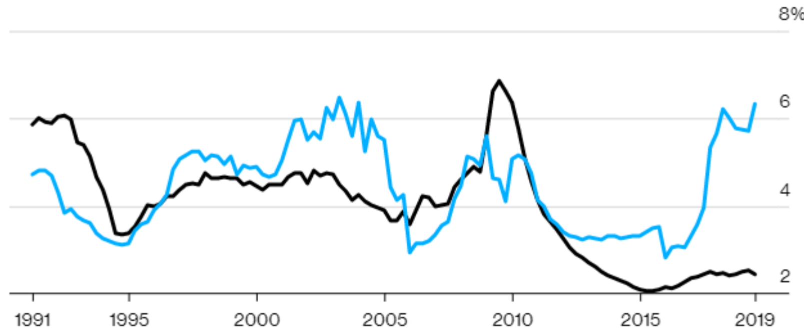
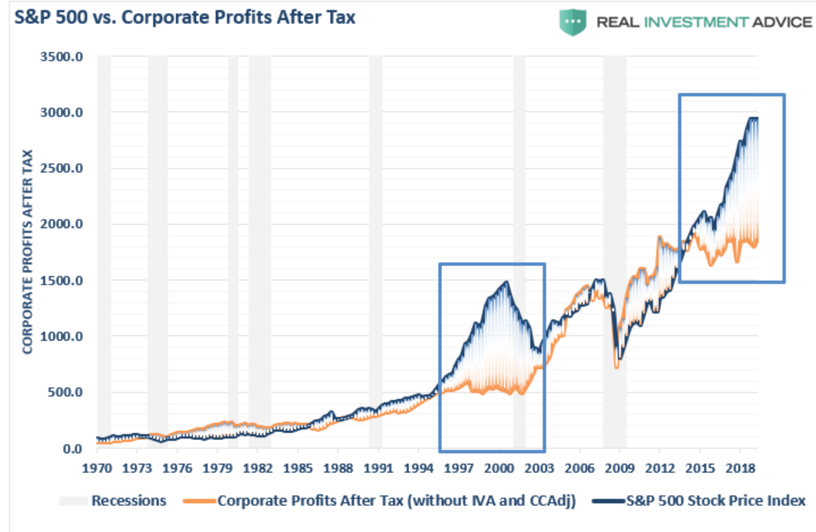
spread between the two measures is also at an all-time high."[15] Arguably, these could just be less credit-worthy spenders, but as in the sub-prime mortgage crisis, this is where trouble would first manifest.



Many other record levels of disparities can be found. The next chart shows the relationship of the S&P 500 to after tax corporate profits. The orange line is unadjusted profits which have lagged significantly behind the growth in the S&P. The last time the performance disparity was this wide was just before the NASDAQ "dot.com" bubble in 2000.[16]



[15] https://www.bloomberg.com/news/articles/2019-10-09/credit-card-deliquencies-in-u-s-on-rise-for-smaller-issuers
[16] https://realinvestmentadvice.com/technically-speaking-this-is-nuts-the-reason-to-focus-on-risk/

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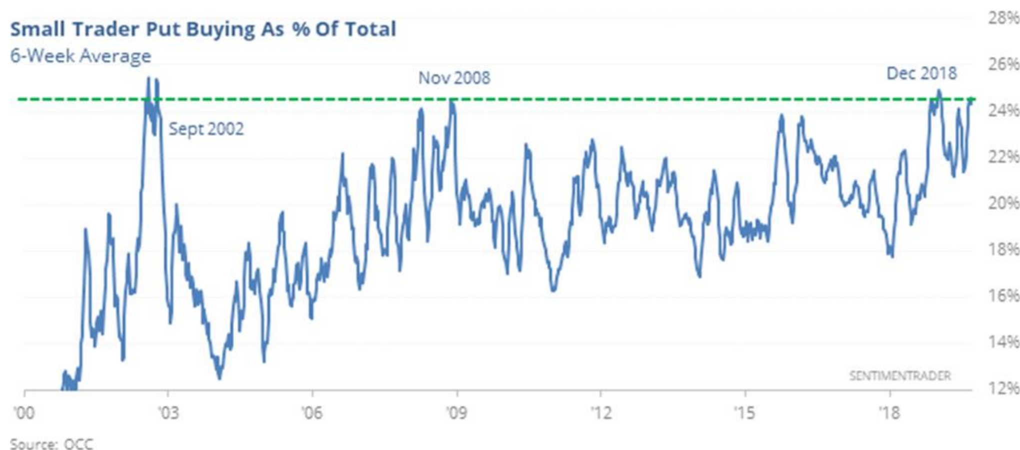
In the face of all this, it's no surprise that the underlying sentiment is deeply negative. This can be seen in the next chart. It's gleaned from Commitments of Traders (COT) data which reports on positions held by all commodity futures traders on all traded contracts. The data can be disaggregated into subgroups based on "the predominant business purpose self-reported by traders on the CFTC Form 40."[17] Commercial users are considered "smart money" and the others are not! In particular, "Smaller Traders" are considered to be representative of the most speculative, emotional and least well informed classification. They tend to be very crowded into the same side of a trade (and tend to be very wrong) at major inflection points.

This is the case currently in the options market for S&P 500 futures. A put option is a bet that the market will decline. The author of the report containing this chart writes "The smallest of options traders keep buying a large amount of put options. Over the past 6 weeks, they've spent more than 24% of their volume on these protective hedges, which has been exceeded only a few times*, **all major market bottoms*** (emph. added)."[18]



Clearly, the wall of worry for the bull market to climb remains alive and well. The other essential ingredient that's been supporting this bull market – and been a source of ongoing discussion in these reports – is the largesse of the central banks. A brief flirtation with rationalizing interest

[17] https://www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm
[18] https://www.sentimentrader.com/blog/small-options-traders-bought-this-much-protection-only-3-times-in-20-years/?utm_source=Daily+Report+Lite&utm_campaign=4fbb62b344-Small_options_traders_bought_this_much_protection_&utm_medium=email&utm_term=0_1c93760246-4fbb62b344-1257326825

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rates and normalizing trillions of dollars of Quantitative Easing programs last year led to a market tantrum in Q IV of 2018. Politicians and central bankers alike panicked and abruptly changed course. According to one report, "The shift in central bank monetary policy direction during the last six months hasn't been this dramatic in a decade. Fitch Ratings, examining the direction but not magnitude of central bank shifts, found that more than a third of them have loosened monetary policy in the past six months."[19]

The significance of these central bank policies cannot be overstated, particularly when looking to the markets as a source of price discovery and market barometer. On the surface, the stock market hovering around all-time highs is signaling that the global economy is okay – slowing but not crashing and burning. The bond markets on the other hand, with negative interest rates and inverted yield curves, are sounding a clear warning of recession.

In a recent "Over my Shoulder" publication from John Mauldin, he offers a research piece from GavekalResearch that addresses this issue and some of its ramifications. Gavekal writes:

> "… yield curves have inverted, prompting fears of a recession, which push investors to buy more bonds, further depressing yields at the long end, and deepening the recession fears. The result is more than US$15trn in negative-yielding debt around the world: ***the greatest bubble any living investor has ever witnessed*** (emph. added), dwarfing in its

[19] https://www.marketwatch.com/story/global-central-banks-havent-shifted-direction-this-abruptly-in-a-decade-2019-08-16

> capital misallocation both the tech bubble of the late 1990s and the mortgage bubble of the mid-2000s.
>
> Inherent in any bubble is the belief that buying assets priced to destroy capital—internet stocks in 1999, Arizona real estate in 2006—makes sense because you will always be able to find a bigger sucker who will buy your valueless assets at an even higher price… In the debt markets today***, the patsies who will buy stupidly-priced bonds are obvious enough: central banks*** (emph. added)***.***"[20]

Gave believes that central bank largesse and monetary experiments are nearing their limit and that political sentiment is shifting towards an era of fiscal stimulus. As Gave puts it, they are "punting the ball back to elected officials." We're not so sure this will work (although one can only hope). Rather, we feel that political expediency argues for extending the monetary experiments into new quantitative easing programs like Modern Monetary Theory, perhaps Universal Basic Income, but QE 4, QE 5...by any other name. Gave brilliantly captures

> "…the quandary confronting investors. Today's world is characterized by low growth, low inflation, and ***central banks that can be counted on to print money in order to buy valueless assets for as far as the eye can see*** (emphasis added).
>
> Historically, the optimized portfolio of choice, and the one beloved of quant analysts everywhere, has been a balanced portfolio comprising 60% growth stocks and 40% long-dated bonds. Yet recently, this has come to look less and less like an optimized portfolio, and more and more like a "dumbbell portfolio", in which ***investors hedge overvalued growth stocks with overvalued bonds*** (emph. added). At current valuations, such a portfolio no longer offers diversification. Instead, it is a portfolio betting outright on continued central bank intervention and ever-lower interest rates. Given some of the rhetoric coming from central bankers recently, this is a bet which could now be getting increasingly dangerous."[21]

Jesse Livermore purportedly said something to the effect that "When I see a train coming towards me at sixty miles per hour, I step out of the way!" The chart above shows that at least sixty miles per hour of central bank liquidity has been unleashed on the tracks of the global economy. Over time, it's almost a certainty that the attained speed will diminish and ultimately be ineffective and stall, but trying to call that moment is a fool's errand. Meanwhile, there are glaring disparities in the market that have persisted throughout this bull market run. The charts

[20] "Over my Shoulder" by John Mauldin and Patrick Watson, Mauldin Economics; September 12, 2019 reporting GavekalResearch, "The Danger of a Dumbbell Portfolio", The Daily, September 10, 2019

[21] Ibid. # 20

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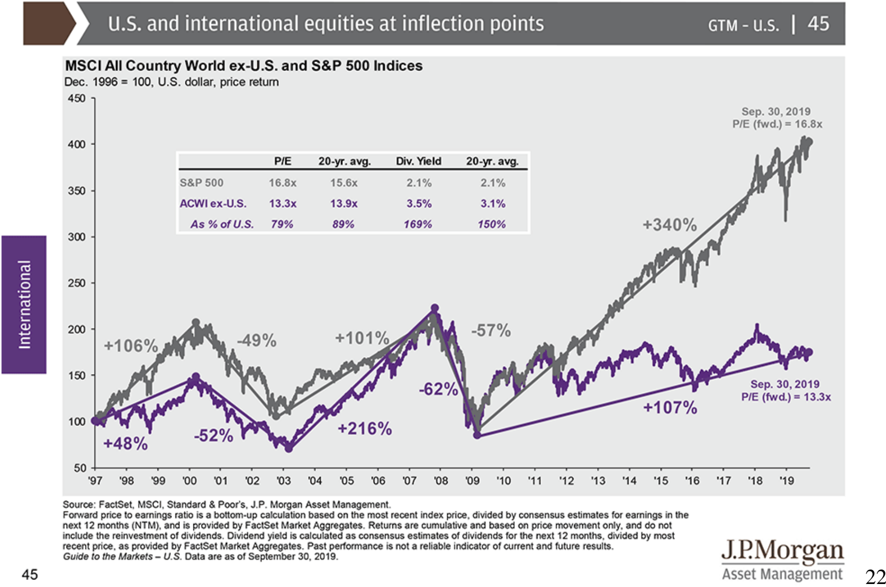
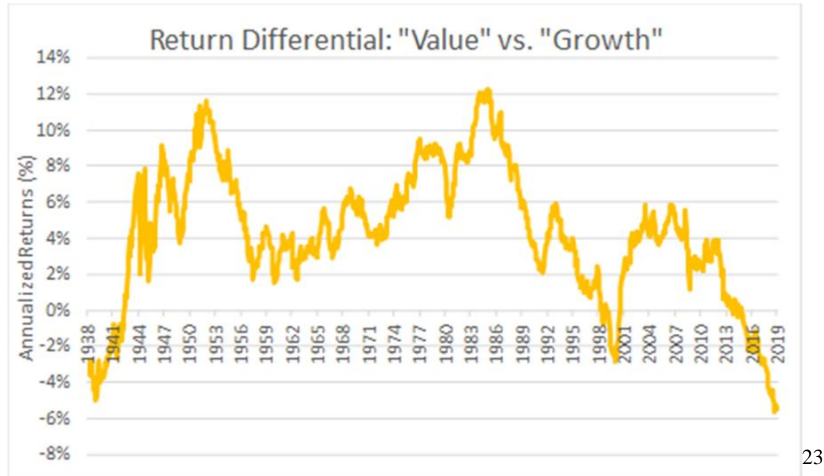
below show performance disparities in sectors/styles such as value vs. growth and US vs. international equities.



	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	16.8x	15.6x	2.1%	2.1%
ACWI ex-U.S.	13.3x	13.9x	3.5%	3.1%
As % of U.S.	*79%*	*89%*	*169%*	*150%*

[22]



[23]

Regarding the bottom chart from Invesco showing the underperformance of "Value vs. Growth", the author notes that ". One can also see that the recent 12-year relative performance of Value is

[22] https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/economic-overview
[23] https://seekingalpha.com/article/4292257-values-time?ifp=0

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the worst relative to Growth since the period that covered the Great Depression in the 1930s. Long-run outperformance by Growth has been rare (the Depression, the tech bubble, and now)."

There are many other disparities that exist, such as the long trend in underperformance by commodities which, if reversion to the mean still exists, should have their day in the sun again. We believe that the markets will ultimately resolve this 10 month period of sideways consolidation with a continuation to the upside and new highs in the equity market indexes. However, it will probably require a more aggressive stance by the Fed. This could finally reverse the trend of a stronger US dollar which, in turn could mark a reversal in the outperformance of some of these sectors just described. For now though, we remain underweighted in bonds, a bit over weighted in cash, and still very much exposed to US equities. If the USD does indeed reverse (as we are expecting) over the upcoming quarters, we will adjust our models and portfolios accordingly.

In the meantime, we are enjoying apple picking season here in the Northeast, and looking forward to pumpkin pie and the changing leaves. We hope you all enjoy the season as well.

Thanks for reading,

Jason Waxler

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