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

- "Bull Markets are Born on Accounting Changes, Grow on Central Bank Monetization, Mature on FOMO, and Never Die. Ever."[1]

The title for this quarter's report comes from a tweet by Rudolph E. Havenstein, Anti-Davos Man. It is a takeoff on the quote from famed investor John Templeton who observed that "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."[2] We're unaware of Havenstein's real identity (although we enjoy his tweets and commentaries) but the real Rudolph E. Havenstein was a German lawyer and president of the Reichsbank (German Central Bank) during the hyperinflation of 1921-1923. Our long-time readers know that we are sympathetic to the author's sentiment, (as well as his sarcasm!). For those who are wondering, FOMO means "fear of missing out", and it does indeed seem like this bull market will never end in our lifetimes…ever!

Market momentum carried through in the fourth quarter, topping off a very good year for global equities. The S&P 500 gained 6.12% in Q IV and 19.42% for the year.[3] So far, the momentum is continuing into 2018. According to Peter Worden (The Worden Report; Friday, January 12, 2018), "The stock market has come out of the gate like gangbusters to begin the new year, resulting in more record highs for the major stock indexes. This is the best start for the S&P 500 since 2003. The index has already gained 4.21% in 2018." Many overseas markets outperformed the US in 2017, as the MSCI Asia (ex-Japan) climbed 35.9% and the MSCI EM (Emerging Markets) rose by 31%.[4]

Perhaps most remarkable was the lack of volatility in the markets. According to JPMorgan, "US equities delivered positive returns ***in every single month of 2017, the first time this has happened since 1958***. On average, US equities experience an intra-year drawdown of about 14%. In 2017, the maximum drawdown for the index was less than 3%. (Emphasis added)"[5]

The momentum was not uniform, however, and there was significant sector rotation beneath the surface. According to data from Lowry's, technology was the overall leader for the entire year and remained strong in the fourth quarter. But former leaders in defensive, interest rate sensitive sectors like Utilities, Consumer Staples, Telecommunications and Real Estate Investment Trusts all began to lag badly. We view this rotation as a healthy development and a positive for maintaining the longevity of this rally.

[1] Rudolf E. Havenstein @RudyHavenstein ; 10:32 AM - 26 Dec 2017
[2] https://www.franklintempleton.com/forms-literature/download/SIRJT-POS
[3] http://performance.morningstar.com/Performance/index-c/performance-return.action?t=SPX
[4] https://am.jpmorgan.com/gb/en/asset-management/gim/adv/insights/market-insights-monthly-market-review-december-2017
[5] https://am.jpmorgan.com/gb/en/asset-management/gim/adv/insights/market-insights-monthly-market-review-december-2017

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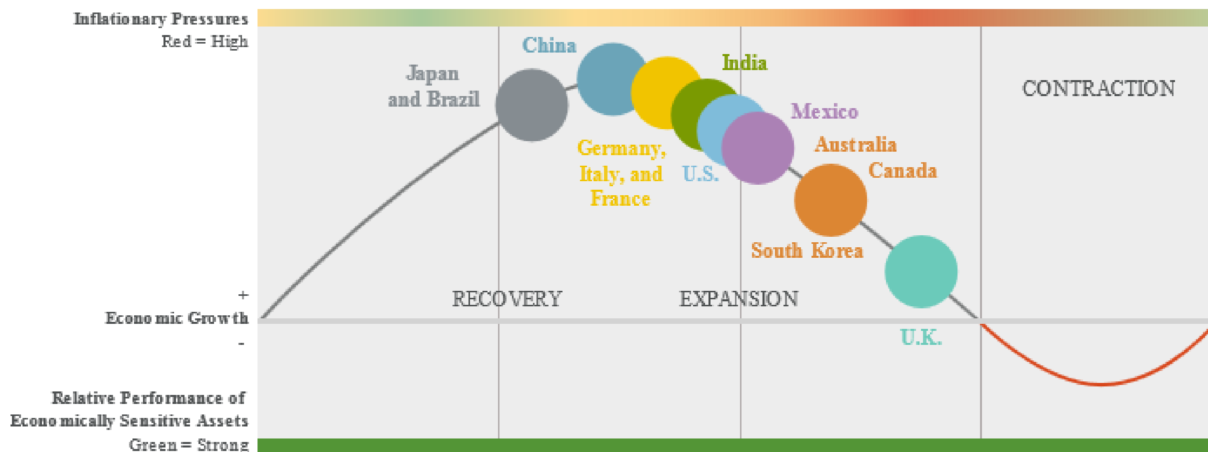
Strength and new leadership was evidenced in Basic Materials, Financials, Energy and Industrials.[6] This is indicative of the mid to later stages of a typical economic cycle and we have been repositioning our models and portfolios accordingly.

As the below chart from Fidelity indicates, they believe that the US is smack in the middle stages of an economic cycle. Of greater significance though is that every major industrialized economy is also in the midst of an expansion.[7]

Most Synchronized Global Expansion in Years



This chart captures our central thesis for the past year or so – that essentially the entire world is experiencing economic growth to some degree and this is now fueling corporate earnings. Central banks have pumped trillions of dollars (and yen, euros and British pounds) into the financial system since the 2008 financial crisis. Yes, the resulting growth may have been sluggish relative to past recoveries and yes, it's taken nearly a decade for the liquidity to work its way into the "real" economy. The results, however, are now becoming apparant.

The two charts below from IHS Markit depict the depth and breadth of the expansion. This data series is focused on manufacturing, but it also correlates well with data for the services sector. They report that "The global manufacturing PMI rose to its highest for over six-and-a-half years in November, with output, new orders and employment growth all strengthening. Even better news came on the broadening out of the upturn: for the first time in over a decade, no country reported a deterioration in manufacturing conditions."[8]

[6] https://www.lowryondemand.com/members/video/2017Q4-MarketReview/
[7] https://institutional.fidelity.com/app/item/RD_13569_40890/business-cycle-update.html?pos=T
[8] https://ihsmarkit.com/research-analysis/06122017-Economics-Global-manufacturing-PMI-hits-highest-since-March-2011.html

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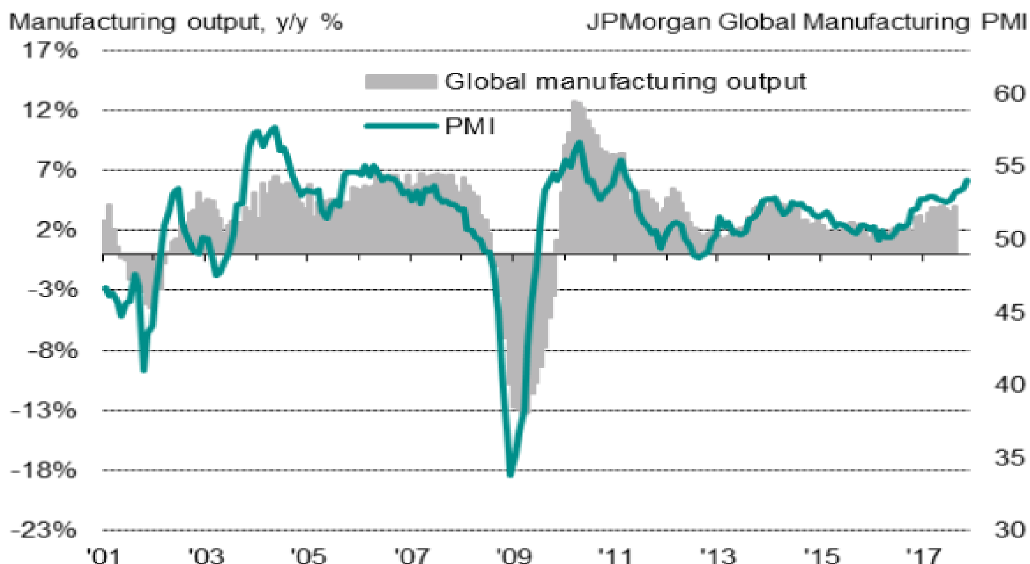
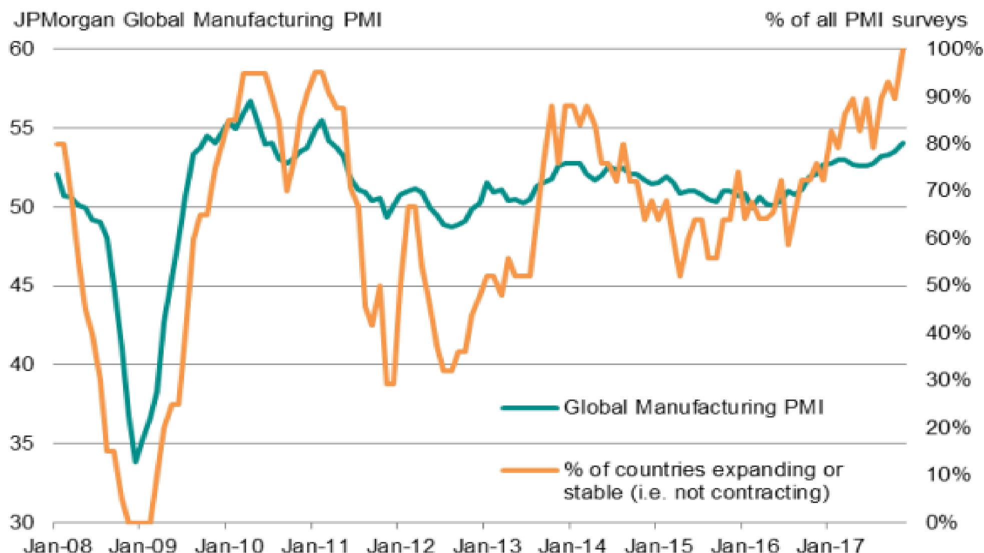


Note the spread between actual output and the PMI index. Markit notes that "Over the past two decades, the PMI shows an 86% correlation (acting with a four-month lead) on the official manufacturing output data. The latest surveys are running at a pace broadly consistent with global factory production rising at a robust annual rate of approximately 6%."[9] This series is for November's data, but it implies 6% growth in global manufacturing through at least the first quarter of this year.

The next graph shows the percentage of countries in the (29 country) index where manufacturing is either expanding or at least stable. It shows an astounding 100% reading, with every country except one reporting an improvement in business conditions (and the one outlier, Thailand, reported no change from last month).[10]



[9] Ibid. # 9
[10] Ibid. # 9

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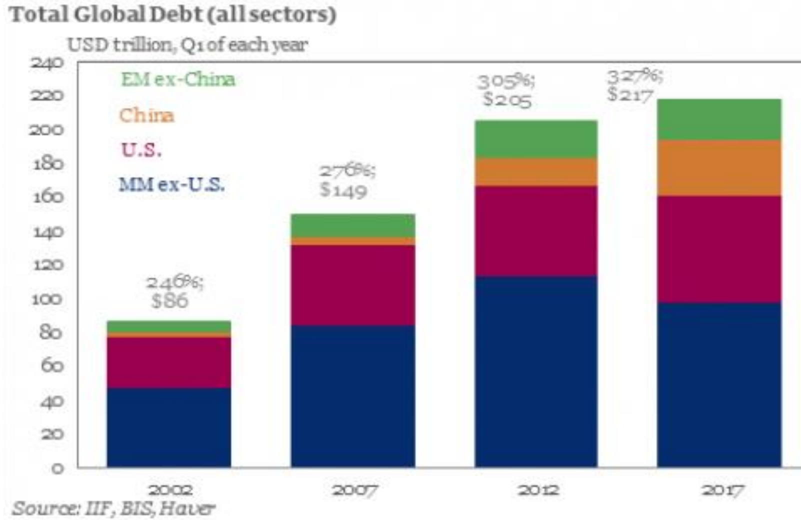
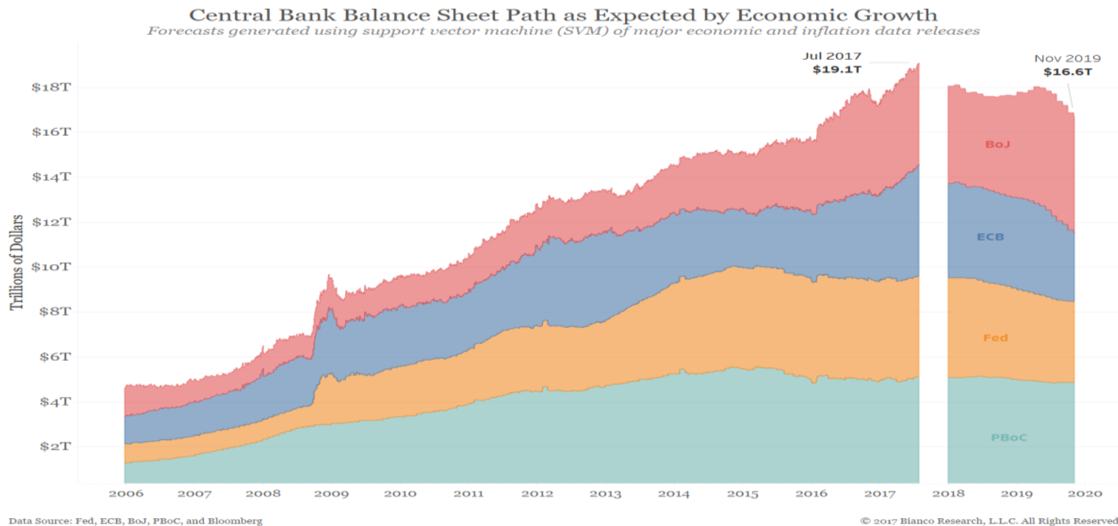
The question, as always, is can this continue and how much is already reflected in asset prices? As mentioned above (and discussed at length in past reports), this growth is due in some significant degree to the trillions in liquidity pumped in to the financial system over the past decade by the major central banks. Global debt has expanded to a whopping 327% of global GDP – far exceeding the levels reached in 2007 just prior to the '08 financial crisis (see below chart from ZeroHedge).[11]



So, the trillion dollar question now becomes can the global economies withstand an eventual unwind and removal of this accommodation? As the next chart below from Bianco Research shows, the Fed and the PBOC (China's central bank) have already begun the shrinking of their balance sheets. The ECB and BoJ are expected to follow suit in 2018.[12]



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[11] https://www.zerohedge.com/news/2017-06-29/global-debt-hits-new-record-high-217-trillion-327-gdp
[12] https://www.biancoresearch.com/?p=143484

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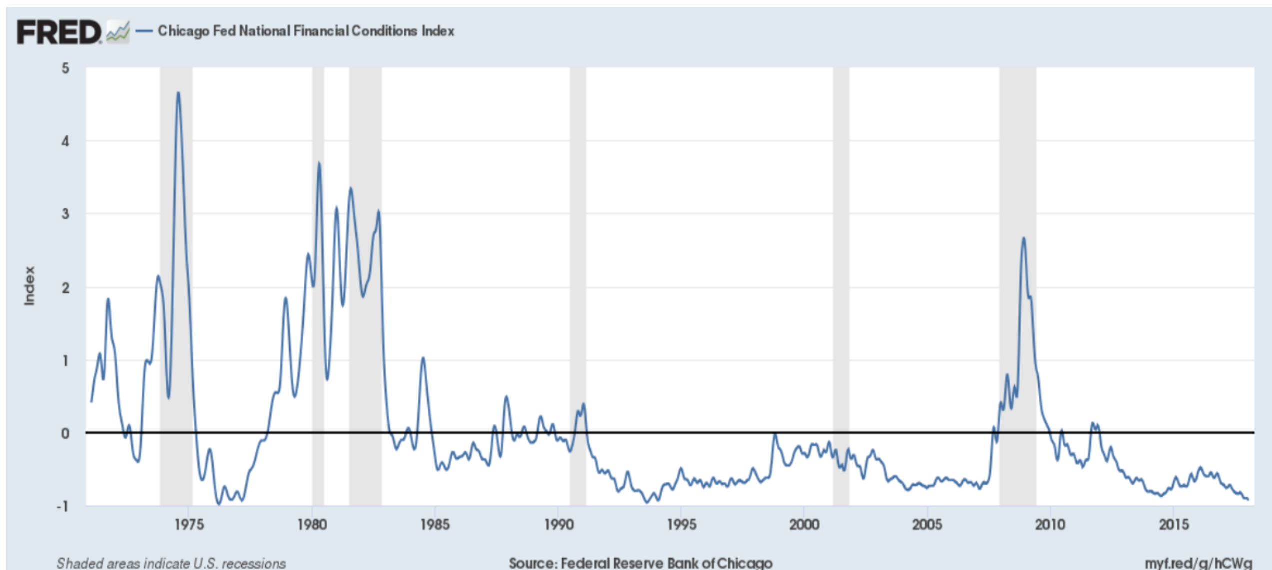
In a “normal” economic cyle, the key is not so much when the unwind actually begins or the magnitude of that unwind, but more importantly, will the restriction cause the economy to tip into recession. By this metric, the economy and, by extension, the equity markets have many more months if not years to run. The below chart is the National Financial Conditions Index (NFCI) compiled by the Chicago Federal Reserve Bank. The NFCI “… provides [data] on U.S. financial conditions in money markets, debt and equity markets and the traditional and ‘shadow’ banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average”.[13] As shown, ***financial conditions are as easy as they’ve been in decades***.



A broader analysis of data that incorporates additional factors such as the BLS Index of Leading Indicators, the Citigroup Economic Surprise Index, the effects of the recent tax reform, unemployment data, and so on, all point to the recovery lasting for a long time. Guggenheim, for example, doesn’t see signs of recession until the end of 2019 or early 2020.[14] If correct, and given that it is ultimately a downturn in the economy that causes secular bear markets, Guggenheim shows that based on history, this current bull market has potentially much further to run.[15]

[13] Federal Reserve Bank of Chicago, Chicago Fed National Financial Conditions Index [NFCI], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/NFCI, January 19, 2018.

[14] https://www.guggenheiminvestments.com/perspectives/macroeconomic-research/10-macro-themes-to-watch-in-2018?utm_source=pardot&utm_medium=email

[15] Ibid. # 14

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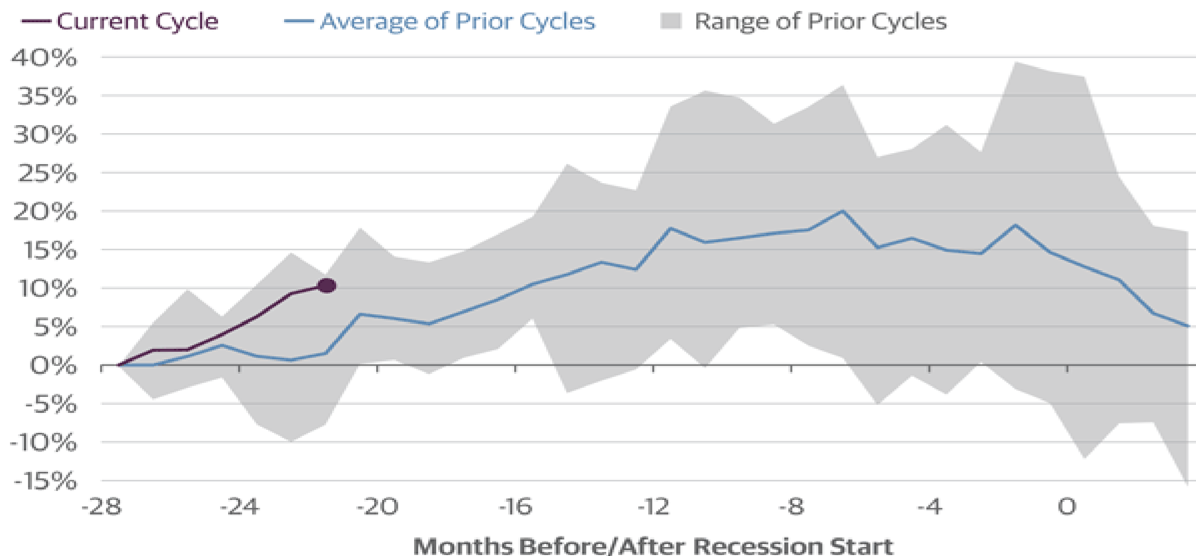
Stocks Will Rise Despite an Aging Business Cycle

S&P 500, Cumulative Percentage Change Leading up to a Recession in Five Comparable Prior Cycles



So, what could possibly go wrong! This is probably one of the more upbeat reports from us in some time. Not to disappoint our longtime readers, no, we do not believe that this is ultimately sustainable and we still adhere to the (apparently antiquated) notion that debt actually does have to be repaid at some point. The largest marginal buyer of debt in recent years has been central banks and we remain unconvinced that in their absence we will have an otherwise "status-quo" financial market! MarketWatch recently reported on a sober warning from Deutsche Bank study entitled "The Next Financial Crisis". The strategist, Jim Reid, wrote "'When looking for the next financial crisis, it's hard to escape from the fact that we're seemingly in the early stages of the 'great unwind' of global monetary stimulus at the same time as global debt remains at all-time highs following an increase over the past decade—at the government level at least—which has been unparalleled in peacetime history…In the end, $34 trillion of stimulus and QE has delivered only very low growth, subdued inflation and sky-high asset prices around the globe, …This is unprecedented territory and how can anyone estimate what the fallout will be when we normalize again?'"[16]

In an article entitled "Draining of QE Punchbowl Sobers up Bond Bulls", the FT reports "'The coming changes in global monetary policy is nowhere near priced in and is actually grossly underestimated' argues Robert Michele, chief investment officer of JPMorgan Asset Management".[17] And, "Wells Fargo estimates that central banks have absorbed more than all the bonds issued by G10 governments over the past two years but next year they will buy only 40 per cent of overall debt issuance."[18]

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[16] https://www.marketwatch.com/story/how-the-great-central-bank-unwind-could-ignite-the-next-financial-crisis-2017-09-20

[17] "Draining of QE Punchbowl Sobers up Band Bulls"; FT; January 3, 2018; pg. 20

[18] Ibid. # 17

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But this appears to still be tomorrow's story. For now, the worst that can be said about the markets is that they are extremely overbought after their recent run-up, and that there are definite signs of froth and excess abounding. Business Insider reported that "Corporate borrowing helped push global debt issuance to a record $6.8 trillion this year, according to data by Dealogic…"[19] The FT cites a BNP Paribas report noting "Total [global] equity market capitalization has more than tripled from the nadir of 2009 and is approaching $100tn for the first time".[20] In another article, the FT reports "Hong Kong residential property values have risen 180 per cent since the start of 2008, says Capital Economics. Officials from the Hong Kong government have described the city's property market as a bubble…"[21] The total value of Australia's housing stock rose more than 50% in the 4 years from September 2012 to the quarter ending September 2017, according to the Australian Bureau of Statistics. "The value of housing is four times GDP, while household debt is among the highest in the developed world at 100 per cent of GDP", they report.[22]

These various examples represent astoundingly large numbers. It gets even better! FT columnist Ben McLannahan writes "Legacy Acquisition Corp did not beat around the bush. 'We are a newly formed company with no operating history and no revenues, and you have no basis on which to evaluate our ability to achieve our business objectives,' it said…in the prospectus for an initial public offering last month on the New York Stock Exchange. Never mind. Investors liked the deal so much that they bought 30m units at $10 a share."

And, we'd be remiss if we neglected to mention the recent auction of a Leonardo da Vinci painting, "Savior of the World", for a mere $450.3 million a few months ago, according to the Washington Post.[23] The painting, created in the early 1500's had an interesting history. Fast forward to the 21st century, it was purchased in 2005 by a NY based art collector for $10,000. It was sold in 2013 for $80 million to another art dealer who then flipped the painting a year later to a Russian billionaire, Dmitry Rybolovlev, for $127.5 million! Upon learning of the mark-up, Rybolovlev was so upset that he filed suit against his seller. One must assume that his feelings were assuaged by the most recent selling price!

Then, of course, are the plethora of spam emails clogging my inbox from such upstanding stalwarts such as cole@izhamburg and crake@dangerousdoses advising me to "Forget about bitcoin, there's a way better coin you can buy." Calls from clients inquiring about the next best biotech or medical marijuana stock – with no earnings and sometimes no revenue – that might be the next Facebook or Amazon!

Sentiment indexes, such as Citigroup's Panic/Euphoria Model, shown below, all show extreme levels of enthusiasm.[24]

[19] http://www.businessinsider.com/corporate-borrowing-record-high-2017-12
[20] Market Dashboard, "Relying on Central Banks to Buoy Asset Prices Looks Risky"; FT; December 20, 2017; pg.18
[21] Op. Cit. # 21; pg.18
[22] Ibid. # 21
[23] https://www.washingtonpost.com/news/morning-mix/wp/2017/11/15/unimaginable-discovery-long-lost-da-vinci-painting-to-fetch-at-least-100-million-at-auction/?utm_term=.e39839693233c
[24] http://www.barrons.com/public/page/9_0210-investorsentimentreadings.html

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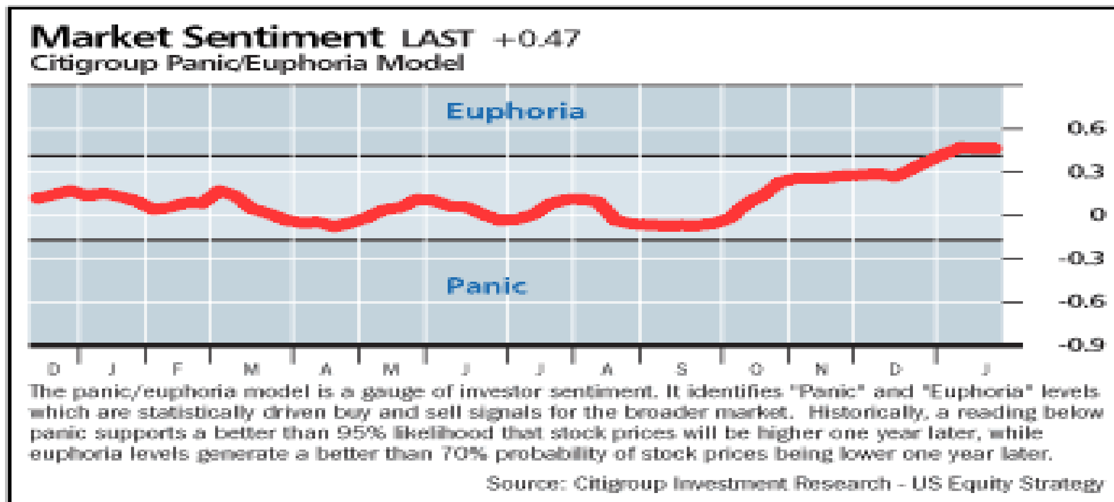

Another interesting sentiment gauge can be gleaned from the news emanating out of the World Economic Forum (WEF) at Davos, Switzerland. In a recent report entitled "Davos as Contra-Indicator" Scott Minerd, Chairman of Investments and Global CIO of Guggenheim writes that "Two years ago, when I last attended the World Economic Forum in Davos, a growing consensus saw the global economy at the brink of recession... Stocks had sold off, and many pundits predicted that we were at the brink of a new bear market... Declining asset prices were offered up as full evidence that the U.S. and probably the entire global economy was at the precipice of recession."… As things kick off here in Davos, the sentiment could not be more radically different from January 2016. Global growth is accelerating and risk assets are soaring. Sentiment is so positive, it feels like the discussion will focus on "How high is up?" This is occurring in the face of U.S. tariffs on solar panels and washing machines, while CNN and the BBC run documentaries on a rising tide of nationalism, and against a backdrop of discussions on restricting immigration just when healthy Western economies are starting to experience labor shortages in certain key industries…While I am hesitant to jump to a conclusion, I am troubled by the euphoria undergirding the gathering here. I will be listening closely and speaking occasionally, most likely asking more questions than providing opinion. I have seen bull market tsunamis before. They can be both rewarding and destructive. ***The key is to know when to get out*** (emphasis added).[25]

And that, it seems to us, is the prevailing sentiment. Investors know the trend is up – the rear view mirror confirms that – and FOMO is certainly alive and well. At the same time, investors are also well aware that the central banks are beginning to reverse their accommodation which will bring us into uncharted waters. Our sense is that this uptrend is potentially more powerful than widely recognized – the years and trillions of monetary stimulus might carry this cycle for longer and higher than most expect. There is still a steep "wall of worry" for the market to climb higher on and the worry is real. As Geopolitical Future's George Friedman noted in a recent email, "The world is too rich to be reduced to a single theme, but if it could, the theme would be disintegration. In every major region, the systems that have been in place either since the end of World War II or since the collapse of the Soviet Union are beginning to fall apart. Faith in

[25] https://www.guggenheiminvestments.com/perspectives/global-cio-outlook/davos-as-contra-indicator?utm_source=pardot&utm_medium=email&utm_campaign=davos%202018&utm_content=global%20cio%20outlook

these systems was badly shaken by the global financial crisis in 2008 and, to a lesser extent, the collapse of oil prices in 2014."

As of this writing, we remain committed to "risk on" in our portfolios which means overweight exposure to equities and to emerging markets. We have also been tilting more towards mid to later cycle sectors such as energy, basic materials, natural resources and commodities. After surviving the "polar vortex" this year (and another one potentially on its way in February), it is hard not to be bullish on energy. The sector was decimated after the collapse in oil prices in 2015 and this makes it attractive to our "value" orientation. The same can be said about basic materials and in fact we are favorably disposed towards the entire commodities sector. We think they can outperform broader equity indexes for some time to come. Meanwhile, there will be an economic downturn and consequent bear market within our lifetimes! Like Scott Minerd, we are keeping a vigilant eye on when to get out.

Stay warm…the days are getting longer as we speak!

Thanks for reading.

Jason Waxler

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Quarterly Market Review Fourth Quarter 2017[26]

U.S. STOCKS

	4Q 2017	*Year-to-Date*
Dow Jones Industrial Average	10.96%	28.11%
S&P 500 Index	6.64	21.83
Nasdaq Composite Index	6.27	28.24
S&P MidCap 400 Index	6.25	16.24
Russell 2000 Index	3.34	14.65

INTERNATIONAL INDEXES

MSCI Index	*4Q 2017*	*Year-to-Date*
EAFE (Europe, Australasia, Far East)	4.27%	25.62%
All Country World ex-U.S.A.	5.06	27.77
EM (Emerging Markets)	7.50	37.75

GLOBAL BONDS

Index	*4Q 2017*	**YTD**
Bloomberg Barclays U.S. Aggregate Bond Index	0.39%	3.54%
J.P. Morgan Global High Yield Index	0.87	8.28
Bloomberg Barclays Municipal Bond Index	0.75	5.45
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	1.63	10.51
J.P. Morgan Emerging Markets Bond Index Global Diversified	1.16	10.26

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