CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 1st Quarter 2019

Summary

Stocks rebounded sharply in the first quarter as investors reacted favorably to the Federal Reserve's change of heart on interest rates. When Fed chairman Jerome Powell said back in early January that the rate hiking cycle was over and that the Fed's balance sheet was not going to contract any further, the market abruptly stopped pricing in recession for 2019 and instead started discounting a profit recovery later in the year. Over the years we have discussed the importance of liquidity – greater liquidity tends to be better for risk assets; this is yet another example of how a positive change in market liquidity can lead to a strong rally.

Arithmetically, last quarter's 13.65%[1] S&P gain doesn't completely erase the previous quarter's -13.52% loss[2], but it sure feels a lot better. The small cap Russell 2000 gained 14.58% last quarter but is still down -8.56% over the previous two quarters combined. See Figure 1. That said, we don't think anybody really hoped we could erase those steep fourth quarter losses in just three months. Markets are sometimes said to take the escalator up and the elevator down, so when stocks rise almost fast as they previously fell, that tends to be a good sign. In our experience, at least.

Figure 1

S&P 500 and Russell 2000, 9/30/2018 – 3/31/2019
Source: YCharts

[1] S&P 500 and Russell 2000 performance are per Morningstar Workstation
[2] You would still have a -1.72% loss

It is also encouraging that international markets largely kept pace with the U.S. market's advance. In fact, in local currencies many foreign markets performed better. There really wasn't any poorly performing major foreign market last quarter, despite evidence that global growth was slowing. According to Barrons[3], world equity funds were up 11.64% (in dollar terms) last quarter. China led the way, while India and Latin America were among the bottom performers. Despite the fiasco that is Brexit, European stocks rose 10.38%.

It was also a good quarter for bonds. Falling inflation and a more friendly Fed created a favorable environment for every area of the bond market. High yield bonds performed the best with a gain of over seven percent[4], but even short-term treasuries, the least volatile bond category, gained 1%[5]. That is an unusually good return for one quarter, considering bonds have averaged 2.74% *per year* over the last five years[6].

Activity

We didn't over-react to stock market weakness during the fourth quarter of 2018, and as such were not in the position of being forced to buy back into the market at higher prices during the first quarter (not that we didn't add a little here and there). Our goal was to carefully work down the level of cash in portfolios.

Outlook

Going forward, we are looking for a catalyst to break out to highs above those we saw in September and January of 2018 (approximately 2935 on the S&P 500). Investors are hoping that a comprehensive trade deal between the U.S. and China will be that catalyst, but the market may well view the trade deal to be a "buy-the-rumor, sell-the-news" event absent meaningful and enforceable intellectual property guarantees. Good luck on that! In the meantime, we believe the U.S. stock market will eventually challenge the old highs on lack of bad news more than anything else. Stocks are still expensive on a price to sales and price to cash flow basis, but decent investor demand combined with corporate stock buybacks continues to provide a tailwind. The concern we have is that the November through April time period is traditionally more favorable for stocks than the May through October period, so a failure to make new highs by Memorial Day (should that occur) may cause market psychology to deteriorate. That said, if Fed policy remains easy, market liquidity is plentiful, and signs of imminent recession are scarce, we will probably not get defensive in any major way.

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[3] Barrons Quarterly Issue, 4/8/19
[4] BBgBarc US Corporate High Yield, per Morningstar
[5] BBgBarc 1-3 Yr US Treasury, per Morningstar
[6] BBgBarc Aggregate Bond, per Morningstar

Commentary – It IS Different This Time

(Note that this commentary takes inspiration from Ben Hunt's April 17th issue of Epsilon Theory, titled "This is Water").

Quite a while ago our Commentary was entitled It's Not Different This Time. The thesis was that although technology stocks were behaving as if we had entered a new era in which profitability did not matter, eventually companies that don't generate net profits don't survive. The idea of the title came from a mentor, who advised to be extremely careful when hearing the words 'It's different this time", because it's never different this time. His point was that we are in a perpetual market cycle of recovery-optimism-euphoria-anxiety-panic-capitulation-recovery. The details change from cycle to cycle but those human emotions don't. Insofar as the discussion relates to investor behavior, he was absolutely right, of course. That said, there is another way to look at market cycles of the past and to conclude that it is, in fact, quite different this time.

Ben Hunt's article (which everyone should read), makes the point that capitalism works because of its dynamism. A company or an industry thrives because underlying conditions turn favorable or because it creates those conditions. Those industries or companies are therefore able to generate higher profit margins. New companies then enter that space to try to capture a share of the higher profits. Also, employees of the higher earning company want to be paid more as a result of the higher profits they are helping to generate. Eventually these and other factors combine to push margins back down. Reversion to the mean also works in the opposite direction. Poor financial results in an industry drive firms out of business and wages down, such that surviving firms have an improved competitive landscape. Hunt goes on to state that if economic dynamism is lost due to "financialization", or the ability to generate higher profitability without having to sell more products or services, it isn't really capitalism any more. He cites dramatically reduced corporate tax rates and super low interest rates as factors that have allowed corporate management to say to employees essentially "you are not the reason for our excess profits, so we are not sharing them with you. We are reserving them for shareholders and for ourselves, as we have been smart enough to leverage these low interest rates and buy the right politicians".

So here we are. In an environment of low inflation, low productivity, and low growth. Where running large deficits does not lead to spiraling inflation. Where the Federal Reserve can essentially keep the business cycle out of recession almost indefinitely by expanding credit. And where a few investors have said lately (more or less), "if this is all true, why not turn the "risk knob" up to 11"?

Fair question. On October 19, 1987, stocks dropped -22.3% IN ONE DAY. We learned a strategy (in that case it was called portfolio insurance) that involves selling when the market drops a certain percent may work for a small group of people, but if EVERYBODY adopts the very same strategy it will not work for ANYBODY. We learned on August 2nd, 1990, when Iraq invaded Kuwait, that you can focus on a myriad of geopolitical hot spots and still fail to forecast the one that blows up in your face. In 1998 the smartest financial minds in academia made more than four billion dollars disappear in the Long Term Capital Management fiasco. From that we learned that just because you create a model that says a certain event should occur no more frequently than once in 10,000 years doesn't mean that it won't happen (or that your model is correct). From the late 1990s tech wreck we learned that if the markets reward revenues instead of profits, eventually people will sell dollar bills for 99 cents. From the financial crisis of the 2000s we learned that just because a particular aggregate price had never declined before (in this case housing) doesn't mean it never could. We all also learned from Chuck Prince of Citigroup that Wall Street firms will do things they know are stupid if everybody else is doing them.

The point of all this is to say that every time the market has indulged in behavior that suggests it believes it has found the key to perpetual prosperity there has eventually been a train wreck. We just had a -19% stock market correction because the Federal Reserve raised the federal funds rate to <u>2.5%</u>! Forty years ago it took double digit interest rates to cause this big of a decline. In 1987 an increase to 7.25% on September 22 helped precipitate the crash. In 2000 rates peaked at 6.5% in May. In 2007 interest rates only needed get to 5.25% to burst the housing bubble[7]. It appears that interest rates have to keep falling or we cannot sustain the bull market. Obviously, there is a wall out there that we will eventually hit since there is a lower limit to interest rates (such that easing won't work anymore). Japan found that level, and Europe seems to have as well.

What we are hoping you take from all of this is that we recognize that this dominant paradigm has shifted. <u>The 3-5 year business cycle of thirty years ago is a thing of the past</u>. The belief that a bull market must end because a certain amount of time has passed has proven unfounded. Today investors and the Fed no longer fear inflation, corporate America no longer fears debt and in fact believes leverage and low taxes solve everything. All that said, human nature has not changed. Losses lead to prudent behavior which lead to gains which lead to increasingly reckless behavior which eventually lead to spectacular busts. We are committed to help our clients avoid spectacular busts in every way we can. When you have short business cycles as we did in the 1980s and 1990s the rewards for avoiding the busts arrive regularly.

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[7] Kimberly Amadeo, Fed Funds Rate History with Its Highs, Lows, and Chart, thebalance.com 03/21/2019

When cycles stretch for a decade or more as they do now, those rewards are much less apparent. Having experienced what we have over thirty plus years, we have a certain respect for risk because we know how quickly large gains can turn to losses. What global central banks have been doing is a great *experiment*. There is no historical precedent for this much corporate and government debt. We hope this works out well for all of us but we have doubts[8]. And because of that, we are going to err on the side of caution.

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[8] Because the unavoidable byproduct of financialization is economic inequality, and this is leading to political instability across the developed world.