CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 2nd Quarter 2019

Summary

The second quarter of 2019 is in the books, as they say, and it was another good one for both stocks and bonds. The key to market gains was Federal Reserve Chairman Jay Powell's capitulation on interest rates. Ordinarily, the Federal Reserve does not cut interest rates during a period of strong market performance for fear of stoking investment speculation. Nowadays, however, restraint is an old-fashioned notion. Investors have understandably reacted to the idea that credit would become both easier to obtain and less expensive in the same way a child would if you told them that there would be two Halloweens this year. Yay! More candy! See Exhibit 1 for a market summary. Concerns about trade wars, Iran, North Korea, etc. have all taken a back seat, at least for now.

Exhibit 1: Second Quarter Market Returns[1]

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q2 2019	STOCKS				BONDS	
	4.10%	3.79%	0.61%	1.29%	3.08%	2.75%
Since Jan. 2001						
Avg. Quarterly Return	2.0%	1.5%	2.9%	2.6%	1.2%	1.1%
Best Quarter	16.8% 2009 Q2	25.9% 2009 Q2	34.7% 2009 Q2	32.3% 2009 Q3	4.6% 2001 Q3	4.6% 2008 Q4
Worst Quarter	-22.8% 2008 Q4	-21.2% 2008 Q4	-27.6% 2008 Q4	-36.1% 2008 Q4	-3.0% 2016 Q4	-2.7% 2015 Q2

[1] Source: Dimensional Fund Advisors

Looking deeper into the U.S. stock market rally, growth stocks continue to outperform value stocks and large stocks continue to outperform smaller ones. Growth stocks tend to do better when inflation is low, because their future earnings do not have to be discounted as much. Large stocks tend to do better than smaller ones when long term confidence about the economy is lacking. According to JPMorgan[2], financial, materials, and technology were the three best industries gaining 8.0%, 6.3%, and 6.1% respectively. Only one sector declined last quarter, health care (-2.8%).

Interest rates plunged during the quarter as investors began to anticipate interest rate cuts. It is somewhat paradoxical to argue that the economy is strong yet continued economic growth requires ever lower interest rates, but here we are. Every category of bonds rose, with riskier ones tending to gain the most. Emerging market debt has done the best this year since lower interest rates reduce the relative attractiveness of the US dollar, causing its exchange rate to decline.

International markets rose last quarter for the most part. Economically speaking, there was a fairly sharp deterioration in the Euro area with Germany contracting the most. In the emerging world, the economies Taiwan and South Korea fared the worst. It is no coincidence that these three countries depend on exports - which were strongly affected by the ongoing trade conflict between the U.S. and China. That said, European stock markets mostly performed quite well due to massive interest rate declines (in many cases to less than 0%!). Russia and Argentina had two of the best performing stock markets in the first half of 2019.

Activity

Given the decline in interest rates and resulting impact on markets, the only "wrong" asset to have last quarter was cash. We reduced the cash position in many portfolios by adding marginally to both stocks and bonds. In bonds, interest rate sensitivity was a positive, so we lengthened duration by adding longer term bond exposure. On the stock side, we increased our weighting to funds that emphasized certain sub-sectors that were thriving – insurance within the financial services sector, payments processing (think Visa, Paypal, and Mastercard) within the consumer discretionary sector, and data infrastructure within the real estate sector (think cell towers).

Outlook

The average person might still be a little skeptical about this year's stock rally, but active investors aren't. A lot of money has been committed to the markets over the last several weeks as Chairman Powell's cooperation is seen as a done deal. How can

[2] 3Q19 JPM Guide to the Market

a professional not be "all-in" knowing a rate cut at the July 31st meeting is all but assured? As such, there is a very real risk that investors will "sell the news" once the cut is announced. Three decades + in this business has trained us to be cautious when we know everybody is on the same side of the trade. While there might be a pick-up in volatility in the short run, we don't see a significant correction as long as interest rate cuts are on the table. In fact, we wouldn't rule out a 1999-style upside blow-off as investors contemplate the possibility of several rate cuts before the 2020 election.

On one hand, despite the U.S. stock market's having gained 20% so far this year, investors are not especially exuberant. If they go all-in on the idea that we will have very low interest rates and unusually high profit margins for years to come (because the Federal Reserve is all powerful when it comes to using monetary policy to fight off recession) we could go much higher. On the other hand, stocks are already expensive based upon historical levels of interest rates and cash flow. If the economy slumps and the Fed is unable to revive it with its monetary tactics (and as a result the "all-powerful Fed" narrative crumbles) the downside could be considerable.

Commentary – How the Investment World Has Changed

Back in the late 1980s, the financial industry was firmly convinced that the stock market was efficient. In other words, if a stock sold for $50 per share, you could be sure it was worth $50 per share, because if it sold for $47, investors would rush to buy it and if it sold for $53, they would sell it. Another name for this process of determining a stock's intrinsic value is *price discovery*. Insider trading grabbed headlines because the only way to outperform the market was to discover something about a company or its industry that was not common knowledge and therefore not priced in. As a result, large investment firms sought preferential access to company management, while less well-connected analysts either pored over financial reports or made visits to a company's suppliers and customers.

By the end of the decade, however, investor behavior had dramatically changed. Internet mania was in full swing. Conventional analysis could not explain why investors should pay three-digit prices for companies that were losing money, yet that is precisely what they did. Almost nobody was still selling overpriced companies short - to do so was financially suicidal.[3] After all, while there was no value-based justification as to why PMC Sierra (PMCS) was trading at $140, you couldn't be sure it wouldn't go to $160 or even $200. Price was a completely separate thing from intrinsic value. As such, it might be reasonable to buy PMCS if it broke above $150 (thereby

[3] A short sale happens when an investor borrows shares from another market participant and sells the shares prior to hopefully buying them at a lower price at some point in the future. At its core, it's a bet the stock will decrease in value.

confirming that momentum was intact) but you certainly wouldn't buy it at $90 (because that price would only be reached if something disastrous happened to the stock or the market as a whole, in which case the stock could go a lot lower). And that is exactly what happened, not just to PMCS but also to Palm and Sun Microsystems and Lucent and ADC Telecom and so many more.

Warren Buffett likes to say that when stocks drop he rejoices like other people do when peanut butter or dish soap prices drop, because he can buy more and save money. And that makes intuitive sense; everybody should want to buy low and sell high, right? Not anymore. It has become a buy high, sell higher world. A low price suggests there is something wrong with the company; perhaps it can't compete in today's digital world. A high price means just the opposite. Companies can make their stock appreciate, even to comically high levels, if they can control both the float (number of shares available to be traded) and the narrative (the commonly held idea about how a company will perform in the future, largely as a function of how it is positioned to benefit/suffer from the way the world is changing).

When a company's narrative matters way more than what its financial statements say, there is tremendous room for error. Though it isn't a company, let's think about Bitcoin. The Bitcoin narrative is that it is the currency of the future. It rose exponentially a couple of years ago because while nobody could really tell you what it was worth, *everybody knew* that in the future we'd probably all be using it. Who was to say it wasn't worth $15,000 per coin? Or $50,000 for that matter? Yet when the narrative broke (because fears grew that world governments were going to outlaw it) and it started falling in earnest, there was no natural level that would support it. Would it stop at $7,000? $4,000? $100? Who knew? As Ben Hunt wrote in Epsilon Theory[4], "the only determinant of price for a non-cash flowing thing is Narrative".

By contrast, a bond gives you a series of payments and then at maturity you get your principal back. You can use basic math to put a value on that income stream. Similarly, companies generate a stream of revenue through sales. If this revenue exceeds the cost of generating it (including taxes and depreciation), you can put a value on the excess cash flow (we call it earnings or net profits) whether they are used to pay a dividend or buy back stock or simply retained on the balance sheet.

Investment assets are generally valued on the basis of the present value of all expected future cash flows. Cash flow should, theoretically, temper one's ability to attach a ridiculous valuation to a stock because you can always use math to determine what future cash flow expectations are embedded in the stock. This is something you

[4] Epsilon Theory – The Spanish Prisoner, 07/05/2019

cannot do with a Picasso or a 1955 Mickey Mantle baseball card because they are non-cash flow producing assets. Occasionally, however, investors make outlandish projections about the future growth of a company because they fall in love with the narrative[5].

The valuation today of Beyond Meat, for example, suggests investors expect a very high growth rate, persistently generous margins, and very little competition. Yet the essence of capitalism is that if a new company takes the market by storm it attracts competitors which fight it for market share and depress profit margins. The fundamentals cannot in any way justify a price which as of 7/12/19 is 100 times sales. Nevertheless, a small float and an extremely enthusiastic narrative have pushed it up over 6-fold since the May 2019 IPO. Beyond Meat, along with Tesla and Uber and most of the cannabis companies and many other nonprofitable companies now public, constitute an increasing share of today's stock market. Yet they trade at valuations that may have very little support if market sentiment should turn negative.

Don't get us wrong, our world is changing rapidly and those firms that can innovate or position themselves to benefit from the innovation of others may well have a very bright future. But words like "disruption" are being thrown around like "clicks" was twenty years ago (especially in the private equity sphere). We are again, we fear, over-projecting the rate at which the world will change. In doing so, we expect profits from new disruptive companies to arrive sooner and be larger than they probably will be.

Investors believe that low interest rates are their friend because they enable securities to trade at higher prices - because the present value of future cash flows is higher when interest rates are low. The problem is that low interest rates destroy market discipline. PMC Sierra and Bitcoin could not thrive in a high interest rate environment because investing in non-interest-producing assets gets tougher as rates rise[6]. Low interest rates are enabling private companies to get financing without going public, and when they do go public it is under terms (often without voting rights and at aggressive valuations) that are designed for *speculators*, not *investor*s.

Previously in the financial markets (floor traders, high liquidity, proprietary trading desks, low investment turnover, etc.) encouraged price discovery, which favored stable prices.

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[5] Thirty years ago, stocks that ran way ahead of intrinsic value would have been sold short. Today, new companies often offer to the public a small fraction of the stock issued, with insiders holding onto the majority of the stock. This makes shorting very difficult, because being "squeezed" (or forced to buy back the stock at a higher price) is a significant danger when the "float" is small.

[6] If interest rates are 2%, for example, I forego very little income investing in something that pays 0%. I just have to believe it will appreciate more than 2% annually. If I believe it will appreciate 10% annually, and my borrowing cost is 3% over short term rates (2%+3% = 5%), I would be justified in leveraging my exposure to that asset. If, however, interest rates are at 6%, the equation is very different. I have a much more significant income penalty to make a non-yielding investment. Leverage is so expensive (9%) that the investment is hardly worth the risk.

Today's market structure (high turnover, algorithmic trading, low institutional liquidity, etc.) has evolved to favor momentum trading, <u>which is inherently MORE risky even though it is usually LESS volatile</u> on a day-to-day basis.

Rising stocks keep rising and falling stocks keep falling. Intrinsic value is meaningless. When a stock goes up steadily for a long period of time, we tend to see it today as less risky than a stock that has been choppy and/or gone mostly sideways because we have learned to focus on an asset's price trajectory - not on its value at the current price. In doing so, we risk dramatically overpaying when the investment climate changes.

We are doing our best to be sensitive to the current (bullish) narrative while also being aware of how quickly investor attitudes can change. Momentum can suddenly reverse. We believe we've done a good job lately of participating in the low interest rate/disruptive technology led bull market. That said, knowing the risks as we do, we will get defensive from time to time as the factors that are driving the rally appear to weaken. It's a balancing act, and we are never going to get it perfectly right, but we believe it is preferable to exposing oneself to the steep periodic losses that a buy-and-hold approach offers.

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