JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 84• Summer 2019**

> *"Many investors prefer comfort, chasing what is popular and loved, rather than pursuing what is out of favor. The markets do not reward comfort."*
>
> *Robert D. Arnott*

Stocks posted solid gains in the second quarter largely due to a shift in the Federal Reserve's appetite for interest-rate cuts. The policy change has resulted in market strength that has erased steep losses from the fourth quarter of last year and prolonged the more than a decade long bull market for stocks. After nine interest rate increases since late 2015, the Powell led Federal Reserve is expected to cut interest rates this month by 0.25% – 0.50%, depending on various economic data points. The S&P 500 posted the best first half since 1997 (+17% on a price return basis) and the best June since 1955 (+6.9%). For the first half of the year the markets were led by technology (+26.20%), consumer discretionary (+20.99%) and industrials (+20.2%). The laggards for the first six months were healthcare (+7.12%), energy (+11.13%) and utilities (+12.82%). All of the major S&P sectors closed the first half with positive returns.

The benchmark S&P 500 index has risen despite an escalation in the U.S.-China trade fight along with mounting fears of a global economic slowdown that has pushed bond yields down globally. The yield on the 10-year U.S. Treasury closed the quarter at 2%, nearly a half-percentage-point drop from the end of March, a downward move that took many investors by surprise.

Index	2019 2nd Qtr	2019 YTD
DJIA	3.21%	15.40%
S&P 500	4.30%	18.54%
S&P Mid Cap	3.05%	17.97%
Russell 1000/Growth	4.64%	21.49%
Russell 1000/Value	3.84%	16.24%
Russell 2000	2.10%	16.98%
NASDAQ Comp.	3.58%	20.66%

Growth stocks (Russell 1000 Growth) led value issues (Russell 1000 Value) for the first half by over 5% and large caps (S&P 500 index) outpaced the small and mid-caps for the six months year to date. Long term treasury bonds (+10.85%), investment grade bonds (+9.57%) and gold (+10.16%) all turned in respectable first half returns.

Fed Up

On November 25th in 2008 in the wake of the financial crisis, then Fed Chairman, Ben Bernanke, announced his first round of "quantitative easing" or QE. Bernanke was fighting a weakened financial system and had few tools left to jump-start the economy and strengthen the financial system. The traditional Fed ammunition was to lower interest rates, but as rates approached zero, Bernanke implemented QE where the Federal Reserve proposed to buy up to $600 billion of agency debt and mortgage backed securities. In late 2015, some seven years after the financial crisis, the Fed began the "rate normalization" process, The Fed raised interest rates nine times, with the last rate increase in December 2018. As you likely recall, with rates rising, the markets began to panic with the S&P 500 index falling 20.2% from the late September 2018 peak until the December bottom. December 2018 was one of the worst eleven months for the stock market in fifty years. Market participants believed that the higher rates, coupled with the tapering of the Fed's balance sheet would result in a recession and lower corporate profits, especially with the uncertainty around trade. Jerome Powell was berated by the media and President Trump. On December 24th, 2018 Trump tweeted, *"The only problem our economy has is the Fed. They don't have a feel for the Market, they don't understand necessary Trade Wars or Strong Dollars or even Democrat Shutdowns over Borders. The Fed is like a powerful golfer who can't score because he has no touch –he can't putt!"* After all the markets had become addicted to easy money and anything other than "easy money" would be construed as a "policy mistake". Starting with the "Greenspan put" followed by the "Bernanke put" and finally the "Yellen put" the markets needed to be reassured that the Fed had their back and that they would provide a safety net for the markets when needed. As expected, after a valiant attempt to normalize rates, Powell succumbed to the pressure and is now expected to cut rates by 25 or 50 basis points this month.

As the Fed fights a slowing economy, some economists wonder if there are enough bullets this time around to jump start growth. With rates at 2.25% the Fed has less than half the ammunition it had in 2007. In 2007 the Fed balance sheet stood at $.8 trillion, now it is $3.6 trillion. Corporate debt has skyrocketed as debt has taken the place of equity on many corporate balance sheets (due to low borrowing costs) rising from $4.9 trillion to over $9 trillion today. What will the Fed do if lower rates fail to stimulate growth? While the lower boundary for interest rates was typically considered to be zero, that is no longer the case today. Today there is over $13 trillion in debt in the world with "negative yields". On July 9th, 2019, the German 10-year bond yielded a negative .36%. Negative interest rates go against everything we have come to believe about money. Essentially every money market investment from bank deposits to the most complex financial instruments involve risks. As investors, we want to be compensated for that risk, and the compensation is usually described in terms of an interest rate. With negative interest rates when one makes a deposit, they will not be compensated for the risk we are taking, but we will have to pay a risk premium for making that deposit. As Jim Grant from *Grant's Interest Rate*

Observer stated, "Radical monetary policy begets more radical policy,". "It seems to me, at some point, markets or voters will put a stop to this." Hopefully Mr. Grant is correct, negative interest rates are not stimulating the economies in Europe or Japan—there is no reason to believe they will work here in the U. S.

Random Investment Musings

What's an investor to do? The old Wall Street adage of "don't fight the Fed", which was coined by the late Marty Zweig, still remains relevant and we would be naïve to think otherwise. An easy Fed usually translates it into higher securities prices and most investors and traders are now in "risk on" mode. There is nothing like "higher prices" to get the speculative juices flowing. From the lows on December 26, 2018 the market has rallied approximately 28%, largely based upon the perception that the Fed would begin to lower rates, so we would surmise that the "easy money" has likely already been made.

Being 62 years of age (I often consider myself a dinosaur in the investing world) gives us what we believe to be a distinct advantage in managing client portfolios—we remember past cycles. We remember speculative manias; we remember how tough a "bear market" is and we remember how investors react to an "easy money" Fed. We remember the 80% drawdown in the tech heavy NASDAQ in the period from 2000-2003. We remember tech favorites Cisco Systems and Intel at over $80 and $75 per share, respectively in 2000. While Cisco and Intel are wonderful companies both are trading over 30% below their all-time highs some nineteen years later. Having experience in the markets reminds us why the price one pays for a security matters. We believe that the "easy money" and zero interest rate policies of the Fed have resulted in most "growth stocks" having valuations that are bordering on absurd. Rob Arnott the Chairman and CEO of Research Affiliates recently stated that "growth-stock valuations are way out of whack and that a mass rotation into lower multiple value stocks is inevitable." Shep Perkins of Putnam Investments in a recent research piece stated: "Today, the valuation spread — the difference between the most expensive and the cheapest stocks — is at one of its widest points in history. The highest price/earnings multiples in today's market, which belong almost exclusively to growth stocks, are extremely elevated relative to the market's lowest P/Es, the bulk of which are in the value universe." We remember in 2000 when most "value investors" were chastised on CNBC for not understanding the "new economy". We remember when value funds succumbed to "career risk" and turned to "closet indexing" strategies in an attempt to stem the outflow of money from their funds. As was the case in 2000, we believe that investors must allocate away from the bubble-like components (sell the market darlings) that are so prevalent today. Over the past ten years many investors have gravitated to S&P 500 index funds for diversification and simplicity. Due to the fact that the index is "market-capitalization weighted" (with the majority of the fund skewed towards growth companies) the index fund could essentially be labeled or characterized as a "growth fund". The top five components in the index are all technology companies. The top twenty-five names in the index consist of predominantly growth issues and make up approximately 37% of the S&P 500 index. Along those lines, in late March Vanguard warned that two of its funds (the Vanguard Growth Index Fund and the Vanguard Mega Cap Growth Index Fund) were no longer in compliance with rules covering "diversified" funds under the Investment Company Act. To be considered diversified, no more than a quarter of its total assets can be invested in fewer than five stocks. As you can see, in the investment world things are not always as they seem.

In our opinion, the current IPO (initial public offering) market also has eerie parallels to the 2000 period. Uber, Lyft and Beyond Meat are all considered to be high quality businesses, yet none generates a profit. Some eighty percent of all IPO's that have recently come to market have no earnings—the highest since 2000. Beyond Meat (BYND) a recent IPO was priced at $25 per share in May and some six weeks later topped $200 per share. Today the market values the company at over $10 billion, larger than eighty S&P 500 companies. BYND, which is a "plant-based" burger company, trades at 35 times sales and lost approximately $30 million in 2018. Obviously, we aren't willing to risk our client's capital in companies losing money and trading at 35 times revenues---particularly when there are bargains to be bought in the market. Just as was the case in 2000, there is a bifurcated market today. While "growth" stock valuations appear excessive, there are plenty of reasonably valued stocks in the "value" universe. We are not having any problems finding companies which we believe are attractively valued and offer what we believe to be excellent risk versus rewards characteristics. As the late Mark Twain once said, "History doesn't repeat itself but it often rhymes." A successful investor must study the past in order to be prepared for the future. We believe our experience in the markets will prove valuable for our clients over the next few quarters.

Summary

Over the past eighteen months the markets have given investors quite the roller coaster ride. Despite the strong start to 2019, stocks have made little headway since early 2018. Small cap stocks, mid-cap stocks, financials and the transports have not confirmed the markets move back to the old highs. While this may ultimately correct itself, it perhaps should be viewed as some type of "shot over the bow" that the current market rally may not follow through. After 20% growth in 2018, S&P 500 earnings growth is expected to be only .2% for the second quarter followed by a .7% rise for the third quarter. While we recognize that we are late in the economic cycle and this bull market, we continue to find value using our bottom-up investment process. With regards to the trade war and tariffs, it is definitely creating economic uncertainty which has a direct impact on capital spending and economic growth. We believe it is quite possible that the market has gotten ahead of the Fed and we would not be at all surprised to see the markets take a pause over the next few months. As always, we will continue to focus on risk versus reward in client portfolios. Please feel free to contact us with any questions, concerns or thoughts. Thanks for the confidence you have placed in Jolley Asset Management LLC.

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