Summary of June 2019 Conference Call

Widespread weakness in the global economy is starting to affect the U.S. Yes, the Fed is thinking about cutting interest rates but, is that a good sign? Absolutely not! It means that the economy is slipping. The likelihood of a U.S. recession has increased but our baseline scenario for the next 6 to 12 months is that GDP growth will slip between 1.5% and 2%. The U.S. investment climate is in a transition from a boom to a sharp slowdown. We can thank the trade war with China for most of the slowdown and the Trump tax cuts wearing off for the rest of it. The latest payroll report demonstrates that the nation's economic output has crested and the slowdown is not over.

Before the Mexico trade tariffs were rescinded, the Federal Reserve was ready to cut interest rates if the trade tensions escalated. After all trade with Mexico is a much bigger deal than it is with China. In response, we have been bullish on bonds and defensive stocks in the past few months. Both defensive stocks and bonds are attractive over the long haul, but the U.S. stock market valuation is once again becoming stretched.

The Trump tariffs remain a risk. After all, the Trump Administration trade tit for tat over migration was so unpredictable it caught everyone by surprise. Who is to say that a similar trade issue doesn't pop up over European cars? In fact, U.S. and China politics could spell further trade tensions as both countries dig in their heels to please their electorate. Although the U.S. stock market has rallied quite nicely since the tariffs against Mexico have been dropped, the demand for defensive assets would return if those or any further tariffs were instituted.

Much of the yield curve has inverted as investors have flocked to safe haven assets such as bonds. This typically spells trouble for the stock market.

For now, we expect stocks to trade within a broad band. Corporate profits may have some heartburn as trade tensions with China continue. The global trade war with China was largely responsible for the decline of the U.S. stock market in May. It has largely bounced back, but we should not expect a quick resolution to the U.S./China trade spat. A U.S.–Sino separation will become a fixture for many years to come. And the U.S. dollar remains overvalued as compared to some other currencies. I tend to think that a further upside in stocks can only happen if the dollar drops and the yield curve steepens. This will happen once interest rates drop. The P/E ratio, a measure of valuation, is currently at approximately 17 for the S&P 500. It would be difficult for that market multiple to expand in a low growth, low inflation world.

Although our baseline calls for a slowing of GDP growth, there is a possibility of a recession. New trade tensions would push any recession forward. However, when an economy moves from a boom to a slowdown, it still feels like a recession even though in technical terms, it is not one. It is hard to tell the difference between a recession and an economy that falls back to cruising speed. Several years ago, we talked about the stall rate, the economic GDP rate in which the economy needs to grow before it stalls out. That rate is 2% and the U.S. economy could easily stall out if growth drops to between 1.5% and 2%. With the help of our colleagues at BCA and Alpine Macro, we are monitoring several pressure points that will help us distinguish between a slowing of growth and a recession. Another item to monitor is any anti-trust actions against the likes of Facebook, Google, Apple, and Amazon. This could reduce capex spending in the tech sector which would knock down expensively priced high-tech stocks.

The U.S. stock market has been trapped in a broad range for 18 or so months with enormous volatility. This suggest that other negative forces have been at work checking the advance of stock prices, bringing down bond yields and stopping the advance of commodity prices.

As I mentioned earlier, the U.S. economy is softening and consumers are more interested in saving rather than spending. Capital expenditure spending is grounding to a halt.

As we said in June 2018, the current Presidential administration's policy toward trade is a negative for stocks. This is why we reduced our equity exposure last year and continues to maintain a 50%-50% split between bonds and stocks.

For several months, we have been advocating a barbell approach to investments with exposure to stocks on one side (50%) and large holdings of safe bonds on the other. We have also purchased gold again as a portfolio protector. This strategy has worked well in the current environment. This strategy makes a lot of sense producing a more balanced approach rather than an all stock or all bond portfolio.

Over the past few weeks, we stepped up our bond purchases in anticipation that the Fed might signal to the market an interest rate cut. This was a good move and we locked in bond yields at a higher rate than what they are trading at today. We also bought a few defensive stocks and one stock that I particularly like.

Luckin Coffee came out in the IPO market at $18 and we bought some shares. Luckin is China's second biggest coffee company outside of Starbucks, but will rapidly become number 1. First of all, as the Chinese government retaliates against American companies in escalating trade tension, a domestic coffee company like Luckin will do well as the Chinese government steps up inspections on Starbucks and the Chines population favors domestic brands. Luckin should greatly benefit.

The DowDupont Spinoff is now complete with the company splitting itself into three different companies. We are buying more of Dow Inc. because it represents good value, high dividends and a very good future.

This spring we reduced risk in the portfolio by taking some profits by selling a portion of PayPal. For those who have PayPal, we kept ½ of the position but sold ½ to reduce risk because this one stock was becoming too large of a position.

I think our stock positions, mixed with our large bond holdings, puts you in a good position. Many of our stocks generate a lot of cash because they pay high dividends and we are in a defensive posture at this moment. However, things change and they change very quickly. If the opportunity arises, we can quickly shift towards a more positive stock exposure. Stay tuned!