"Pot Luck"

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As a kid, I remember my parents and their neighborhood friends had a monthly pot luck dinner (or also referred to as "bring a dish dinner"). Someone in the community hosted the event, and the rest of the neighbors brought various types of salads, entrees or desserts. I used to love these dinners because my Mom made the best stuffed peppers. I am sure the neighbors got sick of them each month, but I would beg my Mom to make them.

In the spirit of my childhood, and because there are so many things I wanted to talk about, I figured I would do my own "pot luck." For you the reader, you too get to pick and choose what you want to digest, and if you see anything that looks intriguing (like my Mom's stuffed peppers), you can dig in.

Before I do that I want to give you a little background on the way I think because some can read my monthly papers and get a sense that I am generally bearish. Honestly, I am not. However, I want advisors and clients to be aware (and hopefully avoid) "left-tail events" like what investors experienced in 1987, 1999, or 2008. It is our jobs as fiduciaries to invest clients money with prudence. With that in mind, my role as Chief Market Strategist is to highlight both opportunities and risk to my partners (the advisors) and clients.

So with that in mind, current economic and market conditions warrant caution, and that's why some of my papers recently highlighted areas that I view as an immediate risk. At some point, that will change. When it does, you'll see me setting a narrative that highlights those opportunities. But for now, I want my partners, and you as clients, to see what's out there, so that none of us are surprised.

"What kind of salad is that?"

As with any Pot Luck dinner, there is always someone who makes a "mystery salad" that either you love, or you say "why in the world did they make that?" Today's "mystery salad" is something happening within the Federal Reserve.

Beyond the normal "Fed speak" that we read about in the Wall Street Journal, the Fed has been quietly adjusting their interest on excess reserves (IOER). For those of you who don't know what the IOER is, it's the interest rate paid to banks for deposits they hold with the Federal Reserve above those required by banking regulation.

Last month the Fed once again tweaked the IOER by a modest five basis points down to 2.35 percent, while keeping the overall target range for the fed funds rate unchanged at 2.25 to 2.50 percent. Fed Chairman Jerome Powell described it as a "small technical adjustment" and that it doesn't reflect a shift in stance on monetary policy.

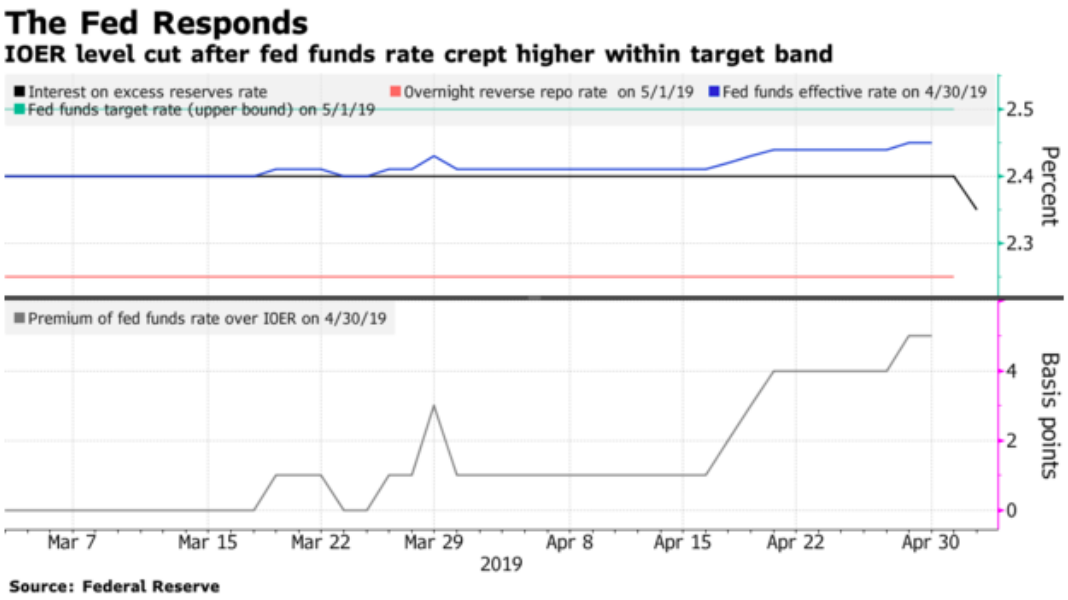
What I find interesting is the effective Fed Funds rate has been trading above the IOER for several months now, highlighting how rates get squeezed higher in other short-term funding markets that banks use for overnight liquidity.

So why were federal funds suddenly in such hot demand? The appearance of spare liquidity sprang back towards the center of the money universe surprising many. It was like any struggling household desperate for any means to keep paying the bills. You use that last credit card tucked far back at the rear of the drawer, the one saved only for emergencies. That's what is happening in the cash space.

Having been the Director of Corporate Cash at two of the world's biggest banks, it signals to me that something is just not right. After all, why would banks supposedly overflowing with capacity, as the Fed tells it, sit there and let the Effective Fed Funds (EFF) rise above that specified rate again and again and again? That makes no sense.

The money market sector is questioning the salad made by central bankers. Since the cash markets are the place where investors run for safety, this side of the market needs to run with capital preservation

and liquidity, no exceptions. Right now, those two things are in place, but there is a dislocation starting to arise that should warrant attention.



Source: Bloomberg and the Federal Reserve

"Oh, I like it when Becky makes that!"

I am not sure what Becky made, but if you are someone who owns gold, then you are very happy with the commodity's recent price action.

Back in early September 2018, the price of an ounce of gold was trading around $1170, only to rally up over $1325 in late February and as of June 3, 2019, sits at $1314. Economic uncertainty fueled by a trade war between the US and China certainly has played a hand, but this is a big move without the help of higher inflation which often has investors running to gold as a hedge. So as I dug deeper into why, only to find some interesting information; or as the late Paul Harvey would say, "And now for the rest of the story."

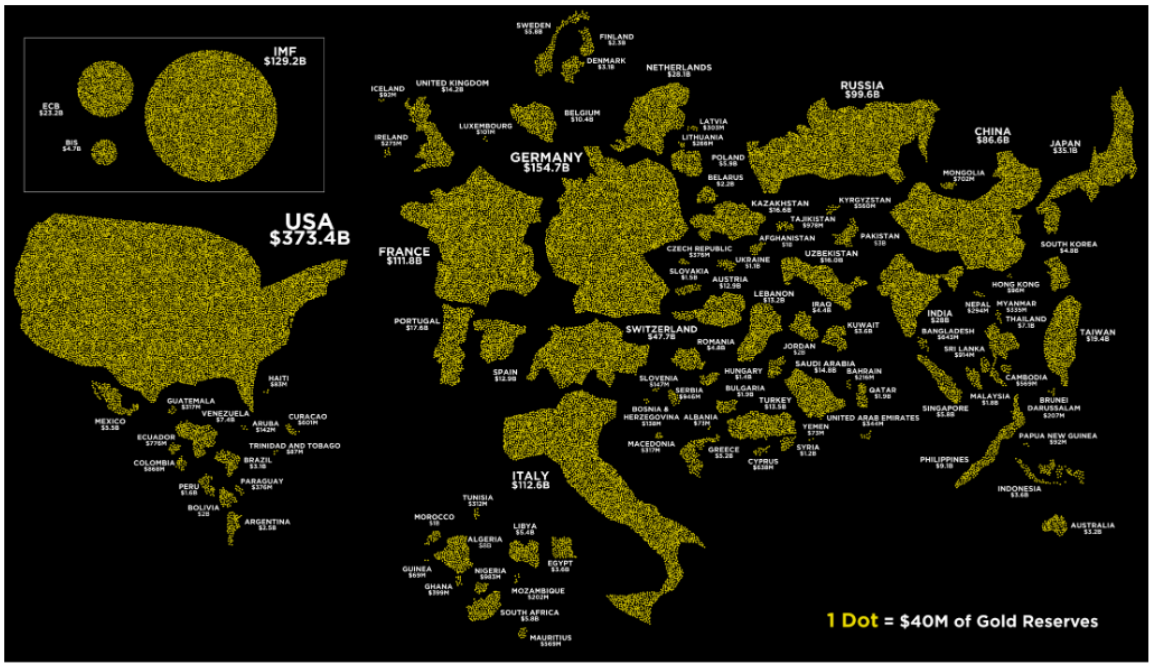
Late last month the World Gold Council published its quarterly report and what it showed was fascinating. The report indicated that central banks and foreign governments from around the world are buying up gold at their fastest pace in six years.

Remember that central banks and foreign governments hold trillions of dollars in US reserves. They do this by buying Treasury bills, notes, and bonds. Due to its liquidity, big institutions like banks use US debt as a form of cash to do things like repurchase agreements (Repo's) or to use as collateral for derivative trades.

But, foreign governments over the last few months have started breaking with the tradition of buying treasuries. Instead, foreign governments and central banks have been buying a lot more gold over the

last six months. According to Bloomberg, net gold purchases in the first quarter of 2019 were up nearly 70% over 2018 at the same time.

It should come as no surprise; the Chinese have been stockpiling gold faster than ever while contemporaneously being net sellers of US treasuries. But they are not alone, Russia, Turkey, Qatar, and Columbia also have been diversifying and buying a lot more gold.



Source: Howmuch.com

Lastly, with both US political parties at a loss on how to control spending and the Congressional Budget Office forecasting deficit spending of 1 trillion dollars until at least 2021, anyone with a pulse can figure out the debt burden in the US is growing at a rapid rate. So maybe those countries want to hedge away some US currency and debt risk by accumulating more of the “bling” (my words not theirs).

So, currently that seems to be a dish that a lot of investors like.

“That looks like some kind of foreign dish.”

If you invested in an overseas fund that has large exposure to Japan, you have probably seen a decline in the NAV over recent months. That’s because Japanese bank stocks hit a new, unwanted record last week; the dividend yield on the Topix banks index rose above 4% for the first time since 1973, according to Refinitiv data.

This record is not because boards are returning excess capital to shareholders; nope, this is mostly due to falling stock prices. As of this week, the country’s banking sector is trading for just 40% of book value (source; Bloomberg), the cheapest of any major market.

If an investor is a contrarian, it would seem that potential opportunities await those who believe that all of the bad news is reflected in the current price of these stocks in addition to there being ample time to see the potential turnaround.

If you read my "Saved by Zero" paper a month ago, you will remember how I talked about the negative feedback loop that the Bank of Japan is now in with a thirty-year zero interest rate policy. Like Europe, low to negative rates are one of the biggest threats to Japanese banks as the central bank tries to boost inflation. But low or negative rates drag down the gap between what banks pay for deposits and what they charge for loans (asset/liability spread). Plentiful liquidity from the central bank also increases competition between banks to lend, thus lowering lending rates (sound familiar?).

To broaden their lending base, Japanese banks have been financing risky loans in the U.S. and Europe by through collateralized loan obligations (CLOs). Over the last five years, Japan's banks have been essentially flat in their domestic loan books while their overseas books have grown by approximately 30%.

What could go right for these banks? Well, higher bond yields would again allow them to make money on loan spread, but that seems to be a few years off in the distance. The banks are selling at an extreme discount to their book value, so those fundamental investors may start to nibble into this sector on a purely relative value play. Lastly, merely avoiding further bad news might be enough to boost the value of this sector in Japan given their price.

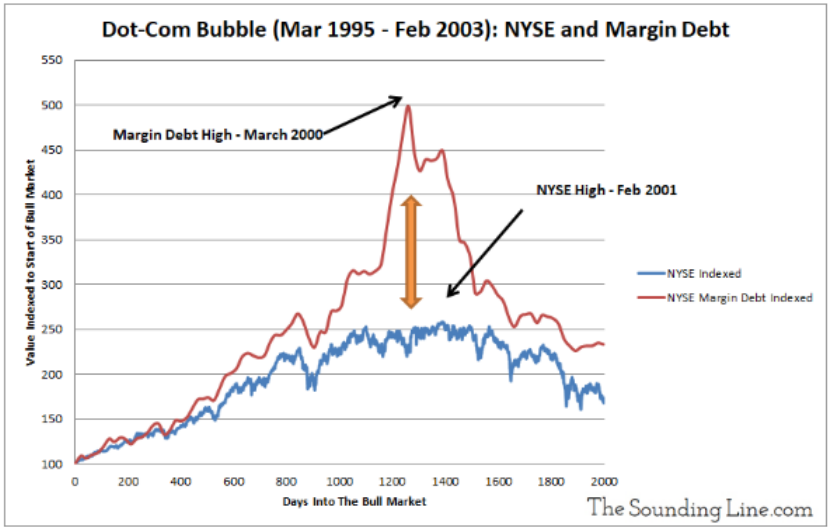
The path to perdition is long for these banks, but there are opportunities for hope for those who have the capital to roll the dice.

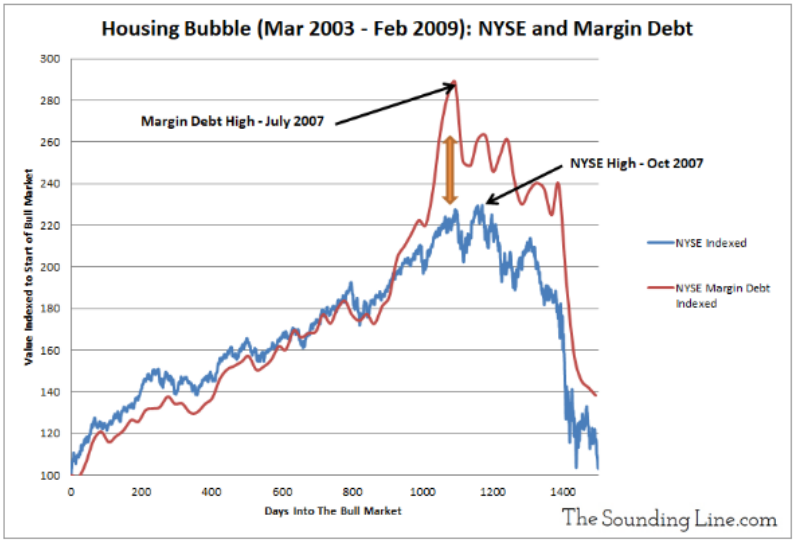
"Oh no, that food makes me gassy!"

Something that should make all of our stomachs a bit upset is what most seem to think is a new high in margin debt on the NYSE.

Interesting fun fact (yes, sarcasm included), in April of 2017 margin debt on the NYSE surpassed the $500 billion market for the first time in history, provoking concern about the risk it posed. Now, historically speaking the key to evaluating margin debt relies not only on its absolute levels but in comparing margin debt growth with the underlying stock market performance.

When one views historical charts (below), you can see that margin debt peaked about one year before the high on the NYSE during the dot-com bubble and about four months before the high during the housing bubble. In both cases, growth matched the growth in equity prices for most of the bull market until margin sharply outgrew the NYSE, and then the market subsequently collapsed.





Source: Soundingline.com

Since 2017, the NYSE stopped publishing margin debt data and removed all historical data from their website. However, that data continues to be published by the Financial Industry Regulatory Authority (FINRA). Based on their data, something interesting is happening.

In May 2018, margin debt grew to a record 669 billion dollars only to drop back down to $554 billion after the market pullback in December. Margin debt at the end of February 2019 (most recent data) shows that margin debt started to climb higher and stood at $581 billion.

Based on data I have seen, it doesn't appear that a surge similar to the Dot-com or Housing bubble has happened. But margin debt levels are elevated and if they start to outpace market growth investors would be wise to consider that a warning flag for pending volatility.

"There is only so much room on my plate."

At the risk of sounding like a broken record, the Fed has become too concerned with the recent events in the bond market and the current yield curve. If you read my weekly market updates, you'll know that parts of the yield curve have been inverted since last November. Now, the key 10-year yield is below the 3-month T-bill.

According to a recent article in Forbes, the track record on inverted yield curves preceding U.S. recessions since WWII is nine for nine (or 100% -). If "old tapes play" there is no reason to think this time will be different — currently, the yield curve is inverting around the world. European, Swiss, U.K., and Canada all have inverted on the short end of their curve. Hong Kong's yield curve is inverted along almost its full length. Japan and South Korea's curve isn't curved at all; it's as flat as a two by four.

Some have said that the yield curve has lost its predictive power. Mohamed El-Erian at PIMCO (for whom I have great respect) has said on CNBC that he is not worried about the inverted yield curve. Over at the Fed, John Williams and Randall Quarles have both argued that the yield curve signal is "distorted by central bank interventions." They also say that the yield curve signal is not as powerful as it used to be and doesn't need to be taken seriously.

All of that may be true since central banks are so entangled in their monetary maze that only they know how they are going to unwind all of this. But if history is any guide, those claims need to be taken with a grain of salt. What matters most is the market is pricing in significantly lower interest rates to come.

Now, I admit bias to the bond market as a predictive indicator of the forward economy. I have been in fixed income for the better part of 25 years. So it's kind of like that little voice in my head that tells me I don't need a second helping because I am 51 and it will go right to my waistline. That voice has worked in both instances, and I am sticking with it.

"So many desserts, which one do I choose?"

The market has just closed out the first quarter profit numbers, and it's a little like dessert at a pot luck table, you only have so much room, so you better pick the right one.

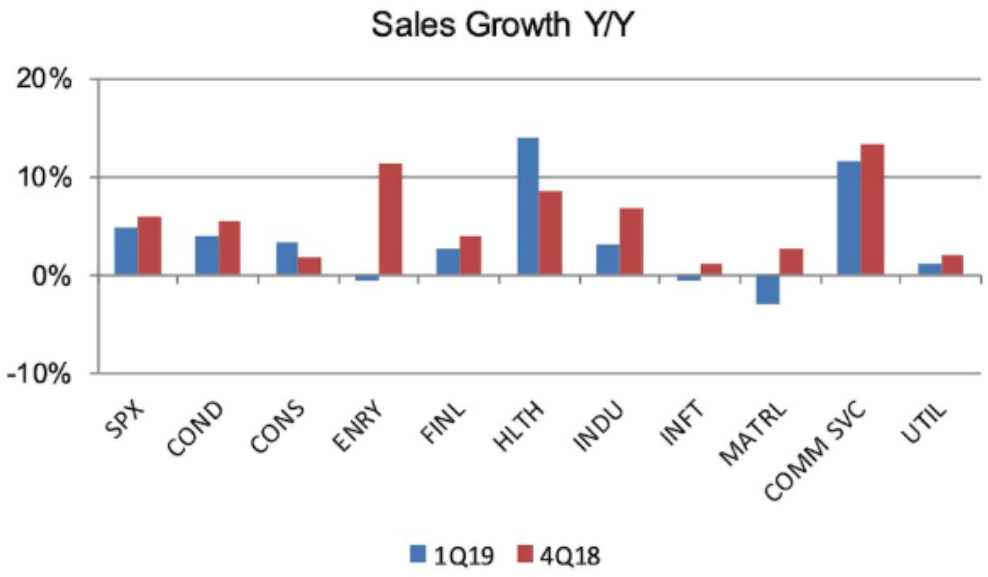
The good news for investors is all of the S&P 500 companies have reported earnings, and the results are; 1) the numbers came in slightly better than expected and 2) Bloomberg reported gains of 1.5% in the first quarter which was better than companies in the EAFE (Europe, Australasia, and the Far East) which only rose 0.5%.

So the headline number looks okay. But under the surface companies are grappling with slowing global growth and the perpetual uncertainty of US vs. World trade negotiations. And like picking the right dessert, corporate earnings health showed significant strength or weakness depending on the sector of the company.

As an example, only six of the S&P's eleven sectors reported positive year-on-year earnings growth – with only one rising double-digit percentage rate. That compares with a respective then and seven

sectors, respectively, in the fourth quarter of 2018. Specifically, real estate and utilities were the only sectors to have recorded strong quarter-over-quarter growth.

Another interesting note is that earnings growth trails sales growth for the first time since the first half of 2016. S&P 500 sales have increased by 4.4% during the first quarter compared with the same period last year, with the healthcare sector leading the pack. That compares with profit growth of only 1.5% versus last year.



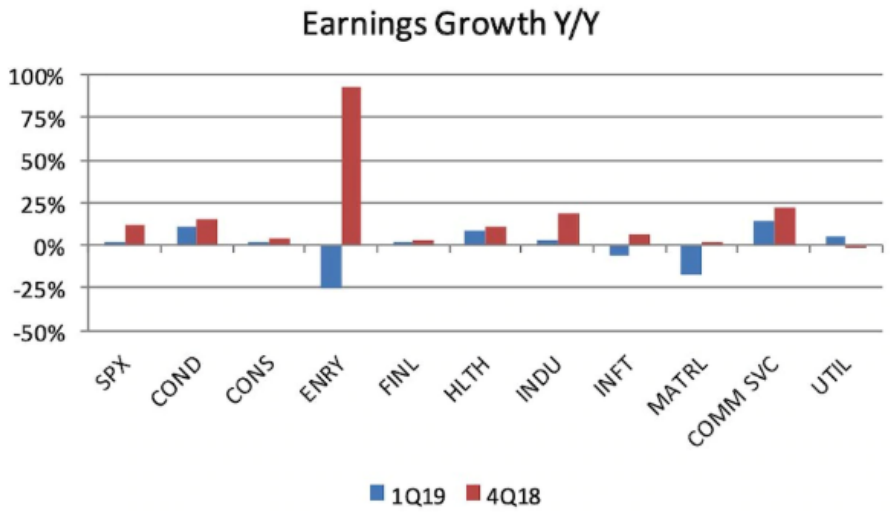


Chart Source: Oppenheimer Asset Management

Should this trend continue, it is likely to mean that a broader market will narrow and stock or sector picking will be at a premium. In a world of index ETFs that have done so well over the many years, we

may be transitioning to a later stage market in which active managers could outperform against a benchmark index.

Dessert for thought.

"Who's hosting next month?"

As we move into the summer trading, market volumes tend to be lower, and volatility tends to be higher (past market performance is no guarantee of future market performance). So it's important to know that regardless of good or bad economic conditions, the summer can be choppy.

While the kids are at camp or you get a little summer vacation, it's always a great opportunity to reach out to your LCP adviser and discuss your current portfolio and any financial planning needs you may have. Before you know it, the summer will be over, and we will all be "man or woman on fire" again just trying to get through the day.

I will be back in about a month or so with a different plate (sorry but they are not my Mom's stuffed peppers because you would have loved them), but hopefully just as easy to digest.

Have a great summer.

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