EXECUTIVE SUMMARY

Fall 2019

Our investment view remains neutral. China trade tensions combined with other factors, (e.g., Iran, Hong Kong, impeachment) are keeping markets within a tight range. At the same time, the Federal Reserve has pulled out all stops to prevent a recession. Quantitative easing (even though the Fed is not calling it that) is again in full force. The Fed is committed to buying short term bonds and similar instruments to the tune of sixty billion dollars monthly through at least January 2020.

MARKET DEVELOPMENTS

As I've often mentioned in these letters, markets eventually return to the mean. What has worked in markets in the past will not necessarily work in the future and vice versa. Over the past decade, momentum stocks have greatly outperformed fundamentally based value stocks to the point that the discount between momentum stocks and value is the largest in history. Here is a recent quote from Marko Kolanovic, noted quantitative analyst at JP Morgan:

> "The extreme divergence between value stocks on one side and low volatility and momentum stocks on the other side reached levels never observed in history, even including the tech bubble."

This kind of a scenario can work for a very long time before some kind of trigger changes it. He continues:

> "This was implemented in directional sector plays such as long software, short smid [small-mid cap] oil and natural gas stocks, etc. Many platform risk management systems don't have a good ability to capture factor risk, and hence it was possible for PMs [portfolio managers] to implement these long-short trades with very high leverage. These trades worked well until the rotation started, and now are in the early stages of a collapse."

The bottom line is that a rotation to value stocks may be developing in the markets. Wall Street is often referred to as the "herd." There's a reason for that. Stocks that go up continue to go up because Wall Street players have a tendency to follow each other in the same direction until they go off the cliff. When this eventually happens, value stocks that have underperformed will greatly outperform those momentum stocks. This took place during the stock market crash of 2000-2003, which followed the momentum based internet bubble of the late 1990's. The Nasdaq 100 index, which is greatly momentum-based, was down about eighty-five percent from peak to trough concurrently with many fundamentally value-based small companies being up. The unknown is whether the impact from revived quantitative easing and other unprecedented adjustments supplied by the Federal Reserve and other Central Banks will be able to save the day once again. Short-term rates are declining again at a time when the yield curve is starting to steepen. This is generally positive going forward—except at the beginning of a new recession.

THE ECONOMY

The LEI, an index of leading economic indicators, is still positive and rising, and no recession has ever started while this was increasing. Unemployment is still near record low levels. Manufacturing has been declining, and much of it can be blamed on the uncertainty of trade tariffs with China. Consumer confidence levels are still high, but are sending warning signals. Mortgage rates have been declining, and this is a positive for the housing market. Other economic indicators are a mixed bag.

SUMMARY

The current question is whether the Federal Reserve and other central banks around the world can continue to hold off recession, while at the same time, stocks in the US are near their most overvalued levels in history. Right now, that answer is unknown and our view remains neutral.

As mentioned many times, holding cash can be part of an overall portfolio strategy. Cash holdings earning close to 1.75 percent annually are quite competitive compared to other asset classes without the same volatility stocks and bonds may have.