January 21, 2020

The Expansion Rolls On

Dear Investor:

The stock market finished the year strong with the S&P 500 up a bit over 9% for the fourth quarter and over 30% for the year. Although that does seem amazing at first glance, we need to remember that the market ended 2018 on a very low note. If we look back to the previous high points in September of 2018, the S&P 500 is up a little more than 10% over the last 15 months, which makes a lot more sense. Another important point to add perspective is that most of the increase is due to multiple expansion. Actual earnings have been flat to slightly down for the first three quarters of this year, and the fourth quarter is not expected to be much better. If it seems like I'm throwing some cold water on things, I probably am. A big number like 30% taken in isolation makes things look much better than they are. I believe the combination of three interest rate cuts, and some hope for improvement on trade late in the year, were enough to keep us in the black.

One of the issues we discussed in my last letter "Thin Ice" was the manufacturing sector. Since that was written, things in the sector have actually gotten worse. The ISM Manufacturing Index has been in negative territory for five months in a row now and ended the year at a 10-year low. The last time the reading was that low was in June of 2009 at the end of the Great Recession. So, you can see, they have taken a pretty hard hit. It's also true that the problems at Boeing with the 737 Max program have contributed to the poor showing in the sector. There is so much business connected to Boeing and the 737 Max, that their problems may actually lower the GDP numbers.

As you likely know, there has been some progress on the trade war. We have made a deal with China that has been called Phase One, and was signed on January 15th this year. The administration states that China has agreed to increase purchases of American goods and services by $200 billion in each of the next two years. They also say that many of the other unlawful trading practices have been addressed. In exchange, we have agreed to ease some of the tariffs we have imposed, while leaving others in place. They also state there are remedies in place to address shortfalls in performance by China. They are planning to start negotiations on Phase 2 immediately. There's no way to know if both parties will perform as expected. If they do, it is supposed to add as much as +0.5% to our GDP. There is also hope that this will increase growth in other parts of the world, as the US and China account for almost 40% of total world GDP.

In another development, the Treasury has announced they are bringing back the 20-year US Treasury Bond. This was retired back in 1986. The purpose is to help fund our ever-growing deficit. The issue already has strong investor interest, as it's a nice time frame for institutions with long term liabilities to fund. Speaking of the deficit, the non-partisan CBO has forecast a deficit of over $1 trillion for fiscal 2020. Speaking in general terms, in the past when unemployment was low and the economy was good, as it is now, we reduced our deficits. These were the times we made some effort to get our house in order for the next time things turned down. In other words, this is the time our deficits should be decreasing. Some of the smartest money managers in the world think our deficit could easily explode to over $2 trillion in the next recession. In today's world, no one seems to care about budgets and deficits anymore. This is a big mistake that will eventually hurt our economy. There's no free lunch.

In another monetary development, you may be aware that the Fed has started to add to their balance sheet again. Back in September there were serious problems in what's called the overnight repo market. I'm not going to attempt to explain this as it's very technical in nature. The relevance to us is that in order to solve these repo funding problems, the Fed has begun to add reserves to the banking system again by buying short term US Treasury paper. Thus, they are expanding their balance sheet again. There is vigorous debate in the financial community if this is considered Quantitative Easing (QE), the one and the same QE that we just stopped a few years ago. The Fed insists not, as they claim this is at the short end of the yield curve and only for liquidity purposes. Many in the financial world aren't buying it and insist we are back into QE. I don't have the answer on that one, but perhaps we will understand it better in the coming months.

Turning last to the outlook for this year, the consensus of opinion seems to be that the economy will continue to move forward. The latest forecast from the Federal Reserve's FOMC is for 2% growth in 2020. As stated earlier, earnings for this year will likely be flat or down, in the range of $162. For 2020, the SP500 earnings are expected to be around $177 - $178 for the year. This is the consensus, the major firms each have their own estimates. A significant amount of this earnings growth is likely already priced into the current market as the S&P500 has risen to over 3,300. Right now, it's expected to end the year around 3,500, which is up another 5% - 6%. I want to stress as always; nothing is guaranteed in investing and no one knows the future. I've always said that projections and $3 will get you a cup of coffee. This is the current outlook and anything could change it. Most of the major financial firms are putting the odds of a recession at around 35%. It was higher before the interest rate cuts. Thus, you could reasonably conclude that the rate cuts have provided some insurance and additional protection against a downturn. As in October, the biggest headwinds are still considered to be the China trade situation and the global slowdown. If these improve, growth could come in higher than 2%.

Please contact me anytime to discuss your portfolio.

Best regards,

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