GVA Newsletter

February 2020

And Then What?

"The fundamental business of the country is on a sound and prosperous basis." - President Herbert Hoover 1929

"The United States is in the midst of an economic boom the likes of which the world has never seen." - President Donald J. Trump 2020

"Stock prices have reached what looks like a permanently high plateau." - Irving Fisher - Yale Economist 1929

"The Boom Bust Cycle is Over." - Bob Prince Co-CIO of Bridgewater – Leading Hedge Fund 2020

It is a new year and a new decade. There are so many "interesting" things going on in the world of human affairs right now. To say that we are living in an age of extremes would be an understatement. A close reading of the quotes above may be instructive particularly if you consider the dates. It is right when things are about to change for the worse that we are most confident and least fearful. This is part of the nature of cycles. Another takeaway is that it is best to take what comes out of the mouths of politicians, and so-called economic experts with a grain of salt.

The turn of the year is a great chance to step back and look at our world and assess, and then make plans for the future. We have updated our goals for the upcoming year and decade and hope you have too. In fact, our first order of business is to suggest that you send us your most important goals and we will help you create a way to keep them present going forward.

Last year was one of the best years for financial assets in general. Remarkably the S&P 500 was up 30% even though profits declined for the underlying companies as a whole. Apple stock was up 84% while their revenue was up only 2%. What happened?

After a brief attempt in 2018 to normalize interest rates and reduce their balance sheet, the Fed reversed course, lowered rates and injected more liquidity into the markets. In the last months of 2019, the Fed flooded the repurchase market with liquidity - $65 billion per month which continues today. For the time being market participants are still in "risk on" mode, so with that infusion, we saw a big move higher in markets from the end of 2019 into early 2020. As we have said before, the longer it goes, the worse the outcome we expect. When the Central Bankers pump more liquidity into the economy, encourage more borrowing, creating unsustainable bubbles in all risk asset prices, we ask: "And Then What?"

Happy New Year and Thanks for Reading

Matt and Tom

"Rather than love, than money, than fame, give me truth." Henry David Thoreau

Executive Summary

Risk Tolerance – To accurately assess investors risk tolerance, you must accurately assess risk. Some wisdom from David Rosenberg.

The Melt Up is Here – In case it wasn't obvious, of the two scenarios we envisioned, we got the second one – the blow-off top or "melt-up". Time to party like it's 1999 – and then maybe get out like it's 2000. A look at what future returns are likely to look like.

The Gap Between Profits and Prices... Has never been larger, and Buffett's favorite measure of valuation has never been higher either. We share a few charts to tell the tale.

Remembering the Past – Tops of markets are marked by confidence – particularly in a subset of stocks. We forget that after the tops these stocks fall too. Let's look at some of the numbers.

Housekeeping: We read many annual reviews and forecasts - these three things stood out:

1. Highly recommend Doug Kass' annual forecast "15 Surprises for 2020" – use the Google.
2. Doc Effrig of Stansberry Research recommends writing 2020 on anything you date – not just 20 as it can be so easily changed. For instance, when you write checks or sign documents.
3. The "Secure Act" has made some important changes that can affect your retirement planning.

Create Your Own Economy Corner: LIVE INTENTIONALLY

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Risk Tolerance
"Exponentially rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways." - Bob Farrell's Rule #4 of investing.

David Rosenberg is an economist and market analyst that we have admired for some time. "Rosie" is how many refer to him. He was Chief Economist at Merrill Lynch and Gluskin Scheff and has now started his own research firm: "Rosenberg Research and Associates." Rosie likes to reference Bob Farrell's wisdom and in his recent post he followed the above quote with several important points to consider in the current market environment:

"Right now it is critically important to get as close to the truth of clients risk tolerance. There have probably never been as many characteristics of a top as we are experiencing today."

"No one knows how far the top is, but what happens after the top does not fit into many people's risk tolerance."

"While I cannot pick the date, I can tell you that this turbocharged debt cycle will end miserably, not unlike 2008 and 2001."

What Rosie is suggesting, is that we are in a bubble that will end badly and that as much as people feel ok with markets rising, the downside will likely feel much worse than they are prepared for. It is our sense as well, that the low volatility rise in markets has created a very complacent investor class. Now is a good time to reevaluate your risk tolerance. Rather than making comparisons to the market or being captive to FOMO – the fear of missing out – it may be better to review your goals and the highest probability path to achieving them.

We have been helping clients find tax efficient ways to responsibly lower their equity exposure. If your allocation to equities is over 50% of your investable assets and you are over 50 years old it could be worth reviewing. Later in the newsletter we will point out why the traditional 60/40 portfolio will likely be a money loser for the next 7-10 years.

The Melt Up is Here
As we write this, the world is gripped by the outbreak of the Corona Virus. Historically, these events are short-term in nature. We have no desire to amplify any fear driven by this health risk and we want to share our thoughts and prayers with those effected.

Many comparisons are being made to the SARS outbreak in 2003 and the time it took to recover. We would caution to not be overly dramatic, or overly dismissive about what is taking place, and continue to learn and pay attention. This is an unpredictable event, but the fact that these types of events do happen is to be expected.

In the monetary world we created central banks to help stabilize markets when the unpredictable happened. Unfortunately, we have been convinced that every ill the economy or market faces should be met with aggressive monetary policy, leaving us woefully unprepared for the day that policy actions are really needed. Just think what it means that we have record low unemployment, a record high stock market, and a President calling for lower, even negative interest rates. Last year the economy seemed to be slowing down, so we cut interest rates. Now we have the potential for a global pandemic, do we have the back-stop that we need to respond?

Over-utilizing monetary policy creates asset bubbles. Rather than curtailing the boom-bust cycle we have exacerbated it. Jeremy Grantham of GMO is considered an expert in the study of bubbles. In 2018 he wrote about what the end of this market cycle might look like and, so far, he has gotten it close to right. He was early by a year, but his work is really calculating the trajectory and magnitude. We included his 2018 chart in our newsletter and here it is again:

Exhibit 4: What it Would Take to Make the S&P 500 a Classic Bubble

Source: S&P Dow Jones Indices LLC, GMO

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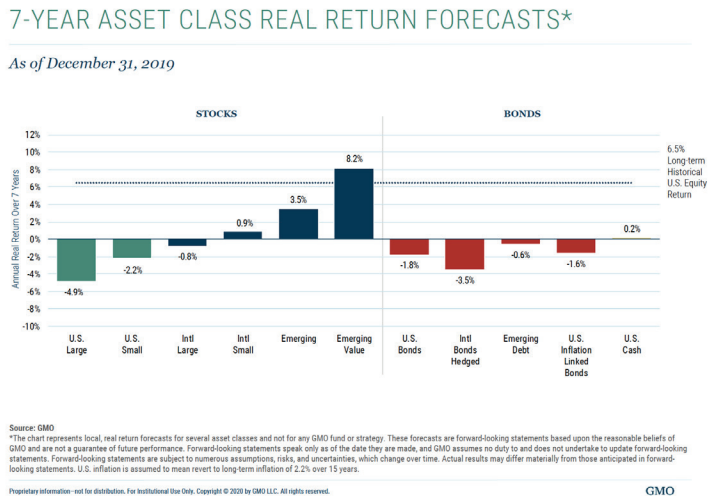
No one knows how this will play out short-term. If one were to update his calculations of a 61% rise in the last 21 months, that could project to the S&P 500 going from a low in December 2018 of 2,400 to the peak of 3,840 by September 2020. Many are talking about this and how to "trade it." Stansberry Research points out that the final rise in the Nasdaq in 2000 was even more extreme. But understand that imbedded in that conversation is that the bubble does eventually pop and everyone is just guessing at when. The range of returns looks to us like 10% upside and 70% downside.

If we return to the world of investing rather than speculating, what GMO has been very good at doing is forecasting returns based on valuation. Below is their recent projection dated December 31, 2019. Note that they expect U.S. Large Cap Stocks to return -4.9% per year for the next 7 years. Yes, that is a projection for the market to lose 5% per year for 7 years. In 2000 their forecast was for the market to lose 2% per year for the next 10 years – it actually lost 3.5% per year as we outlined in our last newsletter.



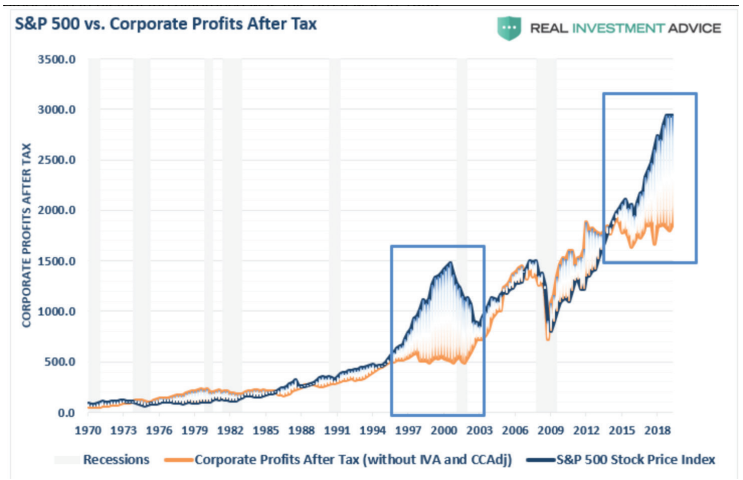
We think that what will become clear to everyone eventually is that monetary policy has limits and we are likely at those limits. The economy is barely growing, profits are not growing, prices are moving higher.

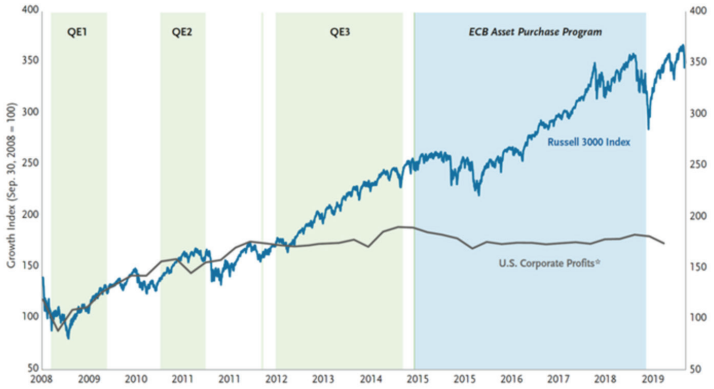
GDP growth was 2.3% in 2019. During Jimmy Carter's Presidency, GDP Growth was 4.6% in 1977, 5.5% in 1978 and 3.2% in 1979, the year that was considered the great malaise that ended his Presidency. President Trump is calling this the greatest expansion ever. And some people are believing him. This whole set-up feels pretty ominous.

The Gap Between Profits and Prices

Every day we see another version of the same story. Prices up, fundamentals not so much. Since 2012 we have seen asset prices outrun fundamentals. Let's just look at a few charts:

The first two charts are comparing profit growth to the S&P 500 and Russell 3000 indexes. Profits are pre-tax profits adjusted for inventory valuation and capital consumption. The in the first chart you can see that the spread between profits and prices is larger than in 2000. The second illustrates better how QE3 and Trumps tax-cuts boosted stock prices but profits have not budged since 2012:





The next chart is referred to as Warren Buffett's favorite measure of market valuation - Market Cap-to-GDP which is now higher than 2000:

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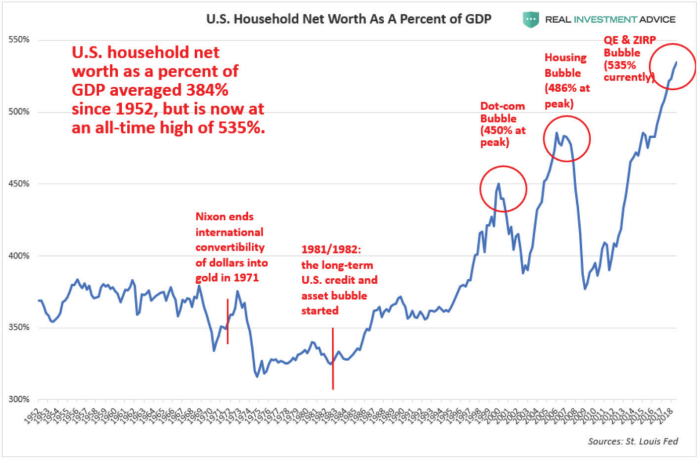
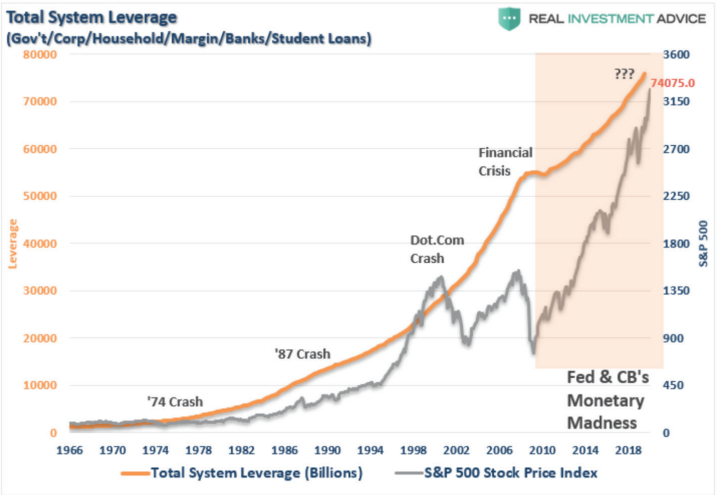
While earnings are easy to manipulate with accounting practices and stock buybacks, sales are pretty straightforward. Even though the S&P has reduced the number of shares outstanding over the time-frame of this next chart, you can see that the price-to-sales ratio is the highest on record:

As we have maintained over the past few years, this story is all about leverage. Below are two charts, the first one shows the household net worth to GDP and the second shows the Total System Leverage (or debt) in the US Economy. This just in from *CNBC: "Household debt balances surpassed $14 Trillion for the first time." -February 11, 2020.*





That little blip in 2008 was the system trying to deleverage. It is our contention that had we allowed the system to deleverage at that time, we would be experiencing much more robust economic growth by now. And perhaps not such great political and social extremes. Things are likely to get very interesting.

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Remembering the past –

Tops of markets are marked by confidence – particularly in a subset of stocks referred to as "Blue Chips". We forget that after the tops these stocks fall too. Right now Microsoft, Apple and Amazon are being referred to as "defensive stocks" by some because their growth is so "reliable." We head the same story in 2000 and 2007.

In each of the previous three bull market tops investors were enamored with the stocks of the biggest companies. In the 60's they called them "one decision stocks". The numbers below were compiled by John Hussman and his team and include the admonition "we forget". These are all losses:

Blue Chip Performance: 1973-1974

DuPont -58.4%
Eastman Kodak -62.1%
Exxon -46.9%
Ford Motor -64.8%
General Electric -60.5%
General Motors -71.2%
Goodyear -63.0%
IBM -58.8%
McDonalds -72.4%
Mobil -59.8%
Motorola -54.3%
PepsiCo -67.0%
Philip Morris -50.3%
Polaroid -90.2%
Sears -66.2%
Sony -80.9%
Westinghouse -83.1%
We forget.

Blue Chip Performance: 2000-2002

Cisco Systems -89.3%
Microsoft -65.2%
JP Morgan -76.5%
Intel -82.3%
McDonalds -74.4%
EMC -96.2%
Disney -68.4%
Oracle -84.2%
Merck -58.8%
Boeing -58.6%
IBM -58.8%
Amgen -66.9%
Apple -81.1%
We forget.

Blue Chip Performance: 2007-2009

Google -65.3%
Bank of America -94.0%
Microsoft -50.3%
Merck -65.5%
Coca Cola -42.3%
JP Morgan -68.5%
Intel -56.8%
AT&T -49.3%
Cisco Systems -60.0%
Boeing -72.6%
Apple -60.9%
Citigroup -98.1%
We forget.

Hussman calculates that the current valuation levels are three times the norm and he expects that a traditional passive portfolio of 60% stocks, 30% Treasury Bonds and 10% Treasury Bills to return 0% per year for the next 12 years but how he puts it is even more instructive:

"Emphatically, the market retreat that we anticipate neither presumes nor requires a global financial crisis (though we can't rule it out, particularly because of low levels of low-grade corporate debt relative to corporate revenues). It would not require a deep recession, or even a move to historically undervalued levels.

"Given the present valuation extremes, a two-thirds market loss would represent a wholly run-of-the-mill completion to this market cycle, ending at pedestrian valuation levels that have been observed or breached by the completion of nearly every market cycle in history (including the most recent one). The fact that such a steep market loss would be necessary to reach ordinary valuation levels isn't a statement about future economic disruption; it's a statement about current speculative extremes." - John Hussman December 28, 2019

If you are anywhere near retirement, or other important goals, it is critical that you understand the impact of declining security prices on your ability to reach those goals or to maintain your lifestyle. We can't just assume that markets trend up forever. Things just don't work out that way.

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Create Your Own Economy Corner - Live Intentionally

What does it mean to live intentionally? Put simply, it means to know what is important to you and not be distracted by the things that don't really matter in the end. Everyday there are so many distractions that grab our attention. Success depends on being able to shut out those distractions that do not serve us. This quote is from a web designer in Las Vegas and I love it:

"Work on purpose, play on purpose, rest on purpose. Do not let yourself or anyone else waste your time." Izey Victoria Odiase

We assert that wealth in its truest sense is made up of your time, your health, your relationships and your money.

Time is about intention. You are wealthy in this category to the degree that you are intentional with your time in work, play and service.

Health is about your energy and your mental clarity. Our ability to achieve our goals and make a difference for others is dependent on our health mentally and physically.

It is possible that as crazy as things are in this world, they may get crazier. In fact, we think it is likely. This will require even more intention in how we live. In turn, it will require that we tend to our mental and physical health with even more vigor just as the world drives us to want to check out.

As I was looking up quotes about being intentional, I came across two from my original favorites. My father taught English and in high school we really connected around the writings of Lincoln and the Transcendentalists. My particular favorite is Ralph Waldo Emmerson followed quickly by his protégé Henry David Thoreau. Lincoln and Emerson both worked to end slavery, sometimes in concert. Imagine what it must have been like – even without social media- to live through the civil war. To see this relatively new experiment in self-governance come so perilously close to ending.

Lincoln and Emerson saw that the Constitution required that we move beyond slavery however inconvenient it was to commercial interests of the south. Slavery did not fit with the vision that the founders embodied in The Constitution. They put The Constitution over the expediency of slavery and were willing to risk war over it. While this over simplifies all of the dynamics of the Civil War to some degree, it is interesting to frame the current debate over Presidential power and The Constitution in this context. We would suggest that no cultural bias, economic imperative or partisan inclination is as important to our Republic as the integrity of our Constitution which separates us from every other form of governance that has been known to man.

If you are like many who could use some sign that there is still integrity left in our leadership in Washington, I would encourage you to read two recent speeches. They are both from Senators outlining their reasons for voting to convict President Trump. The first is from Mitt Romney, the former leader of the Republican Party and the second from Doug Jones of Alabama. You can find the transcripts on Google. These are two intentional men, taking seriously their oath of office to uphold and defend the Constitution.

To close we include two quotes below about being intentional. While they may not fit with the instant gratification of our day, they come from thinkers who stand the test of history and who's ability to be intentional were tested in one of the most trying times of our country's history:

"The purpose of life is not to be happy. It is to be useful, to be honorable, to be compassionate, to have it make some difference that you have lived and lived well." - Ralph Waldo Emerson

"One is not born into the world to do everything but to do something." - Henry David Thoreau

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