Barron's Summary (and other sources) – January 7, 2019

I. Market Update

A. This Past Week

1. DJIA +1.6%; **S&P +1.9%;** Nasdaq +2.3%
2. Stocks had their **worst first two days of year** since 2000
3. **ISM Manufacturing Index** fell to 54.1 (from 59.3)
    a. Biggest drop since October 2008
    b. Still **expanding** (if >50)
    c. New orders component dropped to 51.1 (lowest since 2016)
4. **Optimism** on Friday:
    a. Sending a delegation to **China** for trade talks
    b. **Job creation** strongest since Feb. 2018
    c. Fed Chair **Powell** said that he would be patient
    d. Helped the **yield curve** to steepen again
    e. Over the past year, we've had a **valuation** re-set
        i. Trailing P/E has dropped from 24X (92^{nd} percentile) to 16X (42^{nd} percentile)
5. Market needs to continue growing without causing inflation
    a. Otherwise, Fed will raise rates

B. Employment Report

1. Nonfarm payrolls added **312K** jobs in December
    a. Above the **215K / month** average over the past five years
    b. Payrolls have grown **99 straight months** – longest stretch on record
2. Unemployment rate ticked up from **3.7% to 3.9%**
    a. Due to increase in participation rate from **62.9% to 63.1%**
3. Average hourly earnings rose **3.2% in 2018**
    a. Largest full-year gain of the expansion
4. Optimism of jobs report flies in the face of:
    a. Decreasing stock market
    b. Trade concerns
    c. Apple forecast (really this was China-based)
5. For 2018, manufacturing added **284K jobs**
    a. Biggest increase since 1997
    b. Despite strong dollar

C. The Battered Bull Market is Limping Into 2019

1. Investors **pulled a record $75B from US equity** mutual funds and ETFs in December
2. S&P has risen more than 250% since March 2009
3. People **worried about**:
    a. *Market volatility*
    b. *Flattening yield curve*
    c. *Weakening housing market*
    d. *Waning consumer confident*
    e. *Lower oil prices*
    f. *Possible earnings recession*
    g. *Trade issues with China*
    h. *Rising interest rates*
    i. *Strength of dollar*
    j. *Fiscal deficit*

D. The Daily Shot (WSJ) – There are **a lot of similarities to late 2016**: (this is **lifted directly from their piece**)

1. The **dollar had rallied** during the previous year
2. The **stock market** had been **under pressure**
3. **Oil prices tumbled** going into the year-end, pushing inflation expectations sharply lower. **Other commodities**, such as copper, were **struggling** as well.
4. **Corporate credit spreads widened** significantly, driven in part by weaker oil prices
5. The preceding year ended with the **Fed hiking rates** despite rapidly tightening financial conditions
6. The **yuan saw a significant decline** during the previous year, and the weakness in **China's economy raised concerns** about global growth
7. With conditions resembling 2016, investors around the world are now **rotating into government debt**, pushing bond yields sharply lower

E. Corporate Profit Crunch Looms as Stocks Slide

1. In **2018**, earnings increased **22%**
   a. Boosted by strong economy and tax cuts
2. Earnings **expectations are falling** (but still positive) for 2019
3. In December, **analysts cut their earnings forecasts for 2019** on more than half the companies in the S&P 500
   a. First time this has happened in two years
   b. Earnings expected to grow **7.8%** (down from 10.1% in September forecast)
   c. On average, earnings estimates drop **5.5% from January until end of year**
      i. So there is still further that we could go
4. Could have an **earnings recession**:
   a. Two consecutive quarters of YOY earnings decline
5. **Factors** weighing on companies:
   a. Higher labor costs
   b. Higher cost of imported materials
   c. No more YOY positive impact from tax cut
   d. Slowing economic growth abroad (S&P gets **37%** of revenues outside US)
6. **Most earnings recessions** (but not all) coincide with **economic recessions**
   a. Consumers earn less, spend less, and sales decline
   b. But, it's not always the case
      i. 2015 and 2016 were exception (with lower oil prices) – S&P dropped 14%
   c. Commodity prices will have big impact this time
      i. Does this tell us that global slowdown is happening?
7. **Average maximum market drop** during 12 earnings recessions (back to 1950) was **24%**
   a. We're down about 15% right now
8. **Markets also worried about**:
   a. Nearly inverted yield curve
   b. Weak manufacturing survey
   c. Duke survey of CFOs – almost half believe recession by 2019
   d. China slowdown
   e. Italy on brink of recession

F. Bloomberg Summary

1. Top story at end of 2018 is **rally in longer bonds** (higher prices, lower rates)
    a. **TLT** (long-bond ETF) had **record inflows** to start year
    b. **Reason**s for rally
        i. *Worldwide economic data* is underwhelming (PMIs very low)
        ii. *UST still has higher yield* than developed market peers
        iii. *End of tightening cycle*
        iv. *Stocks are down* (negative correlation)
        v. *Copper/gold and yen/$ are also down* – and these tend to be correlated w/ UST yields
2. **Effective Fed funds rate exceeded two-year yield for first time since 2008**
    a. Indicates market expects next move is down (for Fed)
    b. It's not consistent to think Fed lowering rates and S&P EPS increasing 8%
    c. Fed's 2017 normalization plan said that they would resume reinvestment of principal payments if material deterioration to outlook warranted a sizeable reduction in Fed funds rate
3. There was **not any high-yield issuance** in December in US
    a. Dallas Fed Pres. Kaplan suggested that this may be a "**lack of access**" to capital markets
    b. Or it could be a lack of need of financing or unpleasant market conditions
4. **Tesla cut car prices** and their bond prices were cut by the market

G. The Past and the Future

1. Over the 20 years ending 2018, the CAGR of S&P 500 has been **5.52%**
    a. **Average 20-year CAGR** since 1928 is **10.7%**
    b. But, we've had **two bear markets** during the past 20 years
2. **Result of low returns**:
    a. Rise of **passive investing** (and growth of ETFs)
    b. Forced commissions down
    c. Encouraged use of automation to further reduce broker expenses
    d. **Institutional investors**, pension funds, and SWFs have taken on more risk
        i. Pushing money into **private equity**
3. What would it take to have better returns in the next twenty years?
    a. Need new companies to bring growth to the market
    b. Need repurchases to continue (SL: we could argue about this)
        i. Companies need to be willing to continue to borrow
            1. Corporate debt issuance fell 21% in 2018

II. A More-Dovish Fed

A. Powell Spoke at Conference

1. Fed Chair Powell said that **mild inflation** would give Fed **greater flexibility** to set policy – allows **patience**
    a. Said policy is not on a "pre-set" path
    b. In December, Fed had been talking about two more rate increases
2. Said Fed would be **watching market** and adjust plans if market volatility caused the economy to slow more than anticipated
    a. SL: so much for Powell putting an end to the Fed put!
3. Said **markets are focused more on risks** that haven't shown up in data
    a. Slower global growth
    b. Weakness in China
    c. Trade tensions
    d. Policy uncertainty in DC
4. **Powell** said that he would **not resign** if Pres. Trump asked him to do so
5. Scoffed at the idea that **unwinding the balance sheet** is causing problems
    a. Said that the amount of bonds being put back in the market is being dwarfed by new government debt issuance (due to deficit)
    b. SL: hard to say that the unwinding is causing problems when yields are coming down so much

B. Dallas Fed President (Robert Kaplan) Says "Slow Down!"

1. Said that it's time for **Fed to move to sidelines** until it can better determine whether rising anxiety about economy and financial markets is temporary
2. Pres. Kaplan **attributes current market difficulty to**:
    a. Slowing overseas growth / China
    b. Tighter financial conditions
    c. Performance of interest rate-sensitive parts of economy
    d. General rise in uncertainty
3. Base case: no action in first two quarters
    a. **Patience** is a critical tool that Fed should be using
    b. Said that a rate cut has not entered his mind
4. Fed should **continue unwinding balance sheet**, but open to making adjustments

III. Various Issues About the Market and Economy

A. IPO-Hungry Investors Look to Have Their Moment in 2019

1. Many **big name companies** have been waiting to go public
    a. Uber, Lyft, Pinterest, Slack
2. Question is whether **market selloff** will stop companies from going public
    a. But, it may also rush companies into going public while they still can
3. **231 companies** went public in US in **2018**, raising **$60.8B**
    a. Tech companies accounted for 55 of offerings ($20.9B)
    b. Most since 2014 (which was dominated by Alibaba)
4. IPOs increased 13.1% on first day (2018) – average **underpricing**

B. One Year Later, Benefits From Corporate Tax Cut Seem Muted (WSJ)

1. One year after **lowering rates and speeding up deductions, results seem modest**
2. **Business investment** (nonresidential fixed investment) surged early this year, but **has slowed** since
    a. Most likely, has swung with **oil prices**
    b. Shipment of capital goods has tailed off
    c. **Other factors** impact investment plans:
        i. Economic cycles
        ii. Customer demand
        iii. Long-term strategy

C. U.S. Economy Fuels Boom in Consumer Debt

1. **Consumer debt** is on pace to top **$4T in 2019**
    a. Doesn't include $10.3T of mortgage debt
2. Consumers seem to be handling it fine with **strong employment and wages, low rates**
    a. On average, consumers owed **$6,826 on credit cards**
    b. Average new car loan was $30,977
3. Households are paying **9.8% of disposable income** to stay current on all loans (including mortgages)
    a. This is near the **all-time low** (2012)
    b. Caused by:
        i. Lower rates
        ii. Rising incomes
        iii. Post-crisis slowdown in home buying
4. Biggest concern: credit card loan **losses** (while small) are **rising** despite low unemployment
    a. Also, student debt has reached $1.5T

D. Behind Lumber's Collapse: A Perfect Storm of Housing and Trade

1. In **May**, **lumber** hit a **record high – 30%** above record price in early 1990s
    a. From that high, lumber **lost almost 50%**
2. **Bloomberg Commodity Index** was **down 13%** for year
3. **Reasons** for drop in lumber prices:
    a. *Housing market* cooled
        i. Rising rates
        ii. Surging home prices
    b. *Lumber yards had over-ordered* in response to tariffs
    c. *Hurricanes slowed construction* in southeast
    d. Trade dispute with China *limited exports*

IV. Best Income Investments for 2019 (Barron's List) – remember: this is showing yields currently. You can receive a high yield and the price can still drop.

1. **MLPs –** (SL: be careful…these result in you receiving a K-1 and can complicate your taxes.) Close to a 9% yield (on average).
2. **Junk bonds –** average yield of 8%
3. **European dividend stocks and funds** -- ~4% dividend yield (investing in high dividend stocks)
4. **US dividend stocks and funds –** high dividend ETFs are in the 3.5% - 4% range
5. **Preferred stock –** many yield ~6% (price is very interest rate sensitive)
6. **REITs –** yielding about 5%
7. **Telecoms –** some are yielding 4% - 7%
8. **Municipal bonds –** intermediate-term fund is yielding ~2.8%
9. **Utilities –** ETF yields ~3.4%
10. **Investment grade bonds –** yielding ~3.6%
11. **Treasuries –** 10 year UST is yielding 2.67%