Barron's Summary – January 14th, 2019

I. Market Update

1. DJIA +2.4%; **S&P +2.5%;** Nasdaq +3.5%
    a. Nasdaq +10.1% in past three weeks (largest gain since 2011)
    b. Prior week's gain was **suddenly patient Fed**; this week was **trade talks w/ China**
2. Huge **shifts in emotion**:
    a. Dec. 24th: S&P -2.7%; advance/decline -2,440 (worst since 2011)
    b. Jan 9th: advance/decline +1,938 (highest since 2016)
    c. Since 1990, there have been eleven 3,000 point swings like this
        i. Following year averaged 9.8% gain (vs. 9.1% average)
3. **January effect** in full swing – Russell 2000 +7.3% this year
4. Market cap of US stocks +$1.1T (3.85%) in first six trading days of 2019
5. **Gov't shutdown** continues
    a. **Debt ceiling** issue will be back on March 1

II. Fed

1. Powell has emphasized:
    a. Fed's willingness to be **patient with rate increases**
    b. **Flexibility**, if needed, on pace of **reducing balance sheet**
2. Powell had said in 2012 that it's not the Fed's job to protect stock investors
    a. Yet, the **Fed put** is alive ("BTFD")
3. What starts on Wall Street rarely stays there
    a. **Consumer confidence** drops
        i. **Wealth effect** – consumer spending drops ~2% - 5% of market cap drop ($90B – $225B for $4.5T loss)
            1. This is why Fed acts
    b. We saw this in 2016 when Fed wanted to raise rates four times
        i. Stocks and junk bonds dropped (oil); Fed stopped
        ii. Brexit vote happened in June
4. Central banks (worldwide) are shrinking b/s at 5% annual rate

III. Emerging Markets

1. Emerging markets: **27% discount** to developed markets (forward P/E basis)
    a. Deeper than ten-year **average of 22%**
2. Emerging market companies are **growing faster** (6% profit growth vs. 4.5%)
3. EM may be **riskier**
    a. More susceptible to **trade war issues**
    b. Many old school **industrial companies** susceptible to economic slowdown
4. **EM financials** may be attractive
    a. **Lowest P/B** in 20 years
    b. EMs are doing a lot of **cap ex** (loan growth)
5. **Dollar** could be as much as 20% overvalued and Fed is slowing down
    a. This helps foreign currencies (and foreign investments)

IV. Mutual Funds and ETFs

1. Investors pulled **$200B** out of mutual funds in **Q4**
    a. ETFs saw $76B of inflows in December
2. BlackRock is laying off 3% of its workforce; State Street is going to cut its senior management staff by 15%
3. Nearly **90%** of large-cap stock fund managers **underperformed** the S&P 500 in the **past decade**
    a. Some of the underperformance is due to **fees**
        i. Just 58% of institutional accounts (which are cheaper) lagged the S&P 500
    b. **Before fees**, 71% of large cap managers and 40% of institutional managers underperformed
        i. So, in addition to fees, it's just hard to pick winners
4. Same is true for **mid-cap**
    a. After fees, 96% of mid-cap managers underperformed (78% institutional)
        i. Before fees, 85% and 63% underperformed
5. And, same is true for **small cap**
    a. More than 80% of small cap underperformed (both net and gross)
        i. 82% of institutional underperformed net of fees; 61% gross

V. LIBOR

1. Many preferred stocks have floating rates based on LIBOR
    a. Yet, LIBOR is scheduled to go away after 2021
    b. Some say that the last LIBOR print will determine the rate
2. LIBOR is also important for leveraged loans, mortgages, derivatives
3. Questions remain about the reliability of LIBOR
    a. Rate is based on a poll and only about **30%** of submissions for three-month LIBOR were based on actual transactions in Q1 2018
    b. Rate is meant to measure cost of **unsecured s/t loans** among banks
        i. These loans have been discouraged by regulators
        ii. So, banks have to use other data
4. The Fed-backed Alternative Reference Rates Committee (ARRC) has chosen a replacement called the **Secured Overnight Financing Rate** (SOFR)
    a. But, it measures the cost of **secured transactions** and doesn't include the risk of bank default
        i. So, it's lower than LIBOR

VI. Bloomberg

1. **High yield bonds** and **leveraged loans** completely eliminated their December losses early in the week
    a. Apparently, the market's outlook on the economy is less dire
    b. Part of the recovery may be due to the bounce in oil prices
2. Concerns about **access to financing** (Dallas Pres. Kaplan) seem overblown
    a. A junk issuer raised money this week (first time since Nov.)
    b. Demand for investment grade debt appears robust

VII. Risks to the Global Economy in 2019 – Kenneth Rogoff

1. The **biggest economic risks** will emerge in those areas **where investors think recent patterns are unlikely to change**
    a. A growth recession in China
        i. Would hurt Asia and commodity exporting countries
    b. A rise in global long-term real interest rates
        i. A crescendo of populist economic policy that undermine the credibility of central bank independence
            1. Resulting in higher interest rates on safe advanced-country gov't bonds
2. **China** may already be slowing
    a. Trade war has shaken confidence
    b. Economy was already slowing as it transitions from export and investment led growth to more sustainable domestic consumption led growth
3. A sustained **rise in long-term real interest rates** is low probability, but it could happen
    a. What could cause this to happen?
        i. A spurt in **productivity**
        ii. A sharp decline in Asian growth that causes external surpluses to swing into deficits
            1. Slower Asian growth would probably result in dollar appreciation
        iii. Explosion of populism across world that could overturn market-friendly economic policies
            1. May sow doubt in safe advanced country debt
4. Don't be fooled by arguments that gov't debt doesn't matter
    a. High debt makes it more difficult for gov't to respond to shocks
        i. This heightens the risk of **stagnation**
5. If policymakers rely too much on debt (rather than taxation) to pursue redistribution policies, markets may question whether debt will ever be paid off
6. **Other risks** to global growth:
    a. Ever-increasing political chaos in the US
    b. A messy Brexit
    c. Italy's shaky banks
    d. Heightened geopolitical tensions

VIII. Shelter from the Storm in 2019 – Barry Eichengreen

1. For this to be a tranquil economic year, a short list of **threats to stability would have to be averted**:
    a. **Trade war** b/t US and China would have to be put on hold
    b. **US economy** will have to grow by at least 2%
        i. Otherwise, stocks will drop significantly…hurting confidence and stability
    c. China will have to avoid a significant intensification of its **financial problems**
        i. Corporate debt-to-GDP is 160%
            1. Must restructure bad loans
            2. Must grow GDP
                a. Infrastructure investment is weak
                b. Manufacturing production in decline
    d. Voters in the European Parliament election in May will have to prevent the victory of a right-wing nationalist majority **hostile to European integration**
        i. Need common deposit insurance scheme for banks
        ii. Need modest euro-area budget
    e. A limited outcome for US **Special Counsel** Robert Mueller
        i. Trump would go after Fed, China, Mexico
2. Many of these issues are connected
    a. Strength in some will create strength in others or vice versa
        i. Disappointing US growth will lead us to blame China

IX. What Next for Global Trade? By Pinelopi Koujianou Goldberg

1. As of October, the US had **imposed tariffs on 12K products – 12.6%** of its total imports
    a. Main trade partners retaliated w/ tariffs on **2,087 products** (**6.2%** of US exports)
2. We've **tried this before**:
    a. Nixon imposed 10% tariff on all imports
        i. Trying to halt current account deficit
    b. Reagan erected non-tariff barriers against a number of goods (particularly Japanese goods)
3. **Key differences** this time:
    a. **Timing** is surprising
        i. Trade and globalization widely accepted
        ii. Protectionism when unemployment at 50-year low, stock market up, and good GDP growth
    b. While trying to protect industries that compete w/ imports, we also seem to be **trying to address frustrations with WTO**
4. The idea that trade is liberalized is only tenable if you look at tariffs and ignore **"behind the border" measures**:
    a. Regulatory restrictions that hinder cross-border investment
    b. Subsidies to domestic industries
    c. Licensing requirements that inhibit trade in services
    d. Privacy requirements that restrict e-commerce
    e. Restrictions on foreign ownership that interfere with inward direct investment
    f. Stringent joint-venture requirements that often entail handing over intellectual property
5. These problems should be handled through negotiations at the WTO
6. These policy shifts (using trade as a weapon) **create uncertainty that reduces investment**

X. Why Is Immigration Different From Trade? By Amar Bhide

1. The case for free trade is strong and straightforward
    a. The case for immigration is no less compelling, but more complicated
2. Argument for **free trade**:
    a. Transactions between willing buyers and sellers, within an economy or across borders, almost always **benefit both sides**
    b. May need restrictions for safety (or other reasons), but should be kept to a minimum
    c. Limiting trade to punish other countries tends to **punish that countries' low wage workers**
        i. It also imposes an unwarranted and frequently regressive **tax on consumers**
3. With **immigration**, we're **importing the labor** itself (rather than the goods)
    a. Immigrants benefit from higher wages, greater safety, and individual freedom
    b. Natives win b/c the new labor performs menial or unpleasant tasks, broadens the tax base, and expands domestic markets
    c. Immigrants can bring considerable entrepreneurial energy and enrich the local community w/ their culture, food, and traditions
    d. From moral perspective, we are sometimes sheltering immigrants who would face torture or starvation in their homelands
4. In the US, successive generation of immigrants turned us into the leading technology and military power
5. **Immigration** is different b/c it is a **unilateral choice** (rather than a two-sided exchange) and the **advantages are not guaranteed**
    a. Not all find productive employment and pay taxes
        i. Some will strain safety nets at a time of large public debts and rapid population aging
    b. They may arrive unexpectedly, overwhelming education and health-care systems and exceeding housing capacity
    c. While the link with crime is overstated, it is an issue that can arise
        i. Second generation immigrants can reject their parents' work as menial
6. Be careful of point systems that reward education or other factors
    a. You don't need a degree to make invaluable entrepreneurial, technological, or artistic contributions
7. It is best to assess:
    a. How many can we accept (based on infrastructure)
    b. Who can we reliably do a background check on