December 2018 Newsletter: Focusing on Quality and Value

December 17, 2018

Market Overview

CAPE Ratio	U.S. Market Valuation
29	High

Gold Price (oz)	12 Month Change
$1,238.57	-6.5%

Market/GDP	U.S. Market Valuation
132%	High

Silver Price (oz)	12 Month Change
$14.56	-16.8%

Gold/Silver Ratio	12 Month Change
85.07	12.4%

Currently Attractive Sectors:
Stable Emerging Markets
US Financial Sector, Energy Sector
Commodities/Producers
Quality/Value/Yield Stocks

Recently Published Articles:

- Why Interest Rates & the Yield Curve Matter
- Global Debt: An Overview of Where Debt Exists in the World
- A Concise Guide to Asset Allocation
- Detailed Analysis of Enbridge Inc (Seeking Alpha)
- Storms Brewing for Japan and Europe (FEDweek)

- This Recession Indicator Just Flashed a Warning (FEDweek)

Recent Market News

- U.S. stocks and foreign developed stocks have had big sell-offs since the end of September. Meanwhile, emerging market stocks have largely held up a bit better, since they already had a big sell-off earlier in the year and were already trading at rather low valuations.

- President Trump and President Xi met at the G20 Summit in Buenos Aires to discuss the ongoing trade dispute. They agreed to a ceasefire on additional tariffs for the next three months as they potentially work out a trade agreement, which would include China buying more agriculture and energy from the United States.

- U.S. Federal Reserve Chairman Jerome Powell gave a speech at The Economic Club of New York, where he used a more dovish tone on interest rates that temporarily sent U.S. stocks soaring (which then faded over the following weeks). His speech also boosted emerging markets, because it might mean some relief from the stronger dollar, and boosted gold a little bit because lower interest rates are better for gold in the short-term.

- The price of oil totally crashed within a 6-week period. Saudi Arabia ramped up oil production in anticipation that Iranian oil would leave the world market due to U.S. sanctions. However, due to waivers, Iranian oil is leaving the world market more slowly than expected. As a result, supply outpaced demand and WTI crude crashed from $76 to $50 per barrel. In early December, OPEC and Russia agreed to cut production to stabilize oil prices going forward.

- Existing home sales have been declining through the year, and home-builder stocks are in a deep bear market this year. As interest rates have risen, fewer people want to buy homes with higher mortgage rates compared to the lower rates they've already locked in on their existing properties over the past decade.

The Power of Mean Reversion

Readers of this newsletter are a well-informed group. The single biggest thing readers email me about is that they are concerned that asset prices are high, that we're late in the U.S. business cycle, and that they want information on how to navigate the markets for a potential crash.

I share those concerns. But one thing to keep in mind is that we can never be sure if a crash is coming, or just a prolonged flat/choppy market as earnings eventually catch up to valuations. That's basically what happened in 2018, and periods like that can happen for years.

We know the approximate ceiling for sustained earnings growth for U.S. companies over time, we know how high equity valuations currently are by every measure, and so we know U.S. equity returns are not very likely to be great over the next decade from this price level at this late stage in the business cycle. We also know that since companies levered up so much with low interest debt to buy back their own shares over the past several years, they likely will need to be more conservative with acquisitions and share buybacks going forward.

However, we don't know for sure what the chart will look like along the way. Will U.S. stocks have a big crash and a recovery, giving another great time to buy in between like in 2009? Or will they fall into a deflationary malaise for a while like Japan often has, trading sideways during an economic slowdown, propped up to avoid crashing by central bank quantitative easing or other methods?

Or will it be something between the two, with a moderate 20%+ stock decline followed by a long, choppy malaise?

The current U.S. economy is supported by major federal deficit spending and is therefore unsustainable. The fact that the U.S. government has a budget deficit equal to 4% of GDP during a booming economy is unprecedented and concerning. Add to that very high levels of corporate leverage, reduced share buybacks ahead at some point, a fragile middle class, trillions of dollars in unfunded pension liabilities, and record political polarization and partisanship, I think we're in for a volatile time within the next few years.

My November newsletter issue discussed some of this in more detail, with a particular focus on debt. My article on economic bubbles in the U.S. also touched on the impact of the federal deficit.

The thing is, we can't be sure how things will play out and what opportunities investors will have for cheap stock buying. Will bad things happen at once, or will they be spread out? How aggressive will the Fed try to be at propping things up like last time?

A lot of investors make big, bold moves. Some event convinces them to sell all their stocks, for example.

Personally, rather than taking money entirely out of the market to wait for crashes, I just gradually adjust my exposure in a tax-efficient way to where I think value is. As U.S. stocks have gotten expensive over the past couple years, I've gradually shifted my portfolio to be more defensive and more global, for example.

The U.S. Market Remains Expensive

Despite this recent sell-off, U.S. stocks are still historically expensive. Here, for example, is a chart of total stock market capitalization (blue line) compared to the GDP of the United States (red line):

Chart Sources: *US Bureau of Economic Analysis, Wilshire Associates, St. Louis Fed*

The percentage of revenue that large U.S. companies get from outside the United States has been relatively flat over the past 20 years at around 45%, so this remains a rather useful back-of-the-envelop broad indicator of valuation.

Whenever stock market capitalization considerably outpaces actual economic output, its a sign that equities have gotten ahead of themselves. There's nothing magic about the ratio; it's just a comparative tool that was popularized by Warren Buffett years ago.

Prior to the mid-90's, stock market capitalization was less than GDP. When you go back to the 1970's or 1980's, companies looked a lot different back then and didn't get as much revenue from outside of the United States.

In 2000, after the biggest bull market ever, the U.S. total stock market capitalization was 150% of GDP, but then fell back down to 75% in 2002 after a mild recession. In 2007, total market capitalization was back up to 110% of GDP, but fell to under 60% of GDP during the financial crisis.

In March 2013, just five and a half years ago, the stock market recovered to being worth 100% of GDP, and kept climbing from there.

In September of this year, it was back up to just under 150%, the second-highest level on record. It has since fallen to about 132%, which is still historically high. Even a mild recession could potentially bring us back down to 100%, which would imply a 25% equity sell-off from this point. And historically, it could very well go below that once again.

One of the most powerful forces in the investing world is **mean reversion**. With occasional exceptions, things almost always return closer to their average.

In various decades, different stock markets of the world do better or worse than others, and they often keep switching back and forth. This often has more to do with changes in valuations than earnings growth.

Over this past decade, U.S. stocks were the big out-performers compared to other regions globally:

Stock Performance By Region

Chart Source: iShares

Similarly, we go through multi-year periods in the United States and globally where growth stocks outperform value stocks (often during big bull markets), while other times value stocks outpace growth stocks, often because growth stocks get too expensive and their stock prices got too far ahead of their fundamentals. We've had a multi-year stretch of growth stocks outpacing value stocks lately:

Chart Source: Reuters

Or U.S. equities compared to commodity indices. Looking historically, we're at a super-cycle low for commodities compared to U.S. equities:

Chart Source: Incrementum AG, presented by DoubleLine

In summary, we're in a multi-year period where U.S. stocks have dramatically outpaced global stocks. Stocks outside of the United States, especially in emerging markets, are historically cheap compared to their fundamentals. Growth stocks have outperformed value stocks for a while now but have had a bit of a reckoning in the past few months. Commodities have had a very bad decade, and some commodities or commodity producers look attractive at current levels.

Naturally, I'm finding more bargains with global exposure, dividend/value stocks, and some commodity producers than I am with U.S. equities in general, or growth stocks in general. My September newsletter issue went into detail about why emerging markets are likely to do well over the next decade from this price point, even though the ride will be volatile.

That being said, mean reversion doesn't always work to the same degree every time. Occasionally there are permanent shifts that happen, mainly due to technology or demographics.

Some examples of likely permanent changes:

- Technology plays a bigger role in our lives than it did 25 years ago, and consequently technology stocks represent a much larger chunk of equity markets than they used to.

- Some regions of the world, like Japan, have become aged and have slow or declining population levels. When their markets underperform, this makes it less likely for them to revert to the mean and outperform other markets later, unless they start from a point of being extremely cheap.

- The rise of electric vehicles and more efficient solar cells are expected to eventually replace a lot of gas-powered vehicles. Investors need to keep this trend in mind when analyzing oil producers and oil transporters. On the other hand, natural gas is projected to be a relevant energy and heating source for a couple decades longer, especially as it takes market share from coal.

In addition, mean reversion can take a very long time. Historically unusual differences in valuation are not necessarily a buying signal for the next year; the numbers simply strongly suggest what asset classes may do better than others over the next 5-10 years.

Recession Watch: An Update on Indicators

There’s a lot of talk in the financial media of a recession in the United States by 2020, due to where we are in the business debt cycle.

I think the idea of an economic downturn in 2019 or 2020 is very reasonable, but I don’t put too much emphasis on precise timing. It’s dependent on so many variables like inflation, interest rates, trade negotiations, geopolitical events, actions by the Federal Government or Federal Reserve, etc.

Instead, I think it’s just important to know roughly where we are in the business cycle (rather late), to invest accordingly and know how defensive we should be (rather defensive), and keep in mind that the world is your playground; you can go to where values exist outside of your home country.

Or as billionaire Howard Marks from Oaktree Capital often says, “Move forward, but with caution.”

Here’s the most recent chart of recession indicators from economist David Rice, of econ p.i., which tracks 19 historical recession indicators:

In a typical business cycle, the variables rotate counter-clockwise around the four quadrants, but not necessarily smoothly.

The top right quadrant is full-on expansion, when the economy is growing and the rate of growth is accelerating. The top left quadrant is late-decline, meaning that the economy is still strong but the rate of growth is declining. The bottom left quadrant is a recession, where the economy is weak and things are getting worse. The bottom right quadrant is recovery, where the economy is still below normal but things are starting to stabilize and show signs of improvement.

The current chart shows that, at least based on these 19 variables, we are still comfortably away from a recession. You can see that the mean of coordinates (MoC) is still in the top right quadrant, while the MoC is historically in the top left quadrant imminently before a recession.

It still looks a little better than it did 12 months before the 2001 recession and the 2007 recession:

Charts courtesy of David Rice’s work.

It’s important to realize, however, that a stock market decline usually precedes a recession. In other words, the stock market typically hits a peak and begins declining several months before a recession officially begins.

- The official start of the 2007 recession was in December of 2007, but the S&P 500 peaked in October 2007 and declined thereafter.
- The official start of the 2001 recession was in March 2001, but the S&P 500 peaked six months earlier, around September 2000.

Therefore if you’re trying to position your portfolio ahead of a recession, it’s better to err on the side of being a little early.

With U.S. stocks still historically expensive (based on CAPE, market cap to GDP, price to sales, dividend yield, etc), with the yield curve showing signs of inverting (the 3-year treasury bond inverted over the 5-year treasury bond), with corporations already highly leveraged, and with big federal deficits, it's a good time to play defense in my opinion.

Portfolio Updates

I currently have four investment accounts, and I provide updates on my asset allocation and investment selections in each newsletter issue.

These include a primary indexed retirement account, two actively-managed brokerage accounts at Fidelity and Charles Schwab, and a new account specifically for this newsletter at M1 Finance.

I use a free account at Personal Capital to easily keep track of all my accounts and monitor my net worth.

M1 Finance Newsletter Portfolio

I started this account three months ago with $10k of new capital, with a plan to put an additional $1k into it before each newsletter issue.

It's by far my smallest account, but the goal is for the portfolio to show newsletter readers my best representation of where I think value is in the market.

I chose M1 Finance because their platform is free and allows for a great combo of ETF and individual stock selection with automatic and/or manual rebalancing. It makes for a great showcase portfolio with high flexibility, and it's the investment platform I recommend to most people.

The more I use it, the more I love it.

After adding $1,000 in fresh capital in December, here's the portfolio today:

Here’s the more detailed breakdown of the holdings:

Changes since last issue:

- I changed the “Precious Metals” pie to “Commodities” and added Nutrien (NTR) and the natural resources ETF (GUNR) to it. The pie is still 80% precious metals.
- I also changed some of the mining companies a little. I sold GDX to buy ABX, BTG, and FSM.
- I tweaked the two bond ETFs to be 10% of the portfolio each. Not by selling, just by where new capital was added.

Since its inception 3 months ago, this portfolio has outperformed the broader market by about 6% by being somewhat conservative. It’s down about 4% during this big sell-off across asset classes while the total U.S. stock market is down about 10%.

Primary Retirement Portfolio

This portfolio is my largest and least active. It purely consists of index funds that automatically rebalance themselves regularly, and I rarely make changes.

Here’s the allocation today:

From 2010 to 2016, this account was aggressively positioned with 90% in equities and enjoyed the long bull market.

Starting in 2017 in order to preserve capital I dialed my equity allocation down to 60% (40% domestic, 20% foreign). This was due to high stock valuations, rising interest rates, and being later in the market cycle more generally. If and when the U.S. economy encounters a recession and significant bear market, I would likely increase equity allocations to upwards of 90% once again.

One reason this is so conservative is that my active portfolios are more concentrated and aggressive, so I consider them together when determining how to allocate assets.

This is an example of a fund that takes a rather hands-off approach but that still makes a tactical adjustment every few years based on market conditions.

This employer-based retirement account is limited to a very small number of funds to invest in, unlike the M1 Finance account. I would have some commodity/gold exposure and more foreign stock exposure if there were more/better fund options.

Active Portfolios

My accounts at Fidelity and Schwab are mainly for individual stock selection, single-country ETFs, and selling options:

I made a few investments since the previous issue:

- I bought shares of Franco Nevada (FNV), which is a major gold royalty and streaming company.

- I sold cash-secured put options on Micron (MU) with a strike price of $39 and an expiration date of 1/18/2019. The cost basis if assigned will be a little over $35 due to the premium received. Micron is one of the world's major producers of DRAM and NAND semiconductors, and is currently in a cyclical downtrend but very cheap, with great fundamentals and an experienced CEO.

- I sold cash-secured put options on the United States Oil Fund ETF (USO) with a strike price of $10.50 and an expiration date of 2/15/2019. I don't like oil for the long term but for diversification, I decided to add some oil exposure for the intermediate term due to the oil price crash. It has a better risk/reward upside/downside scenario than equities in my opinion.

- My previously-sold puts for Sierra Wireless (SWIR) were assigned to me, so I am now long SWIR with a small position. This is an out-of-favor pure-play Internet of Things (IoT) company that is now under new management, with a new focus on higher-margin recurring software revenue.

Final Thoughts- Quality and Value

As we approach 2019, I think it's really time to emphasize quality and value even more than before. In other words, investing in companies, regions, and asset classes that can hold up well through difficult parts of the business cycle and that are reasonably priced.

That means less focus on growth-at-all-costs or high-risk areas, and more focus on growth-at-a-reasonable-price, sustainable and growing dividends, low debt, investment-grade assets, and undervalued regions.

Whether we hit new S&P 500 highs before the business cycle ends or not (I don't really know), it's clear that we are in a late-cycle environment and the 9-year bull momentum has cracked. Investors are paying more attention to valuations and risk than they were a year ago.

For several years now, large-cap growth-oriented tech stocks have driven the U.S. market higher and higher, while value investors have been left in the dust. However, the ratio of growth stock performance to value stock performance hit historical record highs, so contrarian investors would naturally start to look more closely at the value end of the spectrum.

The example I've used to showcase this is Disney compared to Netflix. They're both media companies, but Disney is a reasonably-valued dividend stock while Netflix is a high-valued fast grower.

Three months ago in my September newsletter issue, I pointed out that Disney and Netflix had similar market capitalizations, so both companies were worth about the same amount of money to buy, but Disney had 4x as much revenue and 12x as much net income as Netflix, and I cautioned against Netflix stock at these prices. It takes a really aggressive growth assumption for Netflix to warrant such a high valuation.

I followed this up with more detail in an October article on Equities.com, showing that Disney is arguably a better investment based on valuation, and cautioned about how Netflix is burning through cash. That's not to necessarily say Netflix is a bad company or that it won't do well; I even outlined a potential scenario where it could do well. But it just takes a lot of positive assumptions with no margin for error.

And over the past three months since September, we have indeed seen quite a divergence between Disney and Netflix, with about a 30% performance differential (I got lucky with timing):

During a bear market, sturdier companies with reasonable valuations tend to hold up better than stocks with a ton of projected growth factored in, and this divergence between Disney and Netflix was a perfect example.

To make this a broader statement, I think it's a good time to invest along the lines of:

- Investment-grade bonds rather than junk bonds
- Premium quality stocks more-so than speculative stocks
- International regions with low/moderate debt and valuations
- A bit more commodity exposure, but with caution

Going forward, I like stable emerging markets ETFs, natural gas pipeline companies, cheaply-valued U.S. and Canadian banks, precious metals, and high quality dividend payers.

In the tech space, there are several appealing stocks in my opinion after recent sell-offs. Micron (MU) has fallen almost 50% from its cyclical high (they report earnings next week though, a potential volatile day), Adobe (ADBE) is looking reasonably priced for its quality and growth, Google (GOOGL) is rather cheap for its combination of growth and balance sheet strength, and the Chinese internet giants like Alibaba (BABA) seem to be attractively priced and don’t have some of the debt issues associated with the rest of China. These are names I wouldn’t mind buying and holding at current price levels.

For pure index investors, I think it’s just a matter of being reasonably defensive, realizing the downward risks that exist in the current market, and making sure your portfolio is high quality and something you’ll be happy to hold when times get rough.

I hope everyone has a great holiday season, and my next issue should come out around late January.

Sincerely,

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