January 2019 Newsletter: 4 Charts Every Investor Should Know

January 28, 2019

Market Overview

CAPE Ratio	U.S. Market Valuation
29	High

Gold Price (oz)	12 Month Change
$1,302.60	-4.4%

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

Silver Price (oz)	12 Month Change
$15.71	-10.1%

Gold/Silver Ratio	12 Month Change
81.72	4.9%

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

This issue discusses the major drivers of the market as we enter 2019 with high asset valuations and significant leverage in the global economy.

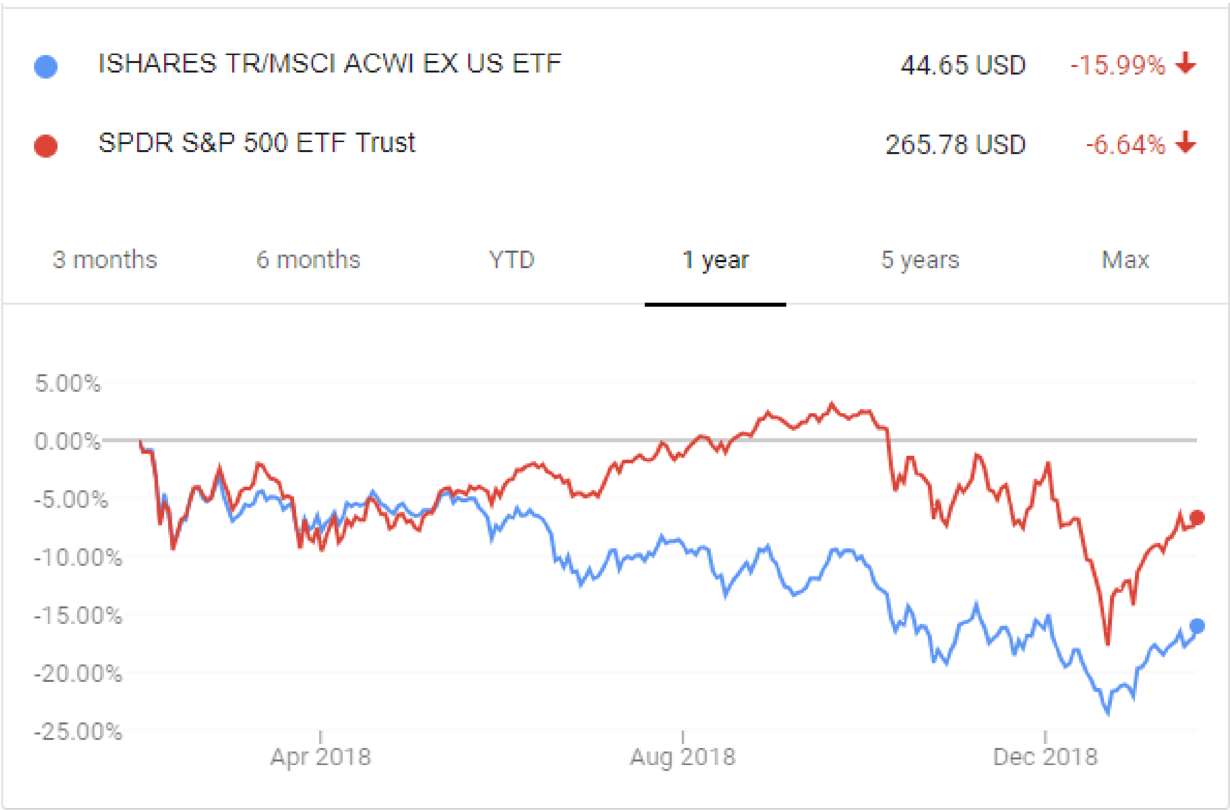
Recently Published Articles:

- 3 Simple ETF Investment Portfolios for Hands-Off Investors
- Fiat Currency: Is a Dollar Crisis Inevitable in the Long Run?

- Safe High Dividend Stock List (Updated)
- 4 Solid Gold Stocks for 2019
- Enterprise Products Partners High-Yield Analysis (Seeking Alpha)
- 4 Dividend Growers I'm Buying Now (Seeking Alpha)
- Micron: A Major Opportunity Trading at Book Value (Seeking Alpha)
- Why I'm Holding Cash and Gold; Bond/Debt Outlook (Seeking Alpha)
- 3 Undervalued Growth Stocks I Bought This Month (Seeking Alpha)

Holding Calmly Through Market Turmoil

This has been a volatile few months in the markets, with many major indices falling into bear market territory (down 20% or more), followed by a strong rally in January.



Foreign stocks (blue line above) were already down earlier in 2018 due to concerns about global trade, China's de-leveraging, and the strong dollar.

U.S. stocks (red line above) sold off towards the end of the year when 10-year treasury yields moved up past 3.2% and the Federal Reserve made a series of hawkish statements about raising interest rates and keeping their balance sheet reduction on autopilot. Tight/hawkish monetary policy is like gravity for asset prices, pulling prices of risk assets downward while encouraging saving and deleveraging.

However, this sell-off frightened the market, and by the end of the year the Federal Reserve made a series of dovish statements about being data-dependent with regards to interest rates and balance sheet reductions, indicating easier monetary policy. Easy/dovish monetary policy helps prop up home values, bond prices, equity valuations, and even gold and other assets, but also allows debt to build up and become a problem later.

- **Related Guide:** Why Interest Rates Matter

The fourth quarter of 2018 was a good test of your risk tolerance, asset allocation, and investing mindset.

Did you feel afraid or nervous when seeing the Dow Jones Industrial Average down by 800 points in a day? Did you sell your equities at the local market bottom? Or did you change little or nothing, or even buy the dip, and just happily continue with your investment plan?

If you're young and/or an accumulator of assets, market sell-offs and lower asset prices are good for you. They give you more opportunities to buy on sale rather than buy during expensive market tops, and it increases your long-term forward rate of return. Just make sure you're comfortable with your portfolio and are willing to hold it through difficult market conditions.

If you're older and/or a seller of assets to fund retirement, market sell-offs and reduced asset prices are a real risk for you. It's important that your portfolio be positioned in such a way that a big stock decline of 30%+ or more doesn't derail your retirement. Investing in securities with lower volatility and higher quality, focusing more on stable investment income, and holding some hedges can help reduce this risk.

January saved investors with a solid bounce back up to higher valuations once again. It gave investors a chance to re-assess their risk and diversification as we move forward.

Opportunities and Risks for 2019

This upcoming year appears to be on the edge of a knife, and could go either way.

- **Bullish case:** The U.S. and China could come to a trade agreement and end uncertainty for a while, the Federal Reserve could maintain or further relax monetary policy and maintain high liquidity, there could even be more U.S. fiscal stimulus in the form of an infrastructure bill, and thus markets could be given a chance to resume their climb upward. I wouldn't be surprised to see the S&P 500 at new highs by year's end if many of these come true.

- **Bearish case:** A few economic reports could surprise to the downside (GDP, purchasing manager's index, job growth, etc), we could have more government shutdowns or political turmoil, there could be a bombshell FBI/Mueller report that further stirs up political uncertainty, the U.S. and China could fail to come to an agreement and instead accelerate their trade war, and/or the impact of the Fed's balance sheet reductions could be a catalyst for further asset price declines.

I lean towards the bearish case over the next couple years. However, improper confidence is one of the main things to avoid as an investor. Many people try to predict with too much confidence what will happen in any given year.

The world's best investors rarely try to predict 1-year stock price movements. Instead, they merely make a series of long-term investments based on valuations and probabilities related to risk and reward.

We're almost a decade into the second longest economic expansion in U.S. history, asset valuations are historically high, debt has built up to big levels normally associated with the end of a business cycle, central banks around the world are trying to tighten monetary policy, and there are a lot of uncertainties around global trade.

Investors should be aware of the following four charts when making decisions about balancing risk and reward.

Chart 1) Corporate Debt Cycle

Corporations in the United States have already built up considerable debt relative to GDP and thus appear to be late in the business cycle (recessions shaded in grey):

Chart Source: Gluskin Sheff

This means corporations will, either in 2019 or the coming years, need to slow down share buybacks and focus on maintaining or decreasing their leverage. This would slow earnings growth and may negatively impact valuations.

It also means interest rates would cause a wave of defaults if raised to historical norms. The only reason corporations can maintain this level of debt is because their interest coverage ratios (the percentage of income they have to pay towards their debt interest in any given year) is still reasonably low.

Companies can have a lot more debt when they pay 4% annual interest on bonds compared to if they had to pay 7% interest, for example.

Similarly, highly-leveraged companies are vulnerable to recessions. If their income falls while their debts remain, their ability to pay back their debts diminishes.

The opportunity here is to focus on companies with strong balance sheets that can weather most economic storms and take advantage of the weaknesses of over-leveraged companies in times of stress.

Companies with great absolute balance sheets, meaning very high levels of cash and income relative to debt include names like Alphabet, Apple, Intel, First Solar, Micron, Disney, Texas Instruments, Microsoft, Starbucks, and many insurance companies, banks, and asset managers.

And then there are companies with great balance sheets relative to their industry, like Enterprise Products Partners, Enbridge, and Kinder Morgan in the midstream industry. All of them have de-leveraged and now have historically low debt-to-EBITDA ratios even though this industry demands a substantial amount of leverage to operate.

Examples of companies with a lot of debt relative to their earnings or assets are AT&T, Netflix, Waste Management, IBM, Tesla, Kroger, Coca Cola, Clorox, General Electric, Campbell Soup, and a lot of retailers, utilities, and energy companies. That doesn’t mean they are necessarily bad investments; just be aware.

Chart Set 2) Central Bank Balance Sheets

Central banks typically raise interest rates during bull markets to keep inflation in check, and reduce interest rates during recessions to stimulate economic activity. During this previous financial crisis, interest rates hit rock bottom at 0%:

Chart Source: St. Louis Federal Reserve

So for further stimulus beyond 0%, the U.S. Federal Reserve began effectively printing a few trillion dollars to buy treasuries and mortgage-backed securities and hold them on their balance sheet, which was called quantitative easing. It added a lot of liquidity into the economy and pushed up asset prices to restore investor and consumer confidence.

Dr. Cynthia Wu and Dr. Dora Xia calculated for the Atlanta Fed that this quantitative easing was equivalent to about -3% interest rates.

The following chart shows the actual interest rate (blue line) compared to the effective shadow interest rate (green line) when taking into account the impact of quantitative easing:

Chart Source: Atlanta Federal Reserve, Wu and Xia

That was calculated in 2015 shortly after the last round of quantitative easing in the United States.

Over the past couple years, the Federal Reserve has been gradually raising interest rates and unwinding its balance sheet (aka quantitative *tightening*), which reduces liquidity in the economy and puts gradual downward pressure on asset prices. If the chart were extrapolated to today in 2019, the blue line would be up to about 2.3% and the green line would be around 3% or so.

It's uncertain to what extent the Fed will continue to shrink their balance sheet in 2019; initially the chair of the Federal Reserve said the process was on autopilot but when that sparked a market sell-off he quickly walked his statement back and said it would depend on economic strength.

The central bankers want to have some tools to deal with the next economic slowdown, whenever it occurs. It will look bad if the U.S. economy enters a recession when interest rates are still low, the Fed still has trillions of extra assets on its balance sheet, and thus starts turning to 0% interest rates and more quantitative easing to further expand its balance sheet. That would imply that quantitative easing is now a never-ending cycle rather than a one-time event to deal with a unique financial crisis.

The Federal Reserve is not the only central bank involved in this. The Bank of Japan, the European Central Bank, the Bank of England, and others have all been doing quantitative easing and are winding down to various degrees. The Federal Reserve winded down first, the European Central Bank is doing so now, and the Bank of Japan is on the other end of the spectrum with no immediate plans to wind down.

This chart by DoubeLine shows the combined size of the major central bank balance sheets (about $15 trillion USD equivalent) and how as a whole they began shrinking in 2018, largely thanks to the Federal Reserve leading the way. This quantitative tightening coincided with the sell-off in the MSCI All-World index (black line), representing U.S. and global equities.

Chart Source: DoubleLine January 2019 Webcast

In January of this year, world markets stabilized to some extent, but if collective central bank assets continue to shrink, it may further reduce liquidity and put further pressure on asset valuations.

Chart 3) Net Worth to Income

This chart shows the ratio of net worth to disposable income in the United States, which serves as a good proxy for estimating asset valuations:

Chart Source: St. Louis Federal Reserve

The chart shows how the collective net worth of stocks, bonds, cash, houses, and other assets compares to income in the United States.

In 2000, stocks were wildly overvalued but houses were not. In 2007, houses were wildly overvalued but stocks were only moderately overvalued.

Currently, almost all asset class valuations in the United States are higher than normal. Stocks aren't currently as highly-valued as 2000, but they are more highly-valued than in 2007. Houses aren't as highly-valued as they were in 2007, but they are more expensive on an inflation-adjusted basis than any other time in history. There is a record amount of liquidity in the form of cash and bonds floating around as well, and bond valuations are near record highs.

The total combination of high-valued stocks, high-valued bonds, and high-valued homes has pushed the current ratio of net worth to income to record levels, higher than any other time. This is what some people refer to as the "Everything Bubble".

During bull markets and periods of easy monetary policy (low interest rates, quantitative easing), asset prices tend to inflate to high levels. Net worth relative to income tends to expand as home prices and stock prices all soar upward.

During economic slowdowns, recessions, and periods of tight monetary policy (higher interest rates, quantitative tightening), asset prices tend to be pulled down due to there being less liquidity in the system and because safer income-producing bonds become more attractive. Net worth relative to income tends to contract as home prices and stock prices decline.

During this recent cycle, ultra-low interest rates and the experiment of quantitative easing seem to have pushed asset valuations as a whole to all-time record highs, even if no particular asset class is at all-time record highs. They're all at *near*-record highs at the same time.

There are some asset types that have diverged from these high current asset prices though:

- Semiconductor companies entered a major downtrend, as this industry tends to be more cyclical than others. The last downtrend was in 2015/2016, and we're in the middle of another one in 2018/2019. I recently bought shares of Micron with a cost basis in the $30's. Months ago this stock was trading for well over $60.

- The price of oil collapsed because Iranian oil came off the market due to sanctions more slowly than OPEC expected, so in response in November I sold put options on the United States Oil Fund ETF (USO) to diversify a bit into that space. My cost basis if assigned would be around $49/barrel for WTI crude, which just a few months ago was trading at $76.

- Commodities in general remain in a long bear market, which bottomed in 2016 but still remains in distress. I own some precious metals and precious metal stocks as a hedge, as well as a bit of Nutrien (maker of potash, fertilizer). Silver and platinum are quite cheap, and agricultural products are quite cheap.

- Outside of the United States, equity and bond valuations are mostly cheap. I'm moderately bullish on emerging markets, meaning I expect them to do well over the next decade based on current low valuations, high growth rates, and less debt than developed countries. Some are much stronger than others. I have no particular opinion about their performance over the next year or two.

Chart Set 4) U.S. Federal Deficit and Debt to GDP

Historically during most bull markets, tax revenues go up and the government is able to reduce its fiscal deficit. Then, during recessions, tax revenues fall, the government does various stimuli (increased food stamps, bailouts, tax cuts, infrastructure spending, etc) which temporarily leads to larger deficits until economic growth picks back up.

This bull market is different because the government performed a fiscal stimulus (tax cuts without equivalent spending cuts) during a bull market in 2017/2018. We now have deficits of 4% of GDP during a strong economy, and the deficits are projected to soon rise to 5% assuming no recession.

Chart Source: CBO Projected Deficits

During the next recession or economic slowdown, federal deficits will most likely rise sharply as they often do. Rising to a recession-level deficit from a bull market deficit that is already as big as 4-5% of GDP would be bad and unprecedented.

The debt-to-GDP ratio is already at historically high levels for the United States and projected to increase sharply due to entitlement spending that outpaces taxation, so there is less flexibility, less “ammunition”, for the government to stimulate the economy next time there’s a recession or economic slowdown.

Source: Congressional Budget Office

The United States hit a peak debt level during World War II, but then began gradually reducing its debt as a percentage of GDP until about 1980, when it started rising. It has now been rising for 40 years and is quite high compared to many other countries, but not as high the most-indebted countries like Italy, Greece, and Japan.

For investors over the next few years, this is relevant for a few reasons:

- The U.S. federal government has less flexibility to stimulate the economy during the next recession or economic slowdown. The deficit will be large, most likely resulting in even more political polarization.

- Less likely but more severe, there could potentially be a crisis of confidence in the dollar or treasury bonds if deficits get too high, resulting in higher yields for those bonds. That could cause stagflation and would be bad for current holders of long-term treasury bonds.

Japan is ahead of the United States on this in a bad way; they have higher government debt and way more quantitative easing without having caused a currency crisis or loss of faith yet, which is a good sign for the prospects of the United States.

Unlike the United States though, Japan has a positive current account (net investment position and trade balance combined) and a much wealthier middle class.

Overall, I'm certainly concerned about U.S. federal debt and deficits for the foreseeable future from an investor perspective, especially when combined with high U.S. stock valuations, high real estate valuations, high corporate debt, and a weak U.S. middle class.

Portfolio Updates

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

These include a primary passive/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 four months ago with $10k of new capital, and I 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 January, here’s the portfolio today:

The portfolio's defensive exposure to dividend stocks, gold, short-term bonds, real estate, and lower-valued international equities has protected it from a big chunk of the U.S. stock declines in Q4 of 2018.

The portfolio is up 1% aside from contributions since inception compared to the Vanguard Total U.S. Stock ETF which is down over 7%.

Here's the more detailed breakdown of the holdings, including recent changes:

Changes since last issue:

- I moved my bond funds to shorter-duration ETFs, like cash-equivalents. Specifically, I sold BND and VCSH and bought BIL and GSY. You can read why here.

- I bought the dip in January and started a new growth stock investment pie for 5% of the portfolio due to the Q4 sell-off and put in Micron, Adobe, Alphabet, First Solar, Paypal, Visa, as well as the Kraneshares China Internet ETF (KWEB) that is invested in Chinese tech stocks like Alibaba, Tencent, Baidu, and others. You can read more here.

- I added Agnico Eagle to the commodities investment pie.

- I added five single-country ETFs and the Vanguard International Dividend Appreciation ETF to the international equities investment pie to further diversify country exposure.

- I added the Bank of Nova Scotia to the dividend stock investment pie.

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.

Related Guide: Tactical Asset Allocation

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:

Since last issue, I didn't make any changes.

- My cash-secured puts on Micron were assigned at a cost basis of a little under $36. Micron is volatile stock for aggressive investors but I believe it has large upside potential over the next 3+ years. You can read my full analysis here.

- Several covered calls expired profitably without being assigned. I may sell some out-of-the-money covered calls on my Brazil ETF to generate some extra yield.

Final Thoughts- A Focus on Dividends

With many characteristics associated with being late in the business cycle continuing to build, 2019 is one worth paying attention to. A few key things related to trade deals, Federal Reserve policy, and other matters could dictate the direction the market takes this year.

I consider myself to be defensively-positioned for my age, meaning I hold some cash-equivalents, short-term bonds, and precious metals as a protective hedge for my equities, while my equities still represent the main bulk of my portfolio.

During this period of high volatility and market declines, you may notice in the M1 Finance portfolio that the dividend stock portfolio held up significantly better than the Vanguard Total Stock Market ETF (VTI). Many good dividend stocks have wide economic moats, reasonable valuations, and good balance sheets.

Focusing on businesses with decent yields that have a good track record through multiple business cycles, at reasonable valuations, with low debt, should serve you well.

I hope everyone has a great new year. It's been an interesting ride for the past few months and we'll see how 2019 shapes up.

No matter how it goes, the key is to stay focused on your long-term goals, and to be comfortable enough with your portfolio that you can hold it through good times and bad times.

Sincerely,

This site provides equity research and investment strategies to give you the insight and data you need for managing your money through all market conditions.

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- How to Increase Your Credit Score to 800 and Above
- The 5 Most Impactful Tactics to Save Money I've Ever Found

12 In-Depth Tactics to Seriously Boost your Energy

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- Roth IRAs: How to Optimize Yours
- Federal Thrift Savings Plan (TSP): The Ultimate Guide for 2019
- How to Survive a Stock Market Crash or Bear Market

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