BLUMBERG B+V ADVISORS

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RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

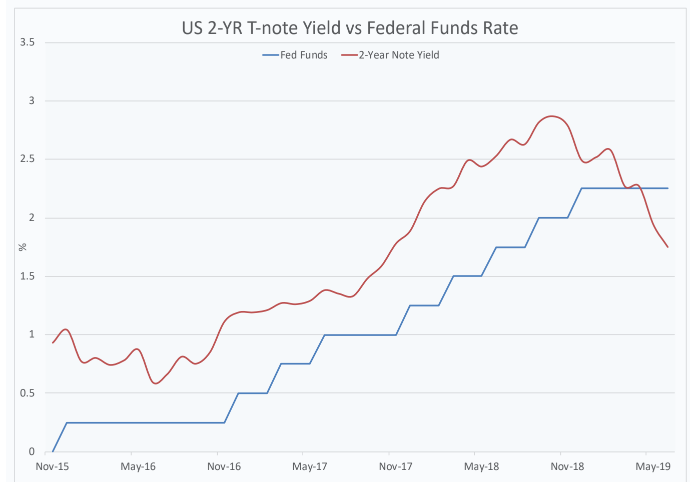
WHERE WE STAND – Q2 2019

The S&P 500 Total Return Index was up 4.3% (including dividends) in Q2 2019. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was up 2.8% for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 12.3% (black line). Data for 2018 is shown, broken lines, to the left.

Overview

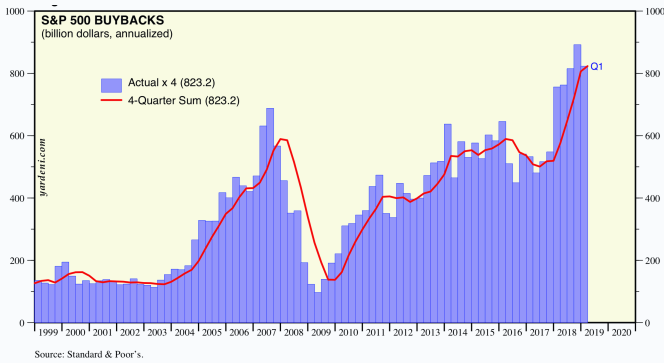
After a rally (to test the October 2018 highs) in April, and a correction towards the 200-day moving average in May, the S&P 500 index reasserted itself in June, returning to the high of its broad 2 year range of 2400-2950. Activity

for Q2 is shown in the shaded area of the chart below. Concerns over corporate earnings, trade friction and a global economic slowdown weighed on investor sentiment during the quarter. However, global central banks responded aggresively by words and, indeed, action to promise to effect aggressive monetary accomodation in an attempt to prolong the economic cycle and avert a worsening of the current downturn. As a result, global interest rates continued to collapse: best exemplified by the US-Treasury 2-year note which has fallen by over 1% since November 2018, to 1.75%; 0.50% below the current target for the Federal Reserve's policy rate. A dramatic shift, to say the least, where expectations have shifted from anticipating the Fed to further raise its

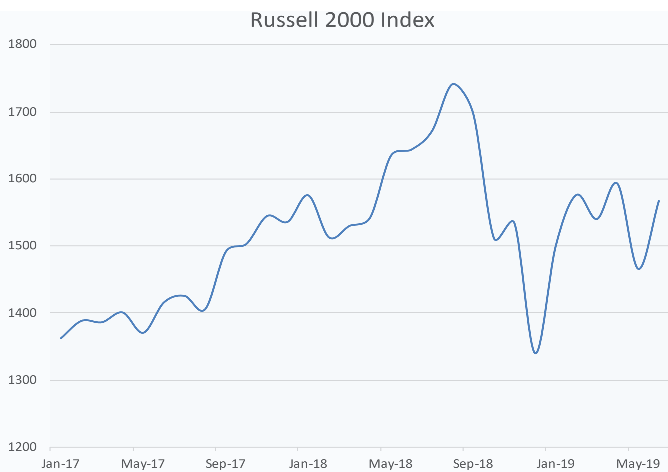


base rate in 2019, to now expecting two *cuts* by the end of the year. The last year has become a hair trigger environment, with sharp swings in investor confidence and increased volatility. Notwithstanding elevated levels of global economic policy uncertainty, however, equity prices have shown fundamental resiliancy. There are two overiding reasons for this:

- As a result of the corporate tax cuts in 2017, corporations have a windfall of cash flow that has ballooned stock buybacks to almost $1trillion per year. Its not uncommon for corporations to be buying back stock at the height of the cycle as they did in 2007 prior to the last recession. See the next chart, courtesy of Ed Yardeni. This is a price insensitive, raw



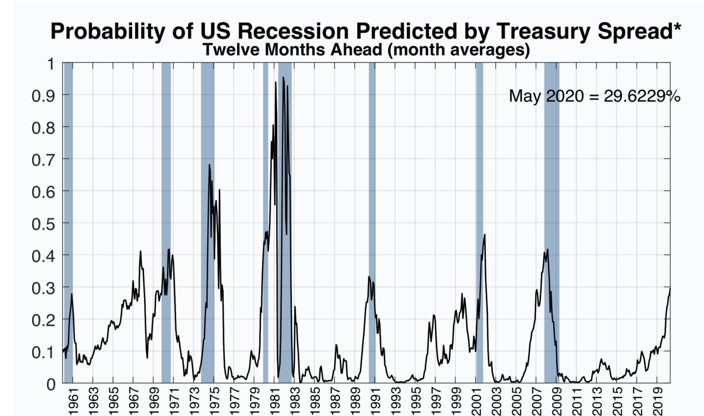
dollar demand for equities and has bouyed, particularly, large cap stocks in the last two years. The Russell 2000 index of small capitilization stocks (growth companies with less cash flow to buy back stock) remain 10% off the high they reached in 2018, perhaps reflecting a different economic reality. For now, however, Wall Street is assuming that buybacks will continue ad infinitum, a thesis that is likely to be tested.



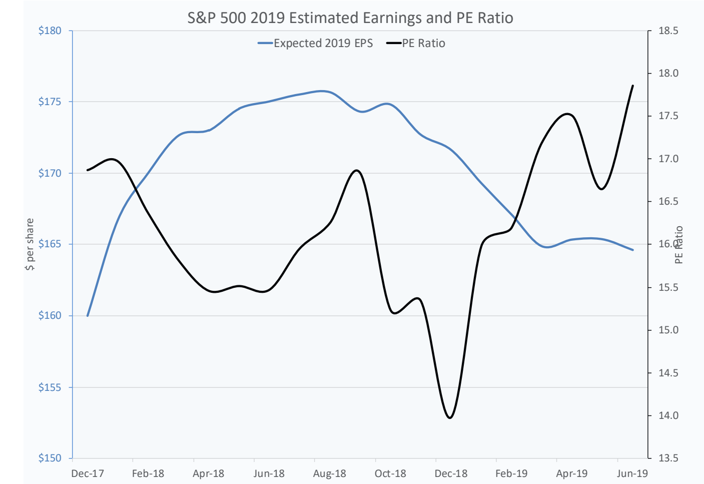
- Central Banks have embarked on an unprecedented experiment: pumping ever cheaper money and credit into the world economy. There are now over $13 trillion of negatively yielding bonds around the globe. That is to say, if you invest in these bonds, you have to pay the borrower to take your money, rather than you earning a rate of return as the lender. There is no historical precedent to this phenomenon. Its safe to say, that there is no telling how this normalizes, but it is easy to see that we are running into the limits of monetary policy efficacy and there is less and less dry powder that Central Banks possess to fight the next recession. For now, however, interest rates remain depressed and this bolsters equity valuations. This is the case as long as future earnings grow at current, optimistic, projected levels.

Heading into the Q3 earnings reporting season, it is apparent that Wall Street is reluctant to build more than a token moderation into future earnings growth for the S&P 500. For example, according to Standard and Poor's even though earnings estimates for the full year 2019 have been trimmed from $175 per share in late 2018 to, now, $165, earnings for 2020 are still expected to grow by over 12%.

This is an aggressive assumption and in no way factors in the possibility of economic slowdown in 2020. Note that as shown in the next chart, the NY Federal Reserve model is showing a ~30% chance of recession in 2020.

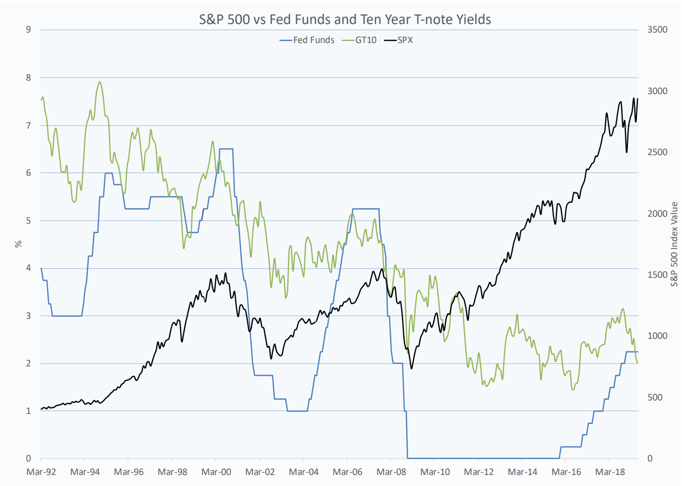


The rally in equities this year is explained by multiple expansion (a manic reversal of investor exuberance relative to the mood in late 2018), with the 2019 PE ratio (black line) rising to almost 18x earnings vs. 14x in Dec 2018.



As an aside, this is the highest PE ratio since December 2017 and September 2018, periods that both presaged market corrections. For now, investors are betting that the Fed will engineer a soft economic landing as it did in the late 1990's. This view deserves to be heard and understood, but we also need to be mindful that in 2000 and 2007, the first Fed interest rate cuts of a cycle were followed by 50% bear markets and ongoing rate cuts

before stabilization returned and the new cycle began. Note too, that back then the Fed had the ammunition to

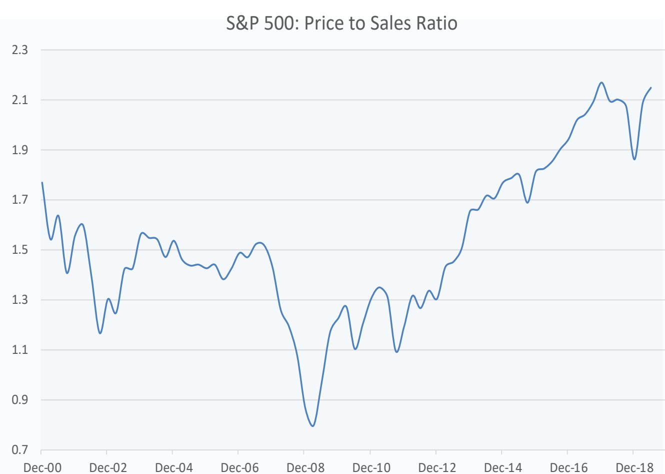


cut interest rates by 5%. Today we are beginning the cycle with a Fed Funds rate of 2.25%.

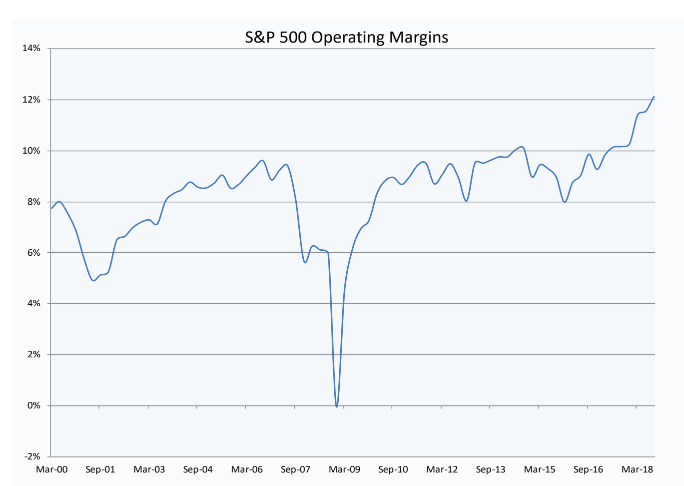
Where We Stand

For the past 18 months our strategy has been one of capital preservation and opportunistic market timing. That is, to keep volatility in our portfolios low, by having an underweight equity holding and by enjoying the higher return offered in relatively risk-free bonds. We have increased our equity allocation on market corrections and reduced it in over exuberant rallies. This is a strategy tailored to the belief that we are late in the economic, and hence investment cycle, and forward equity returns are limited in the medium term. This is different to how we conducted our strategy earlier in this cycle (with aggressive equity allocations) and how we will do so at the beginning of the next cycle.

Other valuation metrics that we look at, like price to sales are at uncomfortably elevated levels as shown below.



And operating margins are at historic highs as shown in the next chart.



If sales moderate, as would be expected in an economic slowdown, and margins* fall, the earnings model that Wall Street is using could be stressed in a negative way, impacting sentiment and valuations. Not to say this is a definite outcome soon, but it is an outcome with a reasonably high probability of occurring.

For now, therefore, our strategy will continue along current lines: defensive, derisked portfolios with steady accretion to new high valuations and opportunistic market timing when bouts of volatility present themselves.

*Margins have risen because labor's share of profits has fallen; taxes fell; tariffs fell until recently; globalization increased reducing cost of production; technology has increased scale and lowered costs; anti-trust enforcement fell; and interest rates have fallen. Many of these variables have stopped positively contributing to margins and in some cases are reversing.