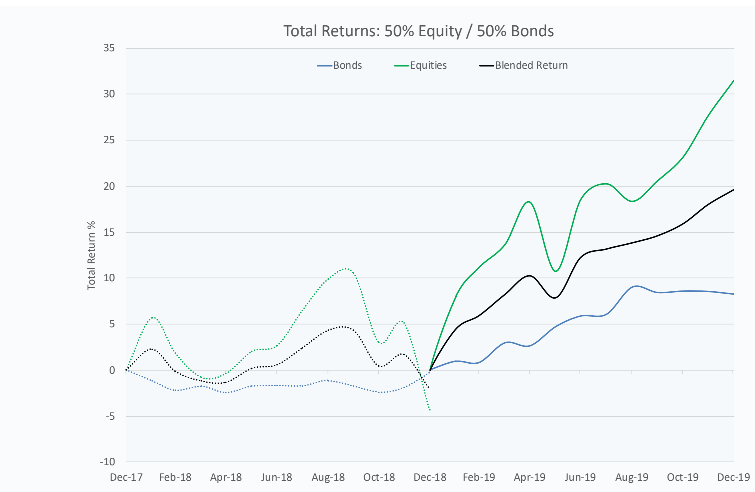
JANUARY 1ST, 2020
RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

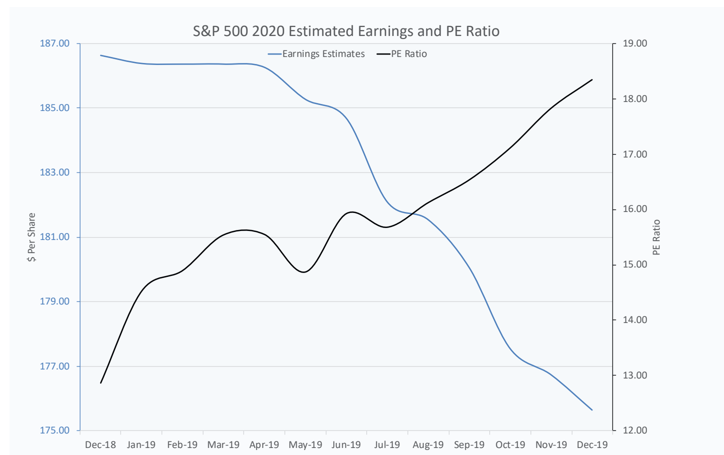
WHERE WE STAND – Q4 2019

The S&P 500 Total Return Index was up 9.04% (including dividends) in Q3 2019. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was down 0.1% for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 19.7% (black line). Data for 2018 is shown, broken lines, to the left.



Overview

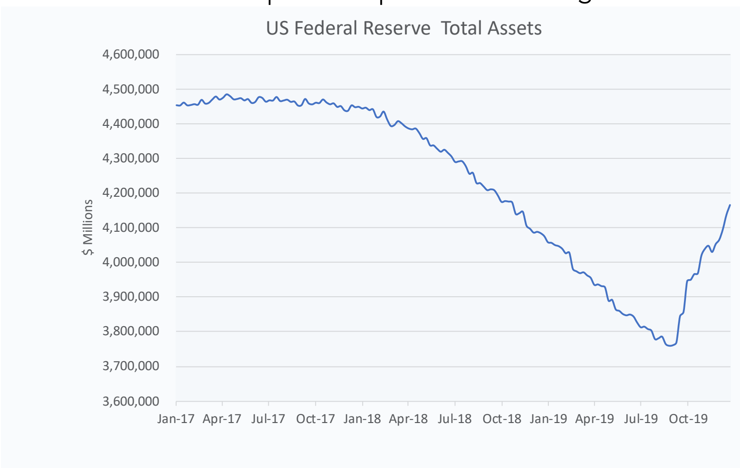
The S&P 500 index ended 2019 with a strong rally in the 4th quarter, further cementing the recovery from the 20% correction in late 2018 as shown in the chart above. This continues to be an investor sentiment or 'multiple expansion' rally as shown below. Earnings expectations for the S&P 500 have continued to decline during the year (blue line), with a comensurate rise in the price:earnings multiple, from 13.0x earnings at the depths of the 2018 correction, to 18.2x now, a 40% increase!



The extreme negativity that pervaded the US equity market in late 2018, has morphed into an excessively positive prognostication at the end of 2019.

Why?

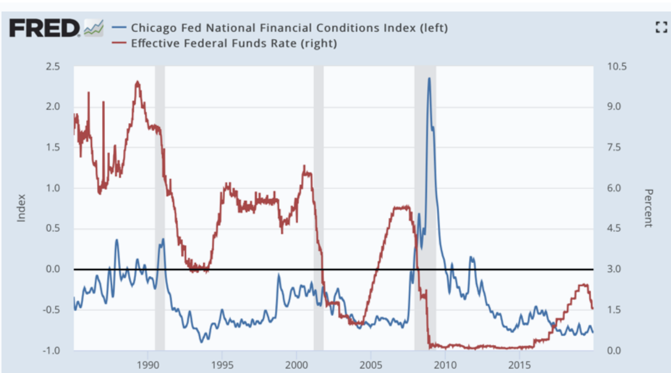
The primary reason lies in the actions of the Federal Reserve. In early 2019, the Fed, reversed course and started to ease their policy rate, owing to concerns that the US economy may be heading for a sharp slowdown. This was enough to stabilize sentiment and reverse the losses in equity prices from late 2018. For most of the period from May 2019 to October 2019, the S&P 500 vacilated in a trading range, as shown in the chart to the left, buffeted back and forth by varying perceptions on future economic growth and progress relating to trade negotiations with our major trading partners, especially China. Then, in October an arcane development in the inner workings of the US money market, created concern at the Fed, that the gears of the system were becomimg 'gummed up' and that there was a lack of sufficient reserves to ensure smooth operation of the funding needs of market participants. Accordingly, the Fed started to add reserves to the system, and although the Chairman of the Fed went to lengths to explain that these actions were technical in nature, market participants interpreted the sudden expansion of the Fed's balance sheet as a resumption of quantitative easing.



The chart above shows how unexpected and meaningful this Fed balance sheet expansion has been, with a complete reversal of the previous full year of balance sheet shrinkage.

So, in a year, the implied valuation of the equity market went from 'recession is imminent' and the S&P 500 doesn't deserve a PE ratio higher than ~13-14x earnings; to 'all is clear and the longest expansion in US history will continue for years to come' and therefore a PE ratio of 18.2x earnings is justifiable. The unemotionally deduced reality is probably at neither extreme.

The actions of the Federal Reserve are intriguing. The blue line in the next chart shows financial conditions in



the US economy going back to the late 1980's. The lower the line, the easier financial conditions. The red line shows the Fed's policy rate. Usually, it's a tightening in financial conditions that causes the Fed to begin easing policy. Typically, recession (shown with grey bars) follows after the Fed starts to ease rates, and the Fed continues to ease into the recession. Today, financial conditions are as easy as they have ever been and yet the Fed has started to use up its limited capacity to reduce rates (because they are uncharectaristically low for this late in an economic cycle).

It remains to be seen whether this is a mid-cycle adjustment by the Fed, that successfully elongates the current expansion (as was the case in the mid 1990's) and leads to a further bubble in financial assets as was the case by 1999. Or, whether it is a precursor of an economic slowdown/recession as was the case in 2000 and 2008 that led to bear markets that halved the value of the S&P 500.

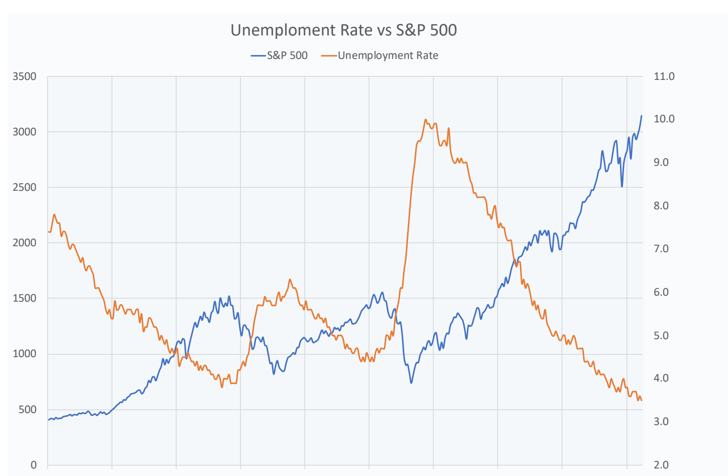
Where We Stand

This has been a somewhat challenging quarter for value investors such as us. Same can be said for 'late cycle capital preservationists' such as us.

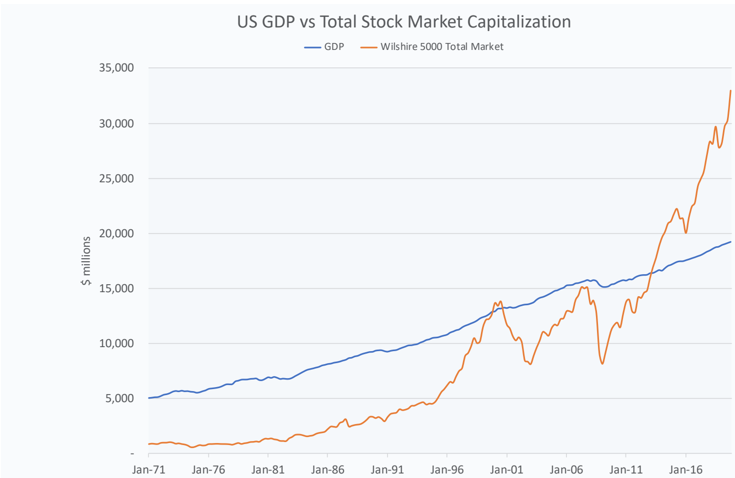
Our macro and micro analysis says to us we have a sober assessment of the investment landscape, but the behavior of the 'crowd' says, at least for now, we have been too conservative. For now, this borders on a mea culpa for me. Even though all our portfolios have grown steadily recently and are de-risked, we have lagged our benchmarks this year. Although our strategy served us well in 2018, it had an opportunity cost associated with it in 2019.

It is typical for value investors such as us to outperform our benchmarks earlier in a cycle and underperform them late in the cycle. That's how we prevail in the long run.

Some macro pointers:



The above chart shows the unemployment rate (orange line) at an extreme low, a reliable indicator of being very late in the economic/investment cycle. Note how this indicator suggests caution vis-à-vis equity prices. Very low unemployment coincides with a topping in equity prices.



The above chart, known as a Warren Buffett favorite, shows US stock market capitalization vs US GDP. It shows how cheap the equity market was in the 1970's age of inflation and how the bull markets of the 1980's and 90's restored equity values to equate with GDP. Also, how the two bear markets of the 2000s provided excellent opportunities, and how the recent experience has distorted the relationship very much in favor of equities. There are some arguments as to 'why its different this time' (a phrase I tend to avoid, because history usually repeats/rhymes) to justify these lofty equity valuations. They are: the very low level of interest rates support higher equity valuations; lower (albeit deficit financed) corporate tax rates aid corporate profits; and increasing levels of corporate debt to finance corporate buybacks (aka financial leveraging) diminish equity supply. However, if inflation does not remain contained, and/or GDP growth falters, these tenets will be harshly judged, with a serious mean reversion possibility of equity valuations to underlying GDP.

There are other distorted and unsustainable macro variables that currently exist, like inordinately compressed high-yield spreads and a deteriorating US fiscal deficit situation that I've left out for purposes of brevity, but will have to be dealt with at some point.

The micro:

Every quarter we conduct a rigorous analysis of all S&P 100 large cap stocks to develop a sense of relative values between these stocks and to formulate an absolute view on the value of the overall market.

We relate the price the stock is trading at now to an expected price in say 3 years (based on a reasonable assumption as to earnings growth and future price:earnings ratios), add expected dividends and thereby arrive at an expected annual compounded return for each stock. We then rank each of the 100 stocks to generate investment ideas. Finally, we estimate an expected return from and index of all 100 stocks and relate that to the yield on the 10-year note to generate a proprietary equity risk premium (a measure of how rich or cheap the overall market is).

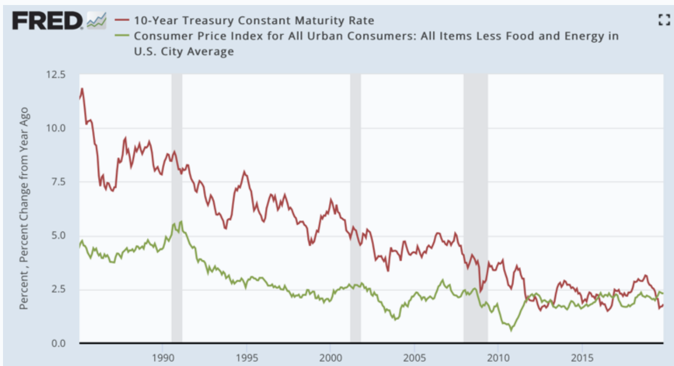
As to the overall market, our work is showing the most overvalued readings of this cycle. This is intuitively understandable given the multiple expansion we referred to earlier. Specifically, for example, even during the mid-part of the cycle (2013-2016), we were arriving at expected forward equity returns of 6-8% p.a., with the yield on the 10-year note ensconced around 2%. Thus, an attractive equity risk premium of 4-6%. Today we show expected equity returns of 2%, and a 10-year yield of around 2%, and thereby an equity risk premium of zero. That is, currently, there is no compensation to the investor for holding equities.

As to individual companies: if they are names one would consider owning, because they are best in breed, the valuations in some instances are fundamentally prohibitive. For example:
<u>Microsoft (MSFT).</u> In 2013, MSFT had a PE ratio of 14x. Today it is 30x. And other examples in various technology stocks are even more extreme, like Nvidia, a high flying investor favorite cyclical chip manufacturer which trades at a 60x PE.
<u>Costco (COST).</u> In 2013, 24x PE. Today, 35x.
<u>Johnson & Johnson (JNJ).</u> In 2014, 17x. Today 28x.

Our plan for 2019 is to stay with our strategy for now. Preserving capital and taking advantage of volatility to opportunistically add to investments that make sense from a valuation perspective. Consistently, over the last couple of years we have questioned whether the current cycle will resemble the late 1990s experience which involved a long late cycle expansion in multiples before a protracted bear market developed, or whether it would be like 2008, a correction from less lofty valuations. For now, the jury is still out although the action of recent months has signified that consensus, rightly or wrongly, is in favor of the former.

We believe though, that the extent of multiple expansion is hindered by a few factors:

- In the late 1990's interest rates, were in a healthy (not approaching zero) declining trend. Today the ten year note trades below the inflation rate as shown in the chart below. This is an unprecedented distortion created by global central banks which adds to the ever-increasing global debt explosion.



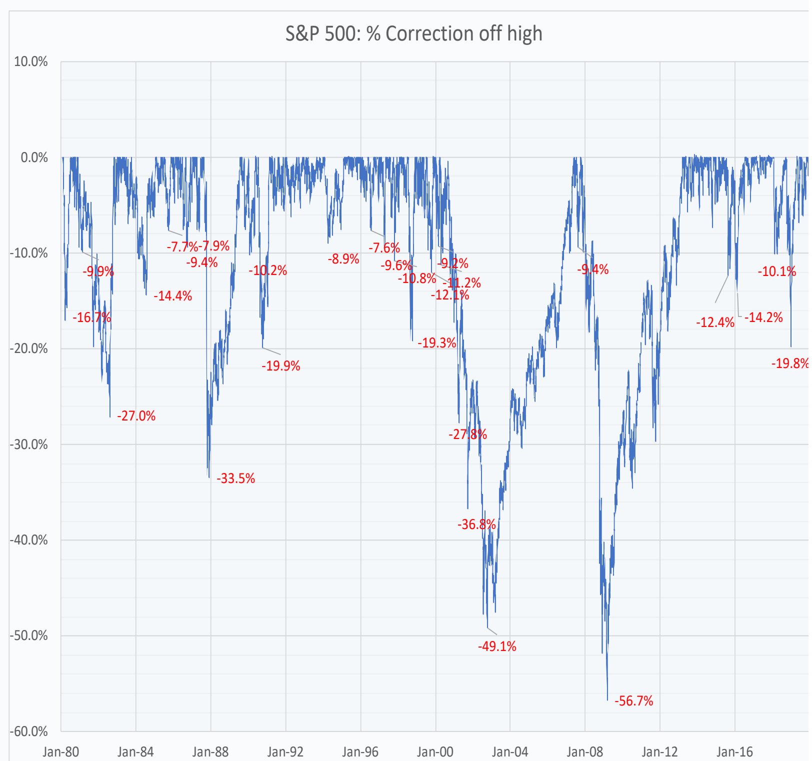
- In the late 1990's government debt to GDP was 40% and the government budget turned to a surplus. By the end of 2020 the ratio will reach 120%! The point being that is there is no room for fiscal policy to become a tool to fight a slowdown in economic growth.
- The unemployment rate was almost 6% in 1995 and had improved to 3.8% by April 2000 a constant contributor to consumer and investor confidence, whereas today, the rate is already at 3.5%, with some forward looking indicators like the rate of change of unemployment claims pointing to the fact that the best of labor market gains in this cycle are behind us.

Currently, as the equity market makes new highs, as it did in 1999 and into 2000, it is worth noting that volatility did present itself during that period. The large chart shows drawdowns off of new highs for the S&P 500 going back to 1980. I suspect that volatility in 2020 will be similar and provide us with both a level of comfort that our portfolios are de-risked and perhaps with some opportunities to deploy some of our capital as was the case at the end of 2018.

We will be mindful to apply the same rigor that we always do in judging whether each opportunity stands on its own merits and how the business cycle is developing.

"Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgement is sound, act on it – even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right. Similarly, in the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgement are at hand."

-Benjamin Graham *The Intelligent Investor*



BLUMBERG
B + V ADVISORS