Commentary
by Steve Henningsen
July 2017

Inflection Points?

"…for there is no folly of the beast of the earth which is not infinitely outdone by the madness of men."
[Or women]
–Herman Melville, Moby Dick

"We do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."
–Ben Bernanke, Past Fed Chairman, 5-17-07

"Would I say there will never, ever be another financial crisis? ... You know, probably that would be going too far, but I do think we're much safer and I hope that it will not be in our lifetimes and I don't believe it will be."
-Janet Yellen, Federal Reserve Chairwomen, 6-27-17

"The stock market seems to be running pretty much on fumes… I am somewhat concerned about the complacency in the market,"
–San Francisco Federal Reserve Bank President John Williams, 6-27-17

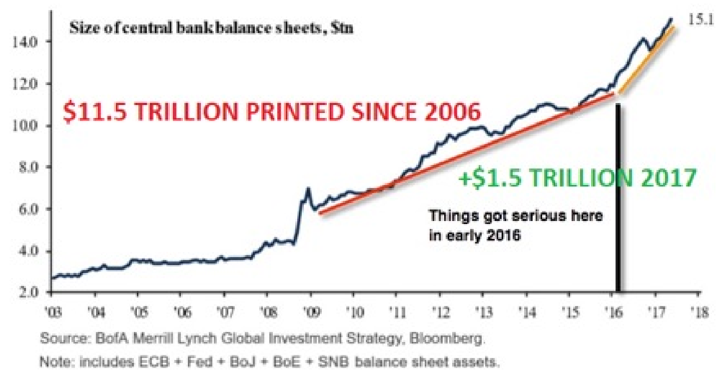
"The Federal Reserve is clearly trying to send a message to the US equity market, but the blind buyers appear to be deaf as well. We cannot recall an instance in our more than two decades in this industry when both the Fed Chair and the Vice Chair has each referred to asset values, especially equities, as expensive on the same day."
-Mike O'Rourke, Chief Strategist for Jones Trading

As I highlighted in my recent client email update, Ms. Yellen's June speech caused a few doubletakes in the financial markets. It wasn't just because of the hubris she showed in confidently stating that there probably wouldn't be another financial crisis in our lifetime (you would have thought she learned from her predecessor Ben Bernanke's gaff right before the 2008 crisis) but in her resolve to maintain interest-rate hikes *and* add in the possibility of reducing the Fed's balance sheet. It's this last part that got market participants' attention, as it would mark a major shift in maintaining their current balance-sheet level. Did the chief monetary bartender just announce, "last call" on easy money? As Mr. O'Rourke points out above, the markets don't seem to have noticed that the central banks just turned on the lights. Are Fed officials worried that the real economy is heating up with increasing CPI inflation, consumer spending, and wages? Nope, not according to the recent numbers. The only inflation has been in asset prices, which the Fed now appears concerned about.

For the past several decades, Fed Chairmen have used the ability to lower short-term interest rates to juice the stock market whenever they saw fit. It started under Chairman Greenspan, which is why it is referred to as the "Greenspan Put," but was quickly adapted by his followers, Chairman Bernanke and now Chairwomen Yellen.

However, low interest rates weren't enough to revive the market after 2008's crisis, so they had to begin adding liquidity to the markets by buying up U.S. Treasury and mortgage bonds during their Quantitative Easing (QE) programs. The liquidity from these QE programs (show in green on chart) seeped into the financial markets and helped elevate them. However, as you can see, whenever they stopped easing, the stock market dropped, or leveled off.

This didn't just occur in the U.S. but globally as central banks worldwide instituted their own QE programs to buy assets. While the U.S. isn't currently adding to their balance sheet, European and Japanese central banks are more than making up for us. As you can see, over $1 trillion more has been added just in the first six months of this year.



Now, back to the Fed's announcement that they were "considering" reducing the Fed's balance sheet. Many suspect that these monetary assets helped prop up the financial markets over the past several years, so wouldn't that imply that by reducing them, the markets might decline? In other words, does the Fed no longer have the financial markets' backs? I don't appear to be the only concerned investor. Eric Cinnamond recently stated on his blogsite, *As the Federal Reserve attempts to exit from years of record low interest rates and previously unimaginable asset purchases, I'm reminded of my experience with overdosing on caffeine. I have unfortunate news for the Fed. There is not a safe exit from a stimulant binge – even if you stop, the effects are already in the system. In the case of the Fed, their relentless doses of monetary caffeine have already significantly altered interest rates, asset prices, and capital allocation decisions. The only uncertainty, in my opinion, is how many more cups of monetary stimulus can be served before investors realize something is wrong, get jittery, and cause the central banks to lose control.*

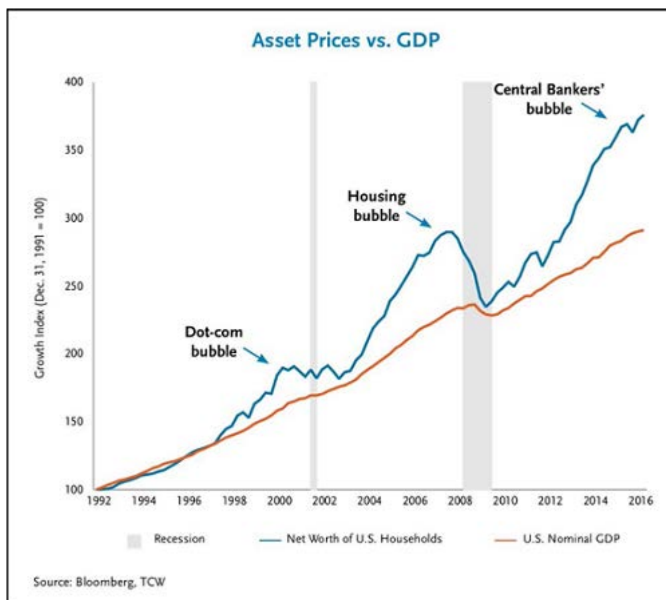
So again, why would several federal reserve governors now suddenly be questioning stock-market valuations? Even the President of the European Central Bank (ECB), Mario Draghi, recently hinted at slowing their QE program, which briefly shook European financial markets. Why are they raising rates in a weak economic environment and with policy gridlock in Washington?

"We are at the end of a multi-decade debt binge monetary supercycle, and global central banks and governments have been taking tail risk, they've been pushing tail risk into the future, they've been bringing returns to the present. And what's occurred is that people have imagined that they're destroying risk. You can't destroy risk. They've simply transmuted that risk, and they have actually even amplified it. …and beyond. Fixed income, bond yields, are at the lowest levels in human civilization. We've only moved debt from the corporate balance sheet to government balance sheets and sovereign balance sheets, and now sovereign debt are at the highest levels in, really, recorded modern history. And there is limits to the efficacy of a central bank stimulus, and this is all occurring at a point where rising populism is potentially going to cause the post Bretton Woods world order to come to a collapse.

–Christopher Cole, CIO of Artemis Capital Management, 2-22-17 RealVision Interview

Maybe, just maybe, central bankers finally realized their policies of low/negative interest rates and Quantitative Easing hasn't worked the way they had hoped. Maybe it dawned on them that adding more than $50 trillion in debt to the global financial system after the 2008 debt crisis wasn't a good idea. John Mauldin pointed out at a recent conference I attended that global debt and unfunded pension liabilities will be over $300 trillion this year. That doesn't even include $120+ trillion in unfunded liabilities in the U.S., not to mention Europe and the rest of the World. As Mr. Cole points out, central banks haven't remodeled by removing risk, they've just rearranged the furniture in the room. Worst of all, a growing number of people have started to notice the "furniture disparity" as while they are stuck with the same crappy fixtures, the highly affluent have been able to use the financial situation to upgrade their accommodations greatly.

But if you close your eyes,
Does it almost feel like
Nothing changed at all?
And if you close your eyes,
Does it almost feel like
You've been here before?
How am I gonna be an optimist about this?
–Pompeii, *Bastille*



Maybe it finally hit central bankers that building yet another bubble on cheap money won't work this time either. While their recent statements certainly demonstrate concern, accepting some blame for the situation is a bridge too far. As James Grant pointed out in his June 30th newsletter when Janet Yellen was asked by a reporter if she had learned anything from the Fed's QE and bond buying programs, she only mentioned that it may have put downward pressure on bond yields. According to Mr. Grant, *She acknowledged no side effects– no mispricing of credit; no artificial compression of real-estate cap rates or elevation of price/earnings ratios; no robbing of savers, pensioners and annuitants to subsidize the net borrowers; no perverse deflationary pressures brought about by the buildup of debt. Observe she said, there has been no 'runaway inflation'.*

While low rates have kept a lid on debt servicing costs, allowing them to leverage-up again under the illusion of affordability, rising interest rates may dampen future demand as consumers retrench. What seems clear to me is that their policies have incented a move towards price-insensitive investing.

Active vs. Passive

"In 2017, I fear the bubble is mainly in passive investing… Most all the positive flows are going into passive funds. 'Don't worry about fundamentals, or values; don't worry about market timing; just buy the market and hold!' Even if there is a small correction, the market has always come back! Sounds 'bubbly' to me."
–Ned Davis, *The Passive Investing Bubble*, 3-22-17

As I have stated previously, I have nothing against passive investment products like index funds and exchange traded funds (ETFs). I currently use them in portfolios and have done so for decades. They are

a great way to get inexpensive, tax-efficient exposure to a specific sector of a market, asset class or country. However, like many things in life, one can get too much of a good thing. The current trend of buying index funds and ETFs that track broad-based stock indexes like the S&P 500 can be indirectly traced back to central bank asset purchases. By methodically purchasing assets, central banks have depressed volatility to record lows which has increased demand for passive investment products. The majority of index funds are capital weighted, which means more and more money is going into fewer and fewer stocks. They're "price insensitive" in that they simply invest in whatever makes up the index. For example, Exxon is the 6th largest component of the S&P 500 index at 1.7%, so whatever money flows to this index gets invested 1.7% into Exxon's stock. It doesn't matter what its fundamentals are, the money has to be invested, which probably helps explain why Exxon's stock trades at a relatively expensive 33% P/E ratio. "By piling into ETFs [broad-based], investors lose the perspective of individual stock valuations that they now own," wrote Fred Hickey, editor of The High-Tech Strategist. "They're chasing performance…without the knowledge that they're almost all piling into the same big-cap tech stock names, pushing them ever higher, thus attracting even more money to the likes of the Fab Five [Apple, Google, Microsoft, Amazon and Facebook] Techs…" Those interested in reading more about this issue can go here.

"All investment frenzies pass. The market is gloriously inefficient and wanders far from fair price but, eventually, after breaking your heart and your patience…it will go back to fair value. Your task is to survive until that happens."

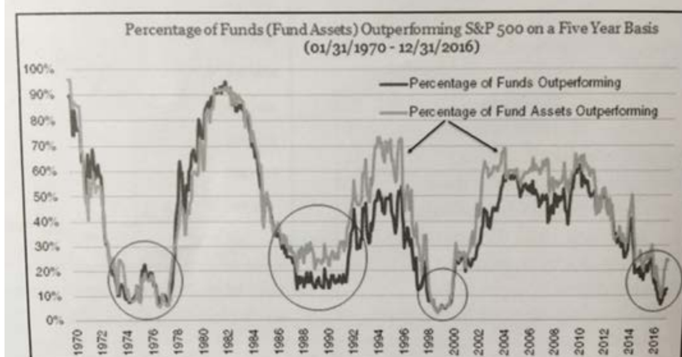
-Jeremy Grantham, co-founder of GMO

The upward trend of the stock markets over the past few years has also caused active mangers (managers who invest using company fundamentals and hedge volatility using cash or "shorting" strategies) to underperform relative to various indexes they are compared to. This is nothing new, as there have been several active/passive cycles over the years.

"We've seen this act before. If you didn't own the nifty 50 stocks in the early 1970s, you underperformed and, thus, money continued to go into them. If you were a growth stock manager in 1998-1999 and you were not buying "net" stocks, you underperformed and were fired. More and more money went into fewer and fewer stocks. Today you have a similar case with the FANG [Facebook, Amazon, Netflix & Google] *stocks. More and more money is being deployed into a narrower and narrower area. In each case, this trend did not end well…When you are in an environment where the lead entity, the Federal Reserve, has its foot on the scale and is distorting the information coming out of the capital markets, where interest rates can go to zero, what is the proper hurdle rate for budgetary or capital allocation decisions? These actions distort the price comparison or discovery process in the capital asset-pricing model. This is highly disturbing."*

–Bob Rodriguez, retired investment manager, *We are Witnessing the Development of a "Perfect Storm"*

Marc Faber's June 1st newsletter contained this chart that shows two lines representing the percentage of actively managed funds and fund assets that have outperformed the S&P 500 over a 5-year span. The first three circled areas represent times when active management reached its low in underperformance and began their 5-year outperformance against the indexes. You will notice that most coincide with the start of volatility/bear markets (1973, 1990, 1999.) My inference is that we have begun another period of increasing



volatility in which active managers outperform passive strategies.
Speaking of cycles…

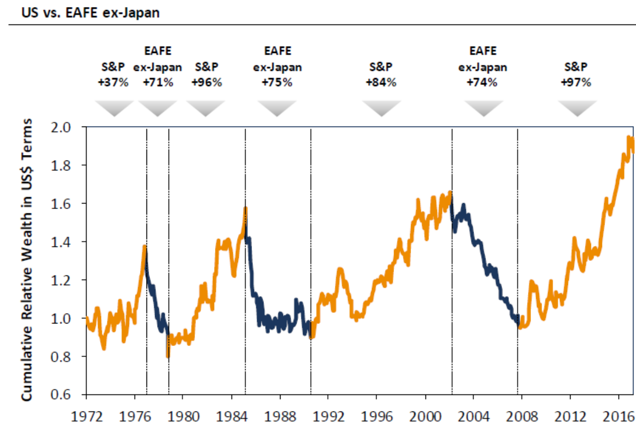
Reversion to the Mean?

"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions."
– Seth Klarman, CIO Baupost Group

"We are at a high level, and its concerning…I think people should be cautious now. We have a high market. That doesn't mean I would avoid it all together. One can invest abroad also, the US has an unusually high stock market compared with other countries, or one can invest in low cape sectors."
–Professor Robert Shiller, Yale School of Management Economics, interview CNBC 6-29-17

As Prof. Shiller points out, U.S. equity markets are relatively expensive compared to many international markets. This trend of U.S. outperforming foreign markets also appears to be coming to an end this year, as this chart clearly shows the cycle is long in the tooth. Although international markets are correlated to U.S. markets in the short-term, my guess is that the next 5+ years will see higher returns in foreign markets, as this cycle also begins to shift. Unfortunately, most U.S. investors have very little international exposure in their portfolios.

Exhibit 1: US and Non-US Equity Markets Change Leadership Position

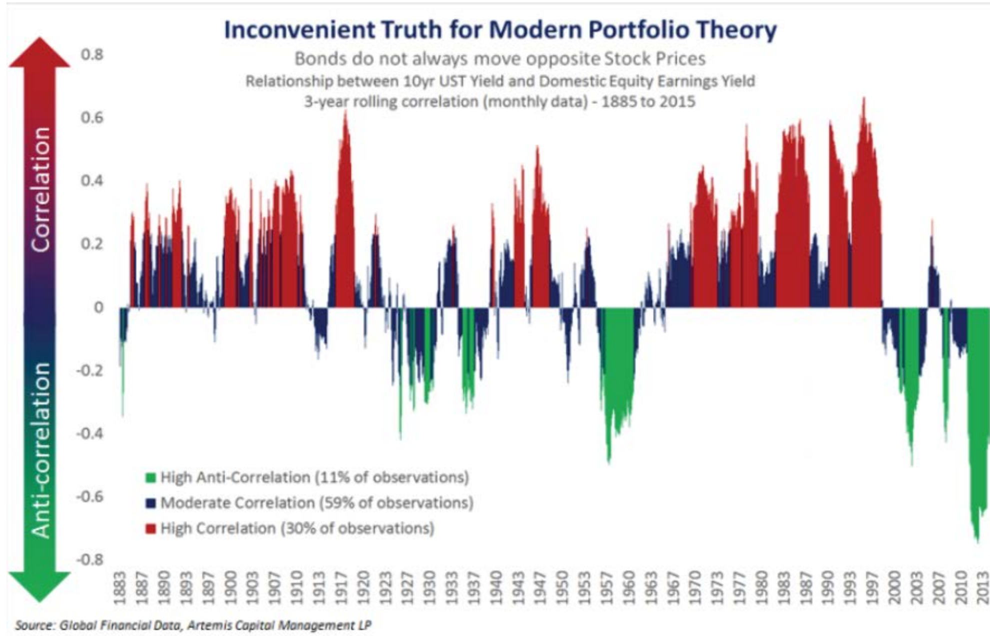


As of 3/31/17
Source: GMO, Standard & Poor's, MSCI
Note: Excludes Japan

Another cycle that could eventually prove worrisome is that between stocks and bonds.

"A 60:40 allocation to passive long-only equities and bonds has been a great proposition for the last 35 years. …We are profoundly worried that this could be a risky allocation over the next 10."
—Sanford C. Bernstein & Company Analysts, January 2017

Most investment professionals are taught that you build a portfolio with both stocks and bonds for mostly diversification purposes – Bonds go up in value when stocks go down and vice versa. However, when looking at 120 years of history, one might draw a different conclusion. Christopher Cole of Artemis Capital Management did just that as he put together the following chart.



It turns out stocks and bonds are more correlated with one another than many were taught to believe. As Chris stated in a recent interview: *They've been highly correlated with one another about 30% of the time, and they're only anti-correlated with one another 11% of the time. It just so happens that the period of anticorrelation has been predominantly since – starting in the late 1970s all the way up to modern times… you had rates peak and rates have gone down, and down, and down…. Now if we look back across history, there'd be multiple times where stocks and bonds have not only been correlated with one another, but they declined together at the same time. We saw this in the period of 1906 to 1912, we saw this in the '70s, where you were getting hammered on both sides of your portfolio.* So the question is if bond yields are currently at historic lows and equities near all-time highs, what are the odds that both can go down in value together at some point in the years ahead? While I still believe bond yields will reach new lows near term, I do think that at some point bond yields will finally reverse higher and begin their long-term trend upwards and that it will coincide with a decline in equity prices as inflation finally takes hold.

Portfolio Ponderings

"How do you survive, both physically and metaphysically, in a market you don't trust but where you must act as if you do? How do you pass? How do you reconcile the actions and beliefs necessary to be successful in this market with the experiences and training of a lifetime that tell you NOT to act this way and believe in all this?"

–Ben Hunt, Epsilon Theory, Tell My Horse

Ben's perturbation on how to invest in broken markets; a market where central bankers prop up asset prices via jawboning, cheap money and asset purchases certainly hits home for me. There is a saying on Wall Street that markets climb a wall of worry, and if it's true, then I'm guessing we are getting close to the top of the wall as there doesn't seem to be much "worry" in the markets anymore. But why shouldn't complacency reign in an environment where investors have been trained that the central banks will be there to protect them at the slightest backstep? Similar to Ben and other advisers who chose to remain defensive, while our reasoning may have been rational based upon experience and training as he put it, the end result over these past several years was that ignoring risk and blindly investing was the most productive path. How much longer will asset prices stay elevated? I don't know and am done trying to time its reversion to the mean. In other words, in a bubble world, prepare don't predict. This doesn't mean one throws caution to the wind – We still maintain a relatively defensive portfolio. But I have

added some positions in small increments to areas that I expect will perform well over the next several years – international and specific technology-based exposure. I will likely continue to add international equities on any pullbacks over the next 12 months. I also may reduce our precious metals exposure at some point, as I surmise that they will be one of the better-performing assets over the next 12 months as faith in central bank omnipotence wanes and inflection points bring volatility back to the markets.

The thought that central banks have banished risk from the markets reminds me of the scene in Jurassic Park where a scientist is explaining how by controlling the chromosomes of the dinosaurs, they are ensured of getting only females. Dr. Ian Malcolm, a mathematician and self-professed Chaos Theory expert, responds (I altered the quote a little): *Chairwomen Yellen, the kind of control you're attempting simply is... it's not possible. If there is one thing the history of financial markets has taught us it's that risk will not be contained. Risk breaks free, it expands to new territories and crashes through barriers, painfully, maybe even dangerously, but, uh... well, there it is.*

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