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Outlook for the New Year

Mark Burkhardt, Portfolio Manager   January 15th, 2016

My outlook of this new investment year brings to mind the title from one of my favorite songs by Martha Reeves and the Vandellas "Nowhere to run, Nowhere to hide" as both the stock and bond markets remain overvalued and each carries its own set of risks. The equity markets on balance are now looking for declines in both earnings and revenues as earlier fears of a global economic slowdown are just now being realized. Currently, there is a dwindling percentage of companies offering investors a compelling value proposition. Even after substantially raising our cash allocation starting in June of last year, my remaining defensive holdings have not been immune to the broader market decline we are now experiencing. A growing number of conservative stocks, many paying substantial dividends, have also seen their share prices come under recent and significant selling pressure.

Over the last six months we have been witnessing the end of what had been an extraordinary and historic bull market for both stocks and bonds. Several prominent investment firms are now raising the specter of a possible US recession beginning later this year. Unfortunately I have to agree that on balance, a number of events last year have set the stage for more serious problems to develop this year. We have already seen the ending of the Fed's extremely accommodative zero interest rate policy resulting in a much stronger dollar. That currency strength is furthering the collapse in commodities already weakened by slowing global demand.

Raising interest rates in a slowing growth environment is never a desirable combination. Especially when nearly every other country is actively cutting their rates to stimulate their own economies. Dramatically slowing growth abroad not only negatively effects the sales of our multinational companies but this also triggers massive declines in the currencies of many developing nations. Progressing into this year we are already seeing credit markets begin to tighten and corporate balance sheets, most notably in the energy sector begin to deteriorate. Corporate profit margins have also very likely peaked having run their full course of near record lows in 2009 to recent historic record highs.

The reason why many equities are still not attractively priced even at their current valuations, is that I cannot foresee any combination of plausible events that would allow the earnings multiple that they already command to expand further. It is hard to envision any scenario that would allow our markets to be up by double digits for 2016. Conversely, there are a number of reasons and risks that would give the markets ample justification to finish the year down by double digits. While the US markets reached new all-time highs in May of last year, for the rest of the year they still failed to move higher. Moreover they actually gave back the earlier gains despite the continued improvement of the underlying economic data. That is proving worrisome as historically the stock market usually peaks 8 to 9 months before a recession begins.

The most concerning scenario, though still remote, is that the events we are now witnessing could eventually morph into a global credit crisis. Enormous amounts of debt, both public and private throughout the world have been issued and priced in US dollars. If you are in a country that has seen its currency fall dramatically versus the US dollar, those debts that you have that are obligated to be repaid in dollars have quickly become much more expensive to pay back. One of the countries that has substantial exposure to this risk is China. While their government has let the yuan drop in value several times since last August, the Chinese currency remains overpriced when compared to their Asian economic rivals. Therein lies the conundrum that so many countries are facing. Do they continue devaluing their currencies in order to support their export dependent economies but by doing so also dramatically increase their risk of defaulting on nearly $5 trillion of dollar denominated debt? The elephant in the room remains China, which is quite likely to be remembered as being in the biggest credit bubble the world has ever seen. While their communist government reported that the Chinese economy grew at an annual rate of 6.9%, just shy of the official target of 7.0%, many astute economists believe its actual growth was far less at 3.5%. We are left to the realization that the global economy will once again become increasingly dependent upon the continued strength of the American consumer to offset the slowdown taking place in other regions of the world.

Looking to Europe, their markets have not been able to avoid the recent global selloff either. Many export dependent companies are under intense selling pressure as their growth has also become dependent upon strong economic growth from China and the emerging markets. While many European equities appear undervalued when compared to their US rivals, their success is unfortunately much more dependent upon growing overseas exports. Unlike the US, with Europe's nearly stagnant population growth, their home markets are in many ways more mature than ours and therefore exports are the only real way to organically grow revenues. So for now, the Eurozone will continue to pursue a post nationalist vision with the hope that a devalued currency, a common economic zone, and a welcoming welfare state will allow it to avoid the growing economic and political turmoil just beyond its borders.

The rest of the world, especially the emerging economies in Asia, South America and Africa are faring even worse. China's enormous appetite for raw materials and resources over the last 15 years has created entire export economies, dependent on that filling what had once been an insatiable demand. Zambia sends its copper, Angola sends most of their oil and South Africa much of her minerals all to China. As that demand shrinks and the US dollar increases in value, the prices which these countries can sell their commodities that are always priced in dollars have collapsed. Remember if something is priced in US dollars, and the dollar is going up in value because the Federal Reserve has stopped devaluing the currency by raising rates, then you will be able to buy more of it. Whether it is oil, wheat or coffee, it is important to realize that those sellers will get fewer dollars in return. How bad has this commodity decline been? We need to first look at the CRB Index to find out what its price history reveals to us.

The Commodity Research Bureau's index was first constructed in 1958 and is currently comprised of 19 various commodities: aluminum, cattle, cocoa, coffee, copper, corn, cotton, crude oil, gasoline, gold, home heating oil, hogs, natural gas, nickel, orange juice, silver, soybeans, sugar, and wheat. Petroleum products are given the heaviest weighting for the group and always make up 33% of the index. That index, just in the last five years has fallen from a reading of 370 to a level of 160 as of this week, a total decline of over 56%. That percentage of decline is very ominous as it is often a precursor of a future recession. For any country and ultimately any society that is dependent upon finding a market for these goods that they produce, this decline can create profound and prolonged economic damage.

If you are an oil producer, it's as if you have gotten lost in a time machine. Crude oil has fallen by nearly 70% since June of 2014 and is now trading at levels last seen in 2003. If you look at it from an inflation adjusted basis you could go all the way back to 1965 and pay the same for a gallon of gas. Why are the oil producing countries and companies still pumping so much oil even as prices continue to fall? They have to, because of their high fixed costs, enormous interest and debt obligations, any cash flow is needed even if it means selling a product at prices below their cost. Any return on their investment is better than none at all and therefore the global oversupply dynamic remains firmly in place.

After a historically long twenty five year rally, the US bond market presents its own unique set of risks as the Federal Reserve seems intent on moving rates higher. Remember that bond prices fall as interest rates move higher, and therefore depending upon their duration risk, many widely owned bond mutual funds can become increasingly vulnerable as rates move higher. As I had stated in my previous client letters, I thought it would be completely irresponsible for the Federal Reserve to begin raising interest rates just when the US and the global economy were beginning to show signs of real weakness. The Federal Reserve had numerous opportunities to raise rates starting three years ago when corporate earnings and revenues were still surging but chose not to. They had more faith in themselves then they did in the ability of the world's biggest and most diverse economy to heal itself. Unfortunately, as the old saying goes, power knows no boundaries. Their academic arrogance has fueled an interventionist addiction in which they can no longer imagine the real and unforgiving world where the markets, not the Fed, actually determine the price of assets, the shape of the yield curve and the true nature of risk.

Since that rate increase in late December, the S&P 500 is down nearly 10% and many global markets are down even more. With short term rates at zero for over seven years it is easy to ask why is only a quarter point interest rate hike such a big deal? Isn't our economy strong enough and our financial institutions stable enough to handle an event so widely expected? Those questions, seemingly relevant actually still miss the point. The amount of the rate increase is actually not what is important rather it is simply the tectonic change in direction after seven years that has created the greatest concern. For financial markets it is still a shock, much like an alcoholic realizing that he really did just have his last drink.

For our economy the change will be more subtle but eventually just as significant. In many ways it is like watching the waves while lying at the beach. I know that I have used this analogy before but it is still the easiest way for me to explain what is taking place. The first time a wave falls a little short of the one that proceeded it, you may have not even noticed it but it was still there. Soon thereafter the next wave falls even shorter and then another. The tide has changed and is going out, a new trend is in place and one that cannot be easily reversed.

The reason I picked "Nowhere to run, Nowhere to hide" to describe the current investment landscape is that for seven years we have watched the world's central banks do everything they can to re-inflate all investment asset classes. They pursued this goal by printing money, encouraging risk taking, manipulating the bond markets, and issuing enormous amounts of sovereign debt. The net result has created a worldwide distortion in the valuation for nearly all asset classes. Unfortunately, this environment is the new reality of investing today. Central banks would have you believe that their role is a noble one, to repair the damage from every financial cataclysm that befalls us due to the never ending greed that capitalism breeds. That couldn't be further from the truth. It is actually the continuous and never ending intervention of these central banks that prevent economies from not only self-correcting but also from healing on their own. I believe that it is the very actions of these central bankers that actually create these financial bubbles and that the policies they use to "repair" the damage they have done only sows the seeds of the yet another bubble and the next inevitable collapse.

While the Federal Reserve loves to use its history as a justification of its need to do more, their memory is much more selective than you would know. We have heard it so many times from Federal Reserve officials and politicians from both parties how close we came to experiencing another "Great Depression". Every one of them wants to take credit as it was somehow through their bureaucratic courage and the combination of fiscal and monetary stimulus that they once again saved the day. I don't need to look at the "Great Depression of 1929-1939" and all of the mistakes that even the Federal Reserve now admits that it made, making the length of the downturn much worse. Let's go back nine years earlier and look at the "Depression of 1920-1921", the downturn that's not taught in school. The depression no one knows anything about or wants to talk about, maybe because it lasted for only 18 months. Or is it because what the government did then was exactly the opposite of what they did during our "Great Recession of 2008"?

While hardly well known, on paper it bears a remarkable similarity to how our "Great Recession" began but ended much sooner. Gross National Product fell by 17%, prices fell by 18% making it the largest deflationary decline in over 140 years of data. Wholesale prices collapsed by 36% and in 1921 unemployment rose to 11.7%. The stock market fell 47% nearly matching the decline in the S&P 500 of 48.7% that took place from August 2008 through March of 2009. In his book "The Forgotten Depression", James Grant explains why the depression of 1920-1921 was so relatively short when compared to the recent financial crisis and the ensuing "Great Recession" that began in 2008. He states that "the essential point about the long ago downturn of 1920-1921 is that it was kind of a last demonstration of how a price mechanism works and the last governmentally unmedicated business cycle downturn, meaning it was the last one that the government didn't attempt to treat with fiscal intervention". Politicians love to repeat the unchallenged claims that the Great Depression was caused by the excesses of capitalism and only the actions of progressive government policies allowed the country to recover.

We now except as gospel that without government fiscal and monetary stimulus that any economic downturn will persist and any recovery would be long delayed. But what would happen if the exact opposite of that economic dogma was not only proposed but actually implemented? In 1920 under President Harding's administration it was. The policies implemented then stand in stark contrast to all of the policies and actions that our government and the Federal Reserve have implemented over the last decade. What if we were to realize that the $10 trillion in new Federal debt and the additional $4 trillion that the Fed printed was a mistake? Could the weakest economic recovery in over 70 years and the resulting suffering incurred by working class families have all been avoided?

During the years 1920 to 1922 there were no infrastructure projects, no bailouts for the states, no deficit spending, and no pursuit of an inflationary monetary policy by the Federal Reserve. Instead the government cut its budget in half, the national debt was reduced by nearly a third and taxes were lowered across the board. Even to this day, economists who embrace the interventionist government policies of today are at a loss to explain how a recovery so complete could so quickly erase the damage from such a deep economic downturn. Thomas E. Woods Jr. writing of the "Forgotten Depression of 1920" in the Fall 2009 issue of The Intercollegiate Review states it quite simply "The experience of 1920–1921 reinforces the contention of genuine free-market economists that government intervention is a hindrance to economic recovery. It is not in spite of the absence of fiscal and monetary stimulus that the economy recovered from the 1920–1921 depression. It is because those things were avoided that recovery came". The key is that low interest rates should only be the direct result of increased consumer saving. As people save more they spend less, interest rates fall as the economy contracts. Those savings and the lower interest rates they produce, eventually sow the seeds for the next expansion.

When a central bank artificially lowers interest rates and prints money in order to create an expansion of credit, the result is always a misallocation of capital, increased risk taking and the creation of the next asset bubble. Ultimately I believe that the world's central banks are going to lose much of their credibility as investors come to the same realization that Dorothy did, that there is no all-powerful Wizard of Oz. In the movie even the Wizard knew his limitations unlike now, when this curtain is pulled back, you will find a group of bureaucratic elites who still believe that only they can control the world's economies. The reality is that even they don't understand all of the ramifications and unintended consequences that their policies have wrought.

While caution now must be the order of the day, the future is not without opportunity. As long as we can avoid any type of global financial contagion or systemic credit crisis, compelling value and prudent investment opportunities will reappear. The problem with any global economic slowdown is the unexpected toll that is inflicted upon government institutions and financial systems which are far less robust, transparent and accountable than the ones which we have become accustomed to. Many developing countries have democracies that are still fragile and lack deep cultural roots. Economic stress creates risks that can quickly reverse the hard won gains of any young democratic society. Governments feeling threatened by a frustrated populace or looming debt burdens, can quickly take back the freedoms that every dynamic economy requires to grow.

In this type of market environment it is very easy to become extremely pessimistic. That is actually a rational response, fully understandable since the financial debacle in 2008 and 2009 is still fresh in the minds of every investor. Fear of unknown and unquantifiable risks are something that we have all learned to live with. Ever since we saw a plane fly into a building on live television many years ago, we understand what "event risk" means, even if it is something that none of us will ever truly get used to. Fear and confidence, whether justified or not is merely both sides of the same investment coin. As I said earlier, this is the hard reality of investing where only our skills of navigating these risks will ensure our safe passage. My responsibility with every investment scenario is to determine which is truly greater, real risk or perceived risk, and to then adjust my asset allocations accordingly.

One final concern is that after a seven year bull market supported and financed by the Federal Reserve, the risk of investor complacency has also increased, dimming the memory in many that markets can still go down. As a slower growth future awaits us, our investment strategy must also adapt and change. Certain sectors of the market will eventually offer compelling value and move higher while several other groups will remain vulnerable to a weakening global economy and continue to decline in price. The shares of many companies still trade at prices that could only be justified by the easy monetary policies of our central bank and as that support has changed so should their valuations. It is important to remember that as future earnings estimates are reduced due to slowing growth expectations, those shares become more over valued as investors are in effect paying more for less earnings. Ultimately our markets must reflect not only the current economic environment but also price in the changes that investors anticipate taking place six to nine months into the future. In these uncertain times, prudence and caution is required and expected. Identifying that unique combination of consistent long-term growth, compelling value, and a reliable dividend will therefore remain the cornerstone of our investment model for quite some time.