November 2018 - Hypochondria

The stock market is behaving like a hypochondriac – concerned over a deterioration in company and economic fundamentals when in reality the underlying fundamentals are fine. This negative sentiment is reflected in recent volatility and performance. As the table below shows, more than 40% of the S&P 500 stocks and almost 60% of Russell 3000 members have now entered a “bear market” as defined as a 20% plus sell-off.[1] No, it isn’t just the FANGs that are down.

S&P 500 Members Below 52-Week High								
	-40%	-35%	-30%	-25%	-20%	-15%	-10%	-5%
# Below	36	63	101	157	223	307	371	435
Total	507	507	507	507	507	507	507	507
% Below	7.1%	12.4%	19.9%	31.0%	44.0%	60.6%	73.2%	85.8%

Source: Bloomberg. As of 11.23.18

Russell 3000 Members Below 52-Week High								
	-40%	-35%	-30%	-25%	-20%	-15%	-10%	-5%
# Below	653	859	1133	1462	1809	2216	2543	2805
Total	3020	3020	3020	3020	3020	3020	3020	3020
% Below	21.6%	28.4%	37.5%	48.4%	59.9%	73.4%	84.2%	92.9%

Source: Bloomberg. As of 11.23.18

Largely exaggerated concerns over a potential economic slowdown in the U.S., fears that earnings have peaked and sales are slowing, continued trade uncertainty and restrictive monetary policy have thwarted recent rallies in the U.S. stock market. However, since last month’s correspondence, underlying fundamentals have not materially changed other than asset prices are marginally more attractive given continued negative sentiment and selling pressure. Rather than rehash similar points, in this month’s letter we wanted to highlight a simple framework for analyzing markets in the near-term, as well as a few noteworthy anomalies.

Currently, the two most dominant short-term concerns for investors are (1) the U.S.-China trade dispute, and (2) the outlook for interest rates. Below is a simple graphic we like that highlights four different market scenarios dependent on trade and interest rate outcomes.[2] The goldilocks scenario would be for a U.S.-China trade resolution and for the Federal Reserve to moderate its pace of interest rate hikes; whereas a full-blown trade war and hawkish monetary policy would be negative for risk assets and a threat to global growth. Given that President Trump needs Midwest support to win the presidential and congressional elections in 2020, we think some trade resolution with China is likely. To date, the trade dispute has taken a harsh toll on Midwestern farmers, as agricultural prices have plummeted (particularly soybeans) because Chinese buyers are shifting purchases away from the U.S.[3] Per a recent study from the Federal Reserve Bank of Minneapolis, farm bankruptcies have more than doubled this year in the district comprising Montana, South Dakota, North Dakota, Minnesota and Wisconsin.[4] It is in Mr. Trump’s electoral

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interest to resolve at least some of the trade issues with China (except for issues regarding technology, which is a bipartisan concern). As to interest rates, Federal Reserve Chairman Jerome Powell's comments at the Economic Club of New York on November 28th (in which he noted that rates are "just below" the Fed's neutral target), point to a likely moderation of rate hikes next year.[5] In consideration of Chairman Powell's comments and our expectation of some trade progress with China, we think an outcome closer to the upper left quadrant in the below chart is more likely than that of the lower right.

In our daily research, we came across the below chart (based on data compiled by Deutsche Bank) that we thought was worthy of sharing. As seen below, nearly 90% of asset classes have posted negative returns this year.[6] While we noted this in passing last month, the below chart highlights a striking anomaly. We don't think the remarkable data point is the high degree of negative returns across global asset classes this year, but rather the lack of negative returns experienced by investors across all asset classes in 2017. That is shown by the teeny-tiny speck 2nd from the right. You will need to strain your eyes to see it. The contrast between last year's historically excellent returns across all asset classes is what makes this year's volatility seem especially jarring. Unfortunately, based on the data, last year's returns appear to be far more unusual than this year's.

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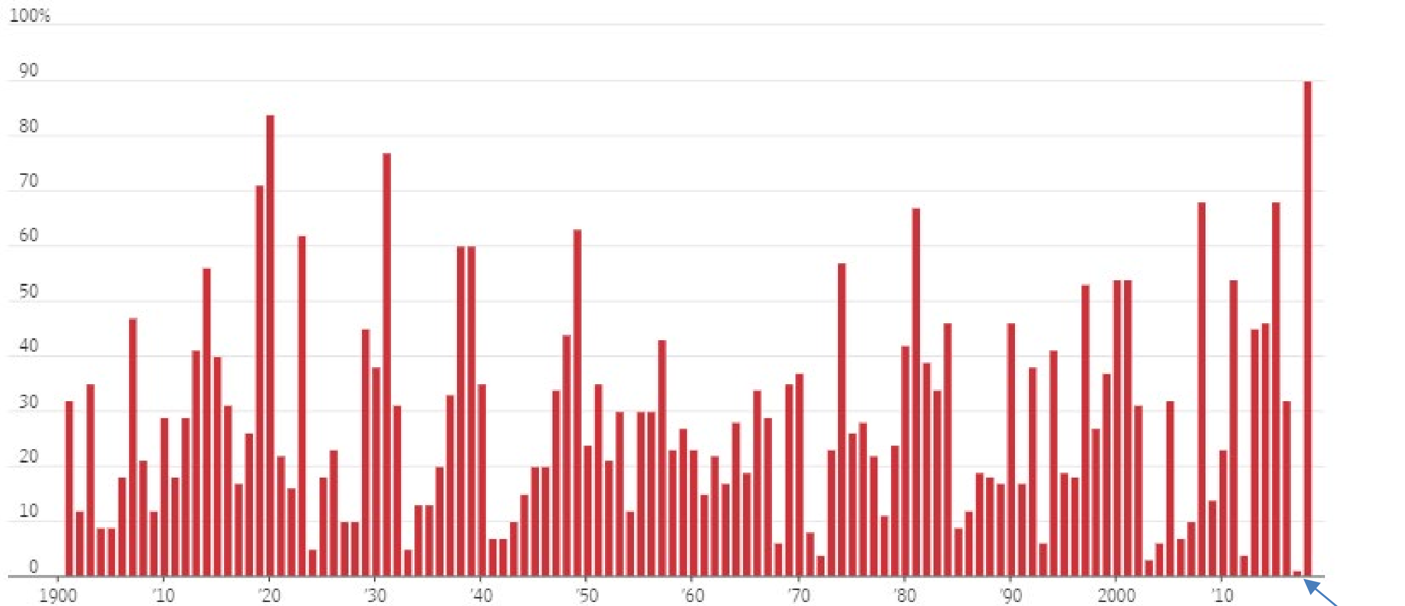

One contributing factor to this year's negative returns across various asset classes has been the selloff in oil, which accelerated in October and continued in November. Since peaking in early October, Brent and WTI are each down close to 30%.[7] As a result, the trailing 45-day return for the S&P 500 Energy Index (which has fallen 15.5% since late September) is nearly the worst 45-day stretch since 2000, only marginally beating out the worst 45-day decline during 2008.[8] We think the sell-off in oil is based on Saudi Arabia and Russia having materially increased output in anticipation that the U.S. would strictly enforce sanctions against Iranian oil exports following the termination of the Iran-nuclear deal. Instead, the U.S. issued 6-month waivers to large purchasers of Iranian oil. A cynic would say this was done ahead of the mid-term elections for political reasons to keep prices low. The temporary waiver has created a short-term supply/demand imbalance that we think OPEC and Russia are likely to work out via a moderate production cut, despite political pressure from the Trump administration on the Saudis to keep prices low.

Another anomaly resulting from the oil price decline and energy company sell-off is a valuation to fundamentals disconnect in midstream energy companies, some of which we own, such as Enterprise Products Partners (EPD). Per the below figures,[9] financial metrics for leading midstream companies are in substantially better shape than they were during their last period of underperformance in 2016. Cash flow per unit/share is up, dividend coverage (the ratio of available cash to cash distributed to shareholders) is up and debt levels are down. Yet stock prices have declined compared to November 2016. For value and income-oriented investors, we think this sector is offering compelling value at current prices. With U.S. oil and gas output at all-time highs and the need for additional energy infrastructure to handle the transportation of oil and gas from basins, such as the Permian, to demand centers

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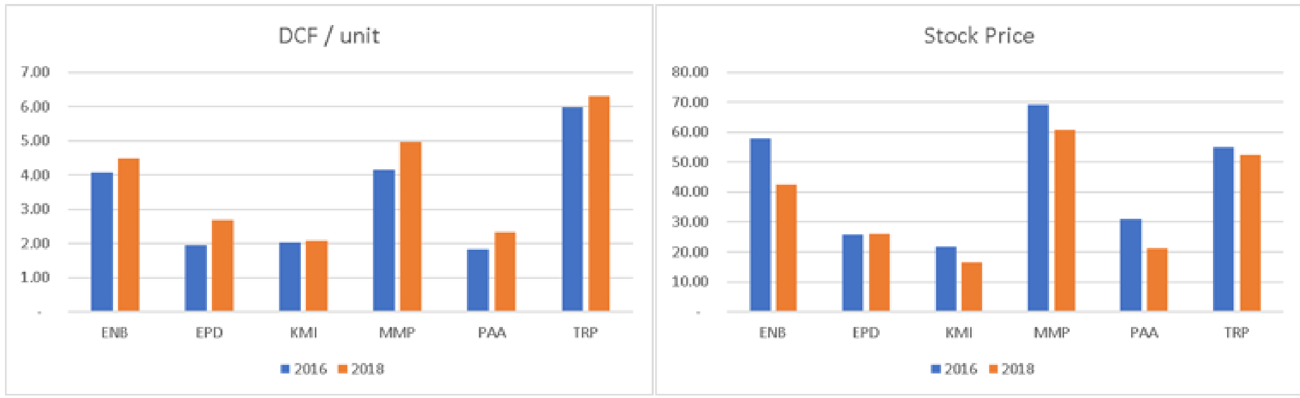
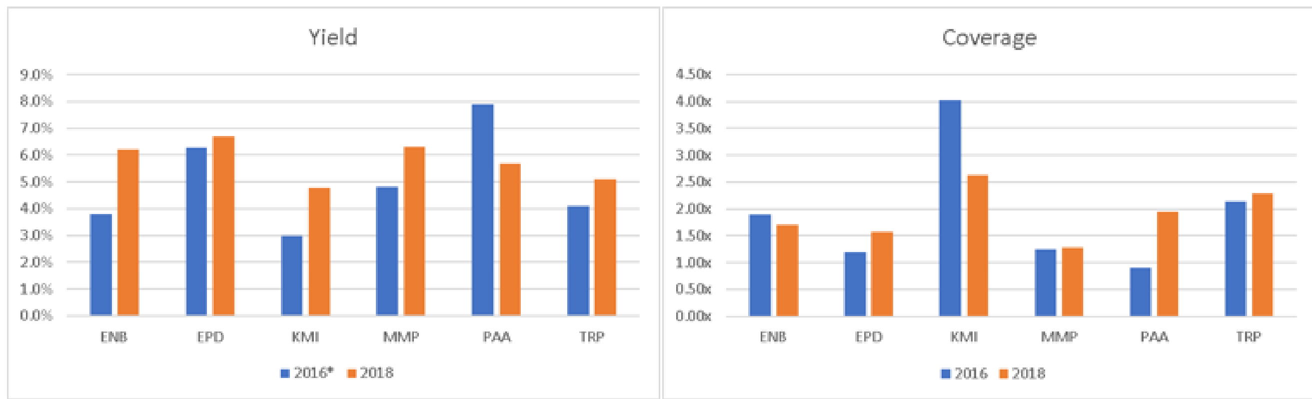
and export hubs, U.S. midstream firms are not only attractively valued based on steady-state financials, but are also primed for growth.

Distributable Cash Flow (DCF) / Unit and Stock Prices (2016 vs. 2018)



Source: Wolfe Research. *Stock prices are as of 11/23/18 and 11/23/16.

Yield and Distribution/Dividend Coverage Ratios (2016 vs. 2018)



Source: Wolfe Research. 2016 yield based on FY 2016 dividend and stock price as of 11/23/16.

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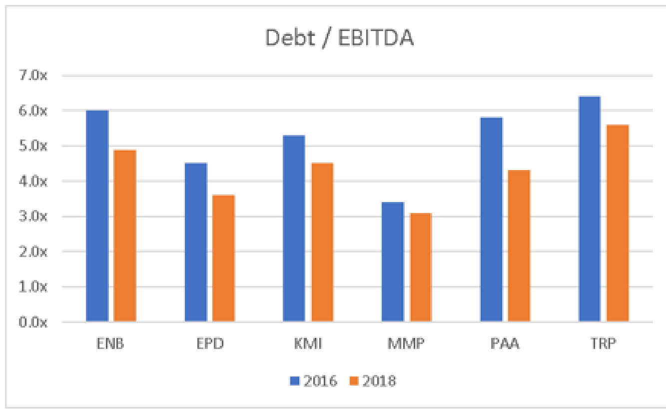
Financial Leverage (2016 vs. 2018)



Source: Wolfe Research.

Despite continued market turbulence, we still recommend remaining invested, as valuations are reasonable and economic data is positive. Please let us know if you would like to discuss your portfolio or any of the ideas covered in this month's letter. As we wind down 2018, we are also focused on tax efficiency and would welcome having a conversation on ways to reduce any taxable liabilities for the year, if applicable.

Sincerely,

Peter Karmin Managing Member	Stuart Loren Director

Citations and Disclosures

[1] Prudent Speculator (Nov. 26, 2018).
[2] Wolfe Research (Nov. 26, 2018).
[3] Federal Reserve Bank of Minneapolis, *Chapter 12 bankruptcies on the rise in the Ninth District* (Nov. 14, 2018).
[4] Federal Reserve Bank of Minneapolis, *Chapter 12 bankruptcies on the rise in the Ninth District* (Nov. 14, 2018).
[5] Bloomberg News (Nov. 28, 2018).
[6] Bianco Research, Deutsche Bank Research (Nov. 26, 2018).
[7] Bloomberg (as of Nov. 27, 2018).
[8] Bianco Research (Nov. 26, 2018). 45-day trailing returns date back to Sept. 21, 2018.
[9] Wolfe Research (Nov. 25, 2018).

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