BERKSHIRE MONEY MANAGEMENT

The Knowledge and Experience to Build Your Wealth

Wednesday, October 3, 2018

CHECKING MY HOMEWORK

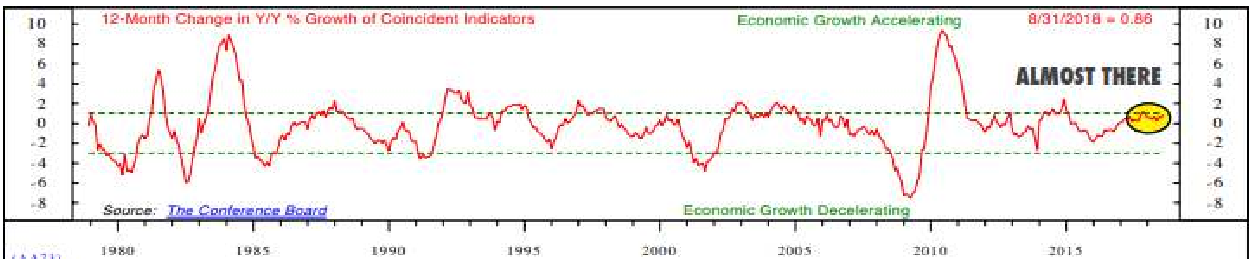
- First, some housekeeping. For my much-less-lengthy and much-more-frequent commentary, connect with me, Allen Harris, on LinkedIn.
- For a long, long time I've been "predicting" a recession in 2020-2022, if only to have an anchor in my investment hypotheses. I am hoping I am wrong, but looking at it objectively if a recession were to happen then you could look back (i.e. now) and see how all the dots could have been connected.
- We've been favoring a slight tilt toward Growth stocks for a long time, but we can see a case building to consider a neutral position in the selection of Growth vs. Value.

Value stocks are generally considered safer than Growth stocks. However, we do have a tilt toward Growth stocks for the equity portion of client portfolios. But that tilt will likely become more and more neutral. **The reason behind preferring Growth in portfolios is because economic growth has been rather anemic.** Until only recently, the decade long conversation about the recovery from the Great Recession was that it had been below trend. Real GDP growth of 2.3% per annum has been the slowest expansion ever. Given that it's been a long recovery, another way to measure the success of the recovery is in real GDP created. But with a 22.3% gain, even at 110 months long (compared to an average of five years) this expansion still only ranks as number six of the past eleven expansions. **The duration of the economic expansion has been impressive, but its magnitude has been mediocre.**

So, in considering the preference of Growth vs. Value, we assessed Supply vs. Demand (ultimately, the only force that adjusts prices) and figured since there wasn't a lot of growth-oriented companies (low Supply) then prices should go up as investors sought out investments that offered growth that was above trend. **Growth stocks typically trade at a premium to Value stocks, but for a while now investors have been willing to pay even more than they typically would for extra growth because so few areas were able to provide it.** Admittedly, it's pretty simple logic – I'm not too proud to take the occasional easy win.

But economic growth appears to be shifting away from the anemic classification. US Gross Domestic Product has topped 4%, the ISM Manufacturing Index hit a 14-year high, and wages are finally accelerating. So now I need to start assessing whether economic growth is strong enough to warrant the premium prices investors have been paying for Growth stocks and, if so, **when might be an opportune time to tilt portfolios back toward Value? The quick answer is "not yet"**, but a lot of indicators are getting pretty close and will require consistent monitoring.

I don't want to turn this into a geek-fest, but I'll share a couple of indicators we've been tracking. Below is a chart with information from the Conference Board. I'm a fan of second derivative calculus (measuring the change of change), and this is a good example of that. The chart doesn't show the growth of the Coincident Economic Indicators (CEI), but rather the change in the growth rate. It's a little tricky to follow, but the gist of it is that when the growth of CEI (which is a pretty good proxy for GDP) has been at least three percentage points slower than a year ago, go with Growth stocks. But when the rate starts to accelerate at a rate greater than 1% then Value becomes more attractive. The most recent reading is 0.86 and getting closer to 1. However, just touching the threshold means little as head-fakes are frequent. Consistency is important. (I told you it was tricky; hopefully the graphic below will be helpful.)



Also, when tracking the merit of Growth vs. Value, we look at things like the strength of the dollar. A stronger U.S. dollar tends to mean better economic growth and therefore favors Value stocks. The dollar has turned down recently, but it's definitely in a zone that favors Value over Growth. I can go back-and-forth with different indicators, each arguing either Growth or Value, some mixed. But in all, the evidence isn't strong enough to warrant a big change from Growth to Value.

Of course, this is a smaller conversation within the context of the bigger question: **Where is the US in this economic cycle?** I've been saying for longer than I can remember that I expect a US recession around 2020-2022. And while those dates seem pretty far out (weren't we supposed to have hovercrafts by then?), they ain't. And the closer we get to those dates, and we see possibilities become probabilities, the more ardent I am that those once arbitrary dates are becoming more of a credible reality. That being said, before delving into some data, **the US expansion will continue through 2019.** I am well-prepared to be wrong about the timing of a recession (all I do everyday is try to prove myself to be wrong; and it happens all the time).

This expansion has lasted well beyond what many other people, people more educated than me had expected. Economists have a lousy track record of forecasting recessions. I seriously don't know how most of us even have jobs anymore. So who am I to think that I own the rights to getting economic calls correct? But my brain works better to root itself on a hypothesis, and then modify that hypothesis, if needed, as we go. I might be scared that a recession is coming, but I ain't scared to change my mind if the data changes. (Just to be clear, I'm not changing my tune or hedging my bets – **I think we get that recession by 2022 and the stock market drops 25-33%, a typical market drop during a recession**.)

Economic cycles are, essentially, made up of a bunch of sub-cycles. Looking at the economy as a whole is not that helpful when you're trying to manage investment portfolios (as stated above, we economists are just awful at trying to predict recessions). Let me give you an analogy. BMM has been around for 17 years and I believe that in each of those 17 years I've likely talked about how a number of stocks will go into their own bear markets before an index makes its final high for the bull rally. For example, with the S&P 500, the index can keep going higher and higher each month as the number of stocks in the index

that have dropped 20% or more in price keep rising and rising, with fewer and fewer companies carrying the index higher. Until, at some point, the entire index turns down. And often down a lot.

Confusing? Ok, try this. It's Saturday as I type this line. I'm looking out my office window on a beautiful 63-degree autumn day. Some of the leaves on our trees are turning from green to yellow and red. Over the course of the next month, more and more will turn. And fall. These falling leaves are the stocks that drop in price by 20%. It happens slowly, and the trees remain vibrant and green even as colors change and leaves fall, and we can still feel summer in the air. But over time, as those leaves (and prices) drop, we can see more and more clearly that Winter (trouble) is coming. It doesn't happen at once. There are signs.

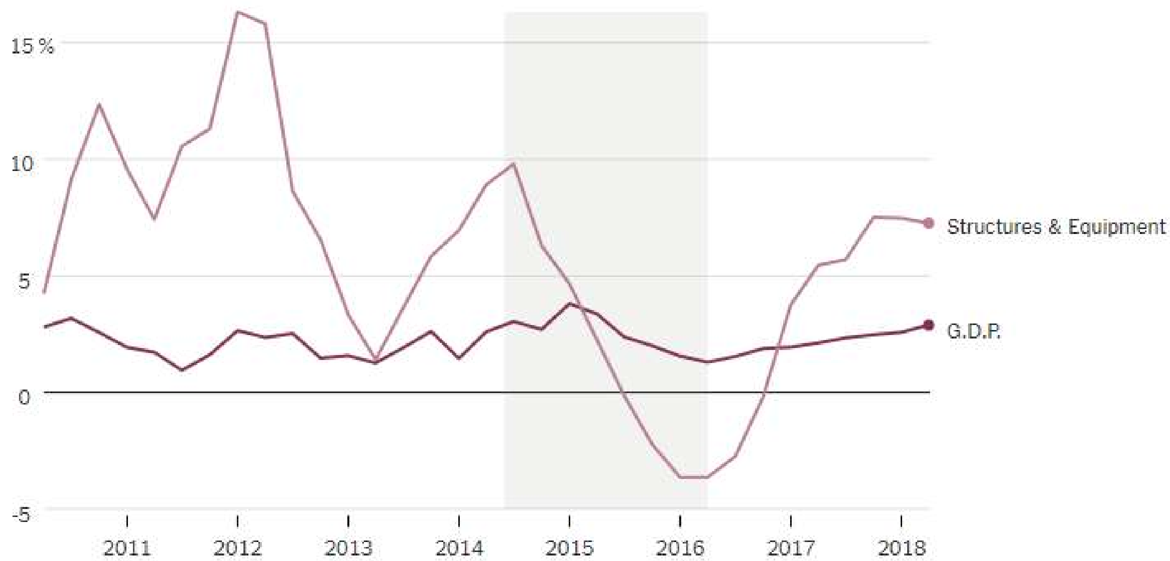
As this happens with the seasons, it happens with the stock market, and it also happens with the economy. **The biggest flaw by economists, in my opinion, is that they try to track the entirety of a $19 trillion economy**. My goodness that's hard! I mean, there are revisions to GDP data not just months but literally years later. **Everyone notes that the stock market turns down before the economy, but noone tries to improve on the methods to track expectations of the economy and to thus be more in line with where it's going, as opposed to where it's been. My way is a better mousetrap.**

The full out recessions get all the headlines. These sub-cycle recessions might get a byline in the financial press, but they largely go unnoticed. This happened in 2015-2016 when there was a significant slowdown in business investment. Recently the NY Times wrote about it – two years later.

The Mini-Recession That Many Missed

A collapse in spending on oil exploration and other forms of business investment, driven by a collapse in energy prices and troubles in emerging markets, slowed growth.

Year-over-year change, inflation-adjusted



By The New York Times | Source: Bureau of Economic Analysis

You can blame a drop in the price of oil or the US dollar strength, but whatever the cause, the point isn't to go through an academic exercise of "why" that or other sub-cycles occur. The point is that unless someone was specifically in this industry, you probably didn't know it happened. The national unemployment rate kept falling, overall business spending on investments like office buildings kept rising. US consumers kept spending. But in more localized regions within the US, unemployment did, in fact, surge and businesses closed.

As the saying goes, economic expansions don't die of old age (this one is 110 months old, currently #2 in its duration, and just ten months shy of tying the record from the 1990s). They do die of over-investment, tighter financial conditions, and/or shocks to the system. And some of those sub-cycles die before others. In examining those sub-cycles, there are currently no material imbalances. A lot will have to go wrong in the next year or two to be correct about my prediction of a 2020-2022 recession. I don't expect a shock (nobody ever expects the unexpected). And it's pretty clear that the Federal Funds rate and the 10-Year Treasury Note will be about 3.5% and 4.5%, respectively, by early 2020 (not comfortable, but not a big enough deal by itself to push us into recession).

If we get a recession, it will be because businesses pushed forward on a lot of expansion efforts and, well, that will dry up demand for further capital expenditures and hiring. In other words, things will get better before they get worse (I know, usually the saying goes the other way. It's weird of me to worry about things getting "too good").

Those shocks, like I said, are unpredictable. But I just don't see how we could have a crisis on the same scale as the Great Recession. Dodd-Frank regulatory reforms require the banking system to hold much more capital. The system has much tougher liquidity requirements and better risk management practices, including stress-testing processes. But as they say in boxing, it's the punch you don't see that knocks you out.

Those aforementioned sub-cycles, I guarantee that you are familiar with them. They're not new, just that type of thinking is different; watching to see if one ticks down, then another, then another – is new. If not new, then at least underutilized. **These sub-cycles are things like labor, monetary policy, profits, housing, commercial real esate, credit, energy, capital spending, autos, and fiscal policy. (Of those, only labor, profits, and capital spending are late in the cycle; only autos are very late. None are yet turning down.)**

So how much longer could this expansion go? Because it has been so weak, it is entirely possible that we could go through 2020-2022 with feeble growth as opposed to an outright contraction. The economy typically grows beyond potential before running into trouble. Slow and steady may win the race, and, hopefully, prove me wrong.

But a strong economy doesn't necessarily make for a great stock market. Earnings have been gangbusters, with both first and second quarters posting growth rates around 25%. **Third quarter earnings are coming out very soon and S&P 500 companies have been cutting their outlooks at a pace simliar to the first quarter of 2015, when corporate America went through what we called a "profits recession".** The ratio of negative-to-positive guidance has been 76-percent, worse than the long-term average of 71-percent. **Not that growth will be bad, but a) stocks move based on missing or beating expectations, and b) again, it's the 2nd derivative – the growth rate of the growth rate. And the growth rate is expected to decline**, down to 19.3% this quarter and 17.3% the next. Then the numbers drop closer to 7% for each of the first two quarters of 2019.

These probably are not the numbers to push the market into a bad correction, but those aren't typically the growth rates of the growth rate that pushes stock prices a lot higher. And given the ebullience of investor sentiment, there is not a lot of room for companies to disappoint without stock prices getting punished. **One sector we have grown more constructive on has been Health Care. The sector has been performing fairly well recently, somewhat on earnings, but also, likely, that investors have been**

growing more and more skeptical that any type of health care reform will even be challenged any time soon. Forgeting political preferences, the Patient Protection and Affordable Care Act will keep more people insured, which is positive for the sector. Given that 15% of the S&P 500 is comprised of Health Care companies (the third largest weighting, a close second to Financials), this improvement for the sector is a plus for the broader market. **Political tailwinds aside, the valuations are better than fair.** The price/fair value ratio is about flat. That's a positive compared to the premium prices that have been paid up for technology stocks (which make up almost ¼ of the S&P 500 index).

Of course, the most top-of-mind concern for all investors seems to be tariffs. Nothing is necessarily safe, but currently U.S. governmental reforms addresssing drug pricing should not have a material impact on the most profitable regions in the world, which is in contrast to some of the pricing concerns that have faded from political rhetoric over the last year, even with the policy paper "The Trump Administration Blueprint to Lower Drug Prices and Reduce Out-of-Pocket Costs" (an awful title, whether you're a Democrat or Republican). In aggregate, the proposal would likely impact less than 1% of US drug spending. **The Health Care sector has always been promising, for all the stories we're now intimately familiar with – innovation, strong research and development, patent strength, strong global protection, the aging of America (and other countries). The reward potential, I feel, will probably be there way beyond my lifetime. For investors, the real question is one of risk, and it appears as if risk has been reduced.**

A good Heath Care sector is good for the broader economy. And on the subject of the broader economy, I'm not currently overly concerned about interest rates being the factor that pushes the US into recession, but I'm also not oblivious to the fact that **10 of the last 13 rate hike cycles ended with a recession.**

Last week the Fed raised its benchmark rate by a quarter point. There could be about four more such hikes by the end of 2019. But that's not all the Fed is doing to tighten the money supply. Remember the term "quantitative easing?" The Fed bought bonds in the open market and now has about $4.5 trillion (trillion with a T) of bonds, which pumped the system full of liquidity. The process pushed investors into equities and out of cash and bonds because the yields were so low (the demand for equities formed a new acronym, TINA - There Is No Alternative).

Quantitative Easing, or QE, was given a tremendous amount of credit for propping up stock prices. But now it's being taken away and it can't be good for stock prices on the one hand and not bad for stock prices on the other. There are going to be alternatives to US stocks.

By the end of the year the Fed is going to start reducing those holdings by $50 billion per month, five times the pace of last year. That's going to happen as the European Central Bank and the Bank of Japan are winding down their QE programs. Tighter monetary conditions cause recessions. So, yeah, we're watching. Closely.

<u>The Bottom Line</u>: I'm not betting the house on a 2020-2022 recession, but I can connect the dots and make a very strong case for it. You can't just buy a basket of stocks and say you're going to keep holding them no matter what. You've got to keep looking for those reasons to sell, to defend your portfolio.

We are still tiltling mildly in favor of Growth stocks vs. Value stocks, but the indicators are beginning to tell us to consider going more neutral. Earnings growth rate are not holding up after a stellar first half of 2018, but we see some relief in the Health Care sector.

<u>Bonus Edition</u>: A few years ago I read this great article saying "*Diversication Means Always Having To Say You're Sorry*" - https://www.forbes.com/sites/brianportnoy/2015/03/09/diversification-means-always-having-to-say-youre-sorry/#3a3d2760961f . Basically, if you own a few different things in your portfolio, by the very definition of having different things, something will outperform and something will underperform. Last quarter small-caps underperformed. That's not a big deal. Like I said, something will always underperform. Unless you own just one thing. But I wanted to bring it up because I used the falling leaves analogy earlier regarding tracking the stock market. So I thought I should comment on that more specifically. The Russell 2000 Index, a small cap stock index, is off its high by nearly 3.5%. That's not a lot. But anytime that happens we like to look at those falling leaves. And what we're seeing is that the percent of small caps down 20% or more from their 52-week highs has been growing over the last few weeks, meaning there are fewer and fewer stocks in the Russell 2000 keeping the index near its highs. As of right now, that's not alarming. It just means that you should keep less than half of your stocks in small caps (Half your portfolio allocated to small caps is a lot; but I'm talking to a wide audience so think of "half" as more figurative. If you'd prefer a more literal number, keep your small cap exposure to under a third of your portfolio for now.)

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