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“By The Way”

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“You will always look like an idiot; the question is just whether you want to look like an idiot before or after the bubble bursts.” Investment pundit John Hussman wrote that sentence last week and in my mind it rather nicely summarizes the current market situation. It explains the angst I and others feel as the market continues to grind higher despite a litany of potential negatives in the global economy and geopolitical backdrop. People accept the fact that the market can’t go up forever, and that with the current level of risk the downside for prices could be very severe, but deciding when to exit the arena is a much more difficult challenge. I for one have already started the process of de-risking my personal portfolio, despite realizing there is an opportunity cost involved in missing higher prices and looking like an idiot. We can’t know the future, but we should assess current circumstances and put ourselves in a place that balances perceived risk and reward.

The S&P 500, the world’s most followed and important index, has recently made a new all-time high above the 3,000 level. The follow-through has been less than impressive in my view. While measures of breadth and momentum are improving, they are not as robust as we would expect given the new high in the Index. The market did become overbought in the effort to reach the new highs, and this could just be a period of consolidation while the market regroups and builds strength for the next move upward. We seem to have entered the summer doldrums as volumes have been very weak, which also might explain the current malaise. This seems like a good time to use the old system and make a short list of pluses and minuses we are facing.

PLUSES

New High
Momentum is Positive
Stock Buybacks Continue
FED Rate Cuts
Trade Wars End

MINUSES

Market is Above Trend
GDP and Earnings Weakness
Negative Credit Event Risk
Rate Cuts Ineffective?
Trade Wars Worsen

That is by far an incomplete list, but at least it gives us something to focus on.

With only a few exceptions, there has been little of note to change the outlook for global economies. A weakening direction persists, but not to the extent of suggesting a recession is close at hand. Of course, as history tells us you don’t know it’s a recession until you’re in it. There are several things worthy of note though. China reported growth of 6.2% for the year ended June 30th which is the

lowest rate since it started reporting almost three decades ago. U.S. job growth surprised strongly to the upside, but that was muted by the fact that over 100% of the growth was individuals needing to take a second job. Business investment remains very unenthusiastic as corporations find other outlets for spending, such as stock buybacks. A murky economic outlook plus trade and tariff concerns make investment decisions difficult and confusing. The lack of new capital expenditures will weigh on future productivity and thus margins and earnings.

Given the relative calm in markets, I'm going to take the opportunity to share some opinions on the current state of affairs. FED Chairman Powell testified before Congress last week and was so dovish that the market was not only convinced a quarter point decline in rates is a sure thing at these month's meeting, but a half point is a possibility. This is the same man who last October said rates were a long way below neutral. He soon learned that "normalizing" rates is nearly impossible these days as the breaking point is very low and signs of a tightening policy will send markets lower in a hurry. He did make two comments I found interesting or perhaps disturbing. One, that the FED's accommodative monetary policy has been less effective in stimulating the economy than the Board expected. (It sure stimulated financial markets though.) Secondly, he admitted that long held beliefs in certain economic models, especially the Phillips Curve, were no longer working. Driver without a map?

I went to some lengths last month to outline my concerns about the potential for bad outcomes in the fixed income and credit markets. This week provided a small but real-life example of how the chase for yield through loans with weak or no collateral protection can implode quickly. Chicago based Clover Technologies was taken over in 2010 by a private equity firm, which as is often the case, strapped loads of debt on Clover's balance sheet in order to pay itself large dividends. Those loans were largely bought by brokers who partnered such poor credit with better loans to form CLO's (Collateralized Loan Obligations) in an eerie similarity to the sub-prime mortgage securities that were a major factor in the 2007-2008 crisis. At any rate, Clover recently lost two major customers and the price of its bonds dropped 30% overnight. No big deal, but it does show how quickly a devastating loss can occur where weak credit is involved. I had lunch last week with a pal of mine who is an ex-broker and ex-hedge fund manager and is very market savvy. I think enough of his intelligence that I was invested in his hedge fund. He told me that I was worrying about markets for no reason. In his opinion, between the FED supplying liquidity whenever needed and Modern Monetary Theory (MMT) allowing the U.S. Federal Government to print and spend money at will, the powers that be won't let the market go down. I called him Bernie Sanders, but he wouldn't be dissuaded from his point of view. I'm not buying what he's selling but coming from someone like him it bears consideration and can't be dismissed out of hand.

Finally, the U.S. elections are fast approaching and the rhetoric is already at a fever pitch. Between Trump's recent rant, which is difficult to interpret as anything but racist, and the unrealistic and hard to understand economic and immigration policies espoused by the candidates at the Democratic Debates, I don't know how anyone can cast a ballot for either party. The U.S. has 15 months to find some compromise or middle ground. End of rant.

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