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“By The Way”

September 2019

“In Denmark a bank will pay you interest of a half percent to take out a mortgage”

September, and the end of the summer doldrums, has brought with it an improving S&P 500. The market was highly volatile in August, mainly because of the ever-changing narrative around the U.S. / China trade wars. At the same time the Index was basically directionless and despite the geopolitical noise traded within a defined range. As of the first week of September the Dow Jones Index had moved up and down a total of 8100 points but was less than 100 points away from where it was at the beginning of August. For the S&P 500, the relevant numbers were 900 points and 15 points. As is always the case, we review market internals to see if they can give us a clue as to the future direction of prices. It must be said that during the extended trading range internals were less than impressive. Market breadth was poor as a limited number of large stocks were responsible for rises in the Index; volume was extremely low, not unusual for August but still indicating a lack of commitment; and a majority of stocks were trading below their moving averages. As usual the market seems to enjoy doing its best to confuse us, and as I mentioned, September has brought with it renewed strength in all three of the factors that I found concerning in August. The S&P 500 has broken out of the trading range to the upside and only the all-time high remains as a level of resistance. While it will likely take considerable effort to make new highs, and my longer term worries are not forgotten, I will stand aside and let the market continue this run.

There have been other surprises recently. While short-term movements do not necessarily indicate a new trend, market factors that have been outperforming for a considerably long period of time have reversed. The two most glaring areas of underperformance, just since Labour Day, are momentum stocks and growth stocks. For the last 5 years, and particularly this year, if one bought the stocks rising the most (momentum) on the assumption they would continue to do so, you would have outperformed the market to a meaningful degree. At least for the last week that is no longer the case. The second factor that has reversed (which is not unrelated to the first), is that growth stocks are underperforming value stocks. Investors who have doggedly researched markets for undervalued companies based on fundamentals such as price to earnings multiples have been badly beaten up over the past decade as market favourites, regardless of valuation, have been the place to be. Consider Proctor & Gamble which is widely held market favourite trading at a premium price earning multiple of 24x forward estimates. This is despite a decline in revenue and net earnings since 2010, during which time the stock has risen from \$32 to over \$120. As I said above, there is no guarantee such a short-term move will translate into a more durable trend, but the change has been so dramatic it can't be ignored.

Of course, all market insights can quickly become useless when the President hits "tweet" on his Twitter account. The positive and negative changes to the outlook for tariff and trade peace are dizzying and unpredictable, but we are now seeing some real impact from the tariffs. Whatever the reason, using our favourite leading economic indicator the ISM Purchasing Manager's Index, the outlook for the rate of expansion in developed economies varies from flat to slower versus a year ago. China and Japan are about the same as last year while Germany is at 51.7% today against a 55.7% reading last August, and France reported 52.9% vs 54.9%. The U.S. is also showing a slower, albeit still expansionary, rate of growth coming in at 50.7% contrasted with 53.9% the year earlier. The interesting thing about the U.S. number is the dichotomy between the manufacturing portion of the PMI and the non-manufacturing segment, usually referred to as the services sector. Probably due to the tariff and trade turbulence the manufacturing PMI actually indicated contraction since it was below the 50% cut-off point at 49.1%. On the other hand the services number still reported a strong 56.4%. Since the U.S. economy is around 70% based on the services side, it is well suited to weather issues arising from a decline in international trade. It is worth noting that while many people think of "services" as hotel and restaurant workers, in fact the sector includes technology, finance and healthcare. In summary, global growth continues to slow, but not yet at a rate that would indicate recession. In any event the world's central banks remain committed to providing any amount of liquidity and stimulation needed to stave off a recession.

Fixed income markets and interest rates continue to confound me. There is now over \$15 trillion in negative interest rate bonds (mostly sovereign debt) or about one quarter of the market. In Denmark a bank will pay you interest of a half percent to take out a mortgage. I hear all the arguments as to why we are all okay, and that is just the financial market's "new normal". I get it, but to me "new normal" is just another way of saying "it's different this time" and we know how much trouble that has caused. It is incredibly old fashioned to imagine an investor buying a bond because of regular interest payments and a return of capital at a future date. Today's bond buyer who accepts an extremely low or negative rate of interest must fall into one of two camps; a seeker of safety who fears a recession or depression, or a speculator believing the bond can be sold at a higher price when rates go even lower. Other bond buyers are desperately reaching for higher yields without, in my opinion, properly assessing the additional risk being incurred. Argentina is just the latest example as it appears to be preparing to default on its bonds which are likely to pay 40 cents on the dollar. Two years ago, when the country issued bonds that were massively over subscribed I wondered at the time who would buy the bonds of a country that defaults on its debt about once a decade. The world remains confusing but interesting.

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