PCM

PEAK CAPITAL MANAGEMENT

The Powell Pivot

PCM Report May 2019 Volume 10, Issue 5

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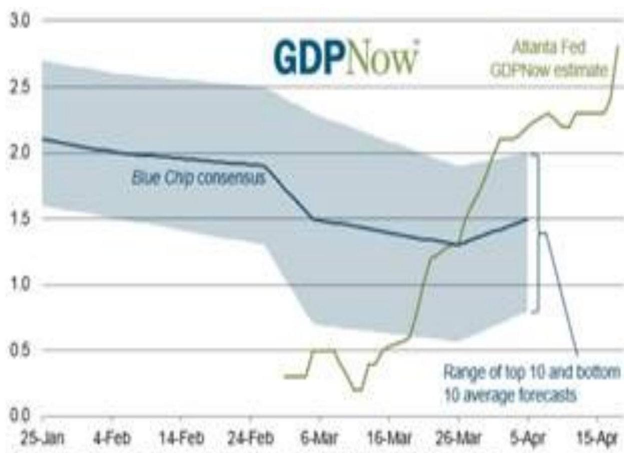
April saw markets soar to new highs with the S&P 500 and the Nasdaq making the concerns over a recession following the inversion of the yield curve seem like a distant memory. More impressive than the rebound in equity prices, the forecast for Q1 GDP growth has risen from virtually 0 to just under 3% in just one month. (GDPNow) The markets have embraced the 'Powell Put,' but the recovery from the late 2018 selloff appears to be the dovish pivot by the Fed Chair.

The markets are placing confidence in more than just Jerome Powell, however. Entering 2019 the slowdown in China was a primary concern for many market participants fearing the global economy would follow China lower. President Xi of China has essentially provided markets with a put as well, adding stimulus to spur growth and keep Chinese growth rate above 6% (at least in official figures) (World Bank). We cannot forget that President Trump remains eager to tout a rising stock market as validation that his policies (tax cuts, deregulation, and trade) are working and creating prosperity.



Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

The question investors must answer is whether or not earnings will continue to rise at a pace to justify the new highs. According to FactSet data, earnings in Q1 are projected to be 3.9% lower than they were in the same period in 2018. The S&P 500 is 12% above where it ended Q1 last year, suggesting valuations are being stretched. Also contributing to the strength in stocks is how companies are choosing to allocate higher cash flow from lower taxes and repatriation of cash from overseas. Over $1 trillion in stock buybacks have occurred over the last 12 months as companies have taken advantage of low interest rates in a speculative debt-for-equity exchange. Price-insensitive buying of record levels of company stock with the markets at all-time highs could be viewed as a sign of desperation as companies see margins fall and profits decline.

The Fed's 180 degree turn in January did boost confidence for consumers taking the University of Michigan Consumer Sentiment survey back near the highs of 2018. Small Business Optimism is also very high with 60% of respondents to the NFIB survey saying they have recently made capital outlays. Lagging behind in sentiment readings is CEO Confidence that remains closer to the lows of late 2018. The gap between those optimistic about the future and those pessimistic is at a cautionary -30.

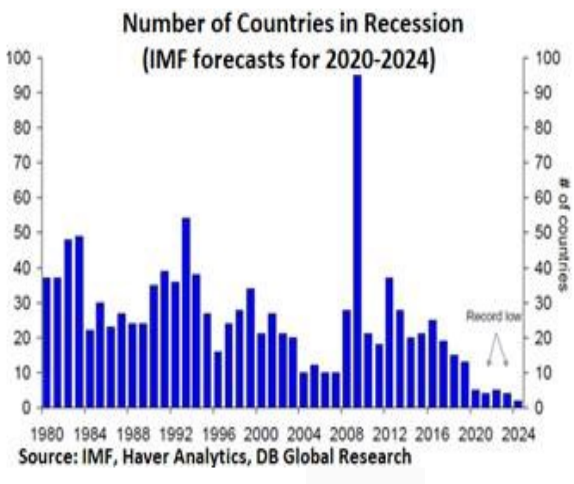
Powell has given confidence to consumers and investors that they can go back on offense after they were forced to play defense when the consensus was that the Fed was going to go too far in tightening monetary policy. What seems clear is that the relative level of interest rates if far less important than the direction the Fed signals it is taking monetary policy. At some point, however, the economy is going to need CEO's to have enough confidence about the future to commit to capital spending rather than buying back their own stock.

Price-insensitive buying of company stock at all-time highs could be viewed as a sign of desperation.

We are entering the time of the year that has historically been the seasonally weak period (May through October). Earnings are contracting, and uncertainty about trade is growing. Prospects for a mutually beneficial deal with China appear high at the time this is written, but Trump has gone to Twitter to express the possibility of tariffs on European cars if more favorable trade terms are not agreed to. The wishful thought that domestic politics would simmer after the publication of the Mueller report was overly optimistic as the thought of initiating impeachment hearings seems to be magnified.

The inversion of the yield curve in March was short-lived and no longer appears to point to a recession in 2019. Momentum is strong to the upside and with almost 50% of S&P 500 companies already reporting their Q1 earnings, three out of four companies have exceeded consensus estimates. The expectations of a rate cut before the end of the year is creating a Goldilocks scenario. Inflation, using the Fed's preferred Personal Consumption Expenditures (PCE), remains muted, taking all pressure to tighten financial conditions off the table for now. The summer trading season with low volumes and higher volatility still poses a risk, particularly for conservative investors who do not have the stomach for rapid drawdowns.

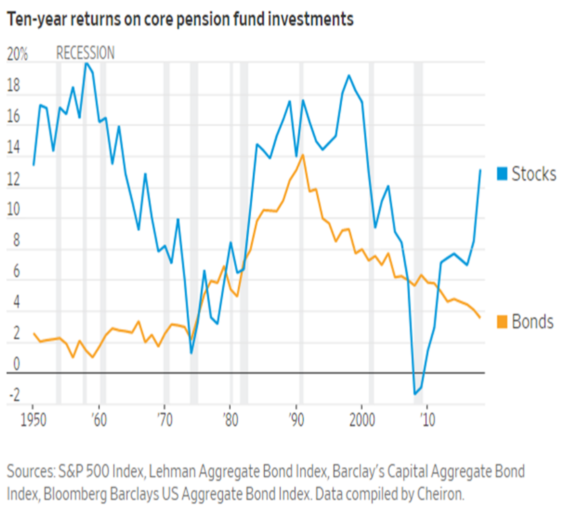
In Search of a Recession



One of the most compelling charts that demonstrates the state of the global economy is how many countries are in a recession at any given time. All economies are in a constant state of flux and expanding or contacting at different paces. Using the formal definition of recession — two consecutive quarters of negative growth — there are currently fewer nations in recession than ever before and the number is expected to decline over the next two years, according to the IMF. This phenomenon can in part be attributed to aggressive monetary policy, negative interest rates, and QE for example, that appears to keep slowing economies from tipping over into negative growth. Those same policies are very likely to stifle long term growth in those same economies.

- The Eurozone is at risk of making the IMF forecast extremely inaccurate. Each of the 19 countries have seen Industrial Production fall to contractionary levels, raising the likelihood of a recession within 12 months.
- Global trade remains one of the greatest risks to economic expansion as countries jockey with each other to create "free trade." If tariff wars were to intensify or spread to additional regions, growth would be impacted.
- Many economists openly question the value of focusing on whether a country is in expansion or contraction, and suggest long term growth rates are a much better sign of economic health and future opportunity.

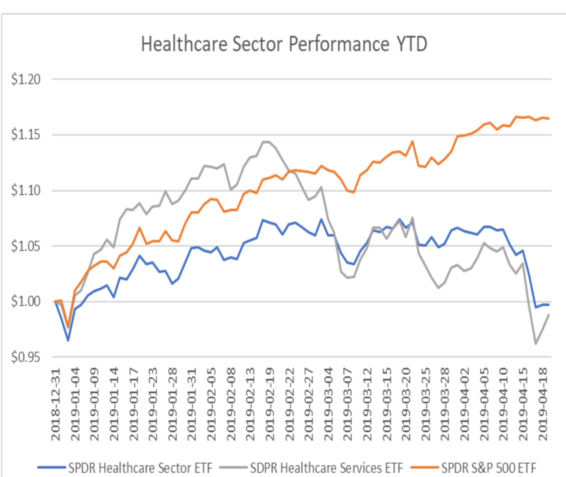
Pension Fund MIA



A topic du jour among industry experts is the impact pension liabilities, particularly unfunded, will have on the market and economy in coming years. One might guess that the prolonged bull market, including the first quarter rise in the market, would give pensions an opportunity to exhale a sigh of relief. Liabilities, or the benefits owed to retirees, is outpacing the growth of the assets on hand and contributions to those assets. The chart below shows 10 year returns on core pension fund investments dating back to 1950. Double digit returns in stocks and bonds during the 1980s and 1990s served as a unrealistic growth measure of pension fund managers, providing a false confidence in the amount of liability the pension was equipped to assume.

- The State of Maine Public Pension Fund is $2.9 billion short of fulfilling its obligation to future benefits of retirees (Wall Street Journal).
- Liabilities of major US public pensions are up 64% since 2007 versus assets up 30% (Boston College Center for Retirement Research).
- Liabilities among major US public pensions is just under $4 trillion as of 2018 while assets are just under $3 trillion. (Boston College Center for Retirement Research).

Healthcare Looking Sick



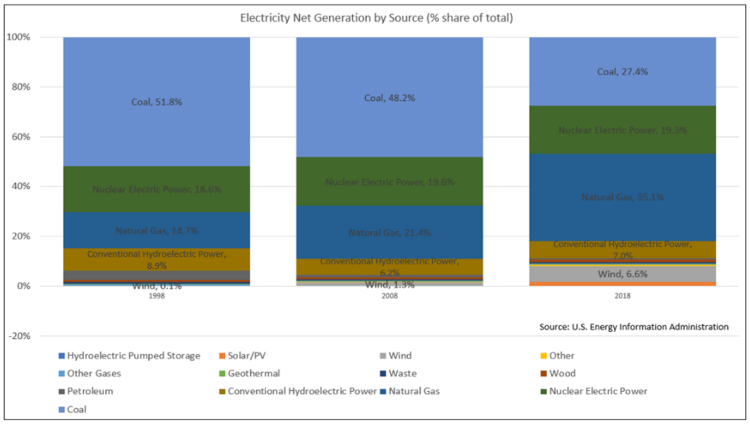
Source: Ycharts and PCM

While the overall S&P 500 Index has enjoyed a remarkable turnaround this year, one sector in particular that has struggled is healthcare. The sector is slightly lower so far in 2019, compared to gains of over 15% for the broader market. It's really no surprise that the sector is coming under pressure, as healthcare has been a major theme for the upcoming 2020 election. If there is one thing the market does not like it is uncertainty, and it's not clear how the proposals from either party will ultimately impact healthcare stocks. The only certainty is that people will continue to get sick.

- Medicare for all, as proposed by the Democrats, is viewed an encroachment from the federal government to further control healthcare, and has stoked fears about “nationalized medicine”. On the other hand, President Trump has called for an all-out repeal and replace of the Affordable Care Act that passed under the Obama Administration.
- The recent pullback is more likely a short-term technical event ahead of the 2020 election. Revenue estimates for the sector are favorable and are expected to surpass earnings from a year ago. Likewise, the long-term trend is increasing demand for healthcare services as the population ages. Once the politics gets sorted out, the sector will likely deliver better returns.

Macro View – Energy Tea Leaves

PCM hosted a group of financial professionals at an educational event recently, and energy was on everyone's mind. The free market system will often gravitate to the lowest cost energy source, which certainly is tied to the supply and regulation around the supply. Monthly average natural gas prices averaged $7.36 between 2003 and 2008, dropping by more than 50% to a monthly average of $3.43 between January 2009 and 2019 (Factset). The chart below shows that natural gas has overtaken the other energy sources, making up 35% of energy generation. As wind and solar become more affordable without government subsidies, they may be likely to continue to chew up coal's role in energy production. Coal exports are saving it from going the way of the dodo bird. The U.S. is a net exporter of coal. The EIA points out that 15% of U.S. coal is exported with exports reaching the highest level in 5 years.



Source: Factset

Taking Stock – The Trillion Dollar Club

Microsoft became one of three companies to have a market cap north of one trillion dollars. Toward the end of April, shares of MSFT traded above the $130.50/share threshold to drive the market cap of the company above $1 trillion. The chart below shows the market cap dating back to 1998, surging from 2017 to the present. Recently, cloud computing is making a positive contribution to sales and share price. Annual revenue in Azure, the cloud computing arm, rose 73% as of the end of the first quarter, 2019 (Wall Street Journal). As of April 25, MSFT is up 27% YTD with a 40% 1 year return. Apple and Amazon are also members of the trillion dollar market cap club. The Powell Put has certainly assisted these megacap names and the tech heavy Nasdaq 100.

MSFT Market Capitalization

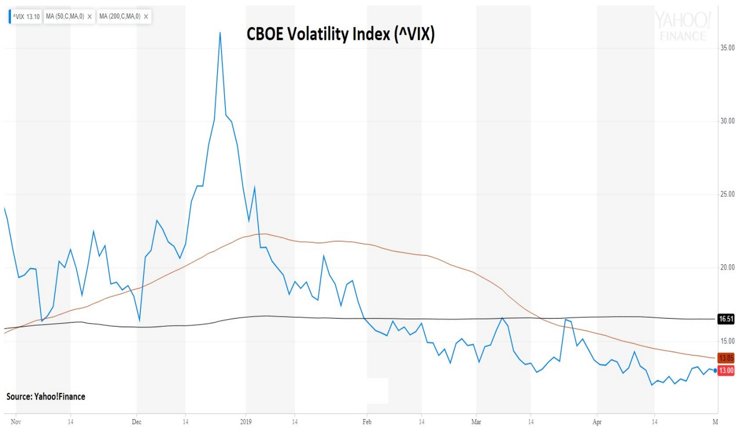
Note: Data through early Thursday
Source: FactSet

Fixed Income - Who is Your Master?

An ancient Proverb states that the borrower is servant to the lender, and has been proven true, both corporately and when individuals over indulge in debt. While much is made of China being a major holder of U.S. government debt, the reality is that over 70% of the more than $21 trillion in total debt (does not include the massive level of unfunded liabilities) is held domestically. China and Japan each own approximately $1 trillion in U.S. Treasuries, and Russia, not surprisingly, has been the largest seller of UST's, reducing their holdings from $150B to just $15B today. U.S. investors are the largest block of debt holders, led by private and state pension plans. These investors are also acquiring approximately 80% of the new issuance of debt, and demand for this safe haven paper does not appear to be slowing.

Technical - Calm Before the Storm?

After rising sharply in December, the CBOE Volatility Index has trended lower for most of 2019 (thanks in large part to the Powell Pivot). In mid-March the 50-day moving average on the VIX crossed over the 200-day moving average in what amounts to a buy sign for equities to many technical traders. There have been horrendous terror attacks, no solution for Brexit and the possible disruption it will cause, a report from the special counsel that amazingly convinced each side they were right, yet investors have treated these events with a yawn and a ho-hum. Earnings, while forecasted to be lower than the same period one year ago, continue to come in slightly higher than expected in over 75% of companies. Time will tell if the world if as safe for risk assets as the VIX is suggesting.



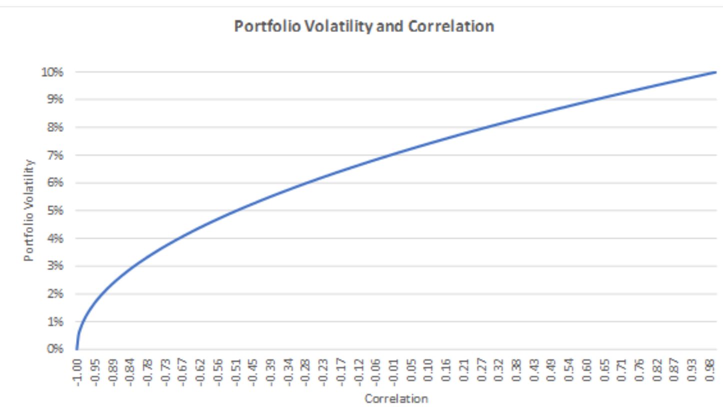
The Correlation Effect

Clint Pekrul, CFA

We've discussed the importance of the role correlation plays in the portfolio construction process. At the core of modern portfolio theory, or MPT, is the realization that combining securities (e.g. stocks, mutual funds, ETFs, asset classes, etc.) whose returns are not perfectly correlated can reduce overall portfolio volatility, and potentially enhance long-term returns.

In the chart below, we've illustrated an example of the "correlation effect" on overall portfolio volatility. For simplicity, we've assumed a hypothetical, two asset class portfolio where each asset has an assumed volatility of 10%. Along the bottom axis is a range of all possible correlations (ranging from -1.0 to 1.0). Along the left axis is a range of all possible levels of portfolio volatility. The curved blue line illustrates how portfolio volatility changes as the correlation of returns between the two assets changes.

At the bottom left, the portfolio volatility is equal to zero. That is, if we hold a combination of two assets with equal volatility but perfectly negative correlation, portfolio volatility is eliminated. As the value of one asset rises, the value of the other asset falls by the same amount (each holding has identical volatility). To practitioners, this is the perfect scenario – combining two assets with positive return expectations that are perfectly negatively correlated.



Source: Peak Capital Management

In reality, however, this scenario is highly unlikely. What we actually observe is that correlations are not only greater than -1.0, but can also often drift much higher towards 1.0. As the chart illustrates, as correlations rise towards 1.0, the volatility of the overall portfolio also rises. In fact, if the correlation of the returns between the two assets is perfectly positive, then the volatility of the total portfolio is equal to the weighted average of the volatility of the underlying holdings. In other words, the diversification effect diminishes as the correlation coefficient increases.

There are metrics we can use to measure the degree to which portfolio volatility is reduced through correlation. In particular, there is the Diversification Ratio (DR) developed by Choueifaty and Coignard in 2008. The DR measures risk reduction through correlation by dividing the weighted average volatility of the holdings in the portfolio by the volatility of the portfolio itself. As we can see from the chart above, if correlation across the assets is perfectly positive (1.0), the volatility of the total portfolio is the sum of the weighted average volatilities of the holdings. However, as we can see from the chart, as correlations drift lower toward -1.0, then the volatility of the total portfolio is something less than the weighted average of the volatilities of the underlying holdings. The result is that the DR will go from a figure of 1.0 (scenario of +1.0 correlation) and begin to increase (scenario of -1.0 correlation). Ultimately, if correlations reach -1.0, the DR is undefined as all portfolio volatility has been eliminated.

In reality, we construct portfolios using more than two asset classes. The example above is relatively simple. When constructing real world portfolios, we have to account for the correlations across multiple asset classes (perhaps as many as five to ten, for example). This makes the portfolio evaluation somewhat more challenging. Fortunately, the DR can be applied to portfolios of any size, and makes comparisons across investments fairly straightforward.

To summarize, as portfolio managers, we want to offer diversification in order to manage uncertainty. The correlation effect can be very helpful in achieving this. As we have seen, combining assets that are not perfectly correlated will reduce overall risk, and we can use the DR to quantify this risk reduction and make portfolio decisions based on the outcome.

Q: Is Modern Monetary Theory (MMT) valid?

I hosted a dinner this week in Chicago with John Mauldin and asked his view on MMT, making the comparison that it is the economic equivalent of the Green New Deal. John, of course, answered with the Austrian School of Economics' response regarding governments running large deficits and the negative impact on growth. Japan is interesting because they have been practicing a form of MMT for over two decades without an economic collapse. MMT proponents benefit from a fact about debt that is simple yet rarely understood: debt does not matter, until it does. The moment debt matters it is already too late to stop an Argentine-type of response with default and falling living standards for decades. This will happen in Japan if they remain on the same path, we just don't know when.

There are no economic free lunches, essentially what MMT advocates. MMT proponents fall victim to one of the classic blunders, the most famous of which is, "Never get involved in a land war in Asia," but only slightly less well known is that excessive debt will destroy future growth rates and prosperity. The government printing money and spending it as stimulus is not going to cause inflation because it is a deflationary exercise. Inflation only comes when the entire currency collapses due to lack of confidence, and you end up where Venezuela is today.

I'll admit that I'm not an economist, but as I understand it, the MMT framework could lead to a potentially disastrous scenario – currency devaluation and inflation. The idea that we can pay our bills by printing money simply because the dollar is the world's reserve currency doesn't seem like a sustainable, long-term plan. Handing over the money printing role to the U.S. Treasury to pay for programs, which MMT proposes, means taking away the independence of the Federal Reserve, which ultimately decides how many Treasury securities to buy, or money to "print." The Fed wants a stable currency with inflation targets; politicians want to fund their social programs with no constraints. According to MMT, if inflation becomes a problem because aggregate demand outpaces supply, the government will simply increase taxes in order to slow down the economy. But I can't image a politician willing to raise taxes in a period where overall prices are rising. Doing so would be political suicide.

So, my take is that an economic theory that adheres to unchecked deficit spending with the prospect of spiraling inflation probably isn't the answer. I understand the appeal, though, of MMT, in that it provides a framework for building out social programs that are in the mainstream today, such as Medicare-for-All, the New Green Deal and guaranteed employment.

Q: Was the yield curve inversion a head fake?

While typing the response to this question, the BEA released the first print off Q1 GDP. I was on the bullish end of expectations, expecting a number just below 3%, and was shocked to see the 3.2% figure. I could stop writing here and simply and emphatically say YES, the inversion was a head fake.

The more important question to ask might be why the yield curve inverted, and what caused it to normalize so rapidly. Interest rates are a function of two independent factors: Fed policy on the short end of the curve and market expectations for inflation on the long end of the curve. While the two factors typically move in tandem (Fed policy impacts market expectations and market forecasts influence Fed policy) sometimes they diverge. The yield curve inverted because market expectations for future inflation were falling, resulting in lower long term yields, at the same time the Fed was publicly saying they were going to keep hiking rates in 2019. The Fed obviously blinked with the Powell Pivot and short term yields almost immediately fell back below long term yields.

The blowout Q1 growth, exceeding even the most enthusiastic bulls' expectations, tell me the short period of inversion did no long term economic harm to the economy. This is great news, unless you were bearish or concerned that this will make the Fed reconsider their pause in rate hikes.

It is well known that an inversion of the yield curve – a scenario where short-term rates that are set by central banks surpass longer-term rates that are set by the market – has historically been associated with a greater likelihood of a looming recession. The rationale is that tighter credit conditions make it more difficult for businesses to access credit, and, as a result, the overall economy slows down and we get a contraction in GDP. But, as with any signal, a yield curve inversion is no guarantee that we're headed into a recession. It is simply a metric to use to help gauge the probability of an economic slowdown.

I'm not sure we can casually look at historical inversions and make inferences about future outcomes today. Sure, the yield curve has historically been a useful forecasting tool, but historically, central banks did not own a sizable chunk of government debt. Ten years of quantitative easing have changed the rules of the game in ways that no economist today can fully appreciate. We could argue that long-term rates are no longer set by the market, which raises questions about the reliability of using a yield curve inversion as a recession signal. Overall, the economy seems to be on solid footing, given current levels of inflation and unemployment, but a flat yield curve isn't generally something you want to see. Our view is that there's a higher probability of a recession now than a year ago, but don't get overly concerned about a brief inversion of the yield curve.

Model Weights

All weights as of May 1, 2019

Income

Mortgage Backed Bond	38.88%
Investment Grade Credit	19.89%
High Yield Bonds	10.83%
Preferred Stock	15.91%
US Dividend Equities	6.80%
US REITs	7.67%

Balanced Income

US Dividend Equities	16.14%
International Dividend Equities	22.16%
US REITs	14.16%
High Yield Bonds	25.48%
Long Term Treasuries	22.06%

US Growth

Low Volatility Factor	16.05%
High Quality Factor	12.86%
Small Cap Factor	12.83%
Value Factor	15.00%
Momentum Factor	12.91%
Long Term Treasuries	30.33%

Global Growth

Low Volatility Factor	8.53%
High Quality Factor	6.22%
Small Cap Factor	6.35%
Value Factor	7.38%
Momentum Factor	6.41%
Developed Market Equity	19.56%
Emerging Market Equity	15.30%
Long Term Treasuries	30.25%

Weights are approximations only and subject to change.

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