PCM
PEAK CAPITAL MANAGEMENT

Storm Clouds Gathering

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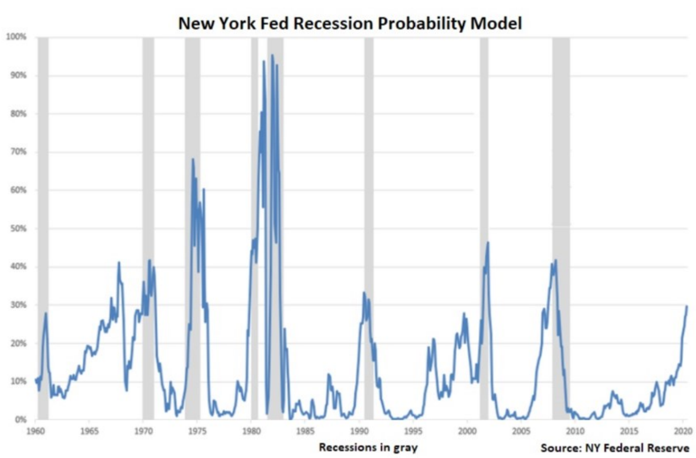
Investment professionals are continually in search of the proverbial “canary in the coal mine” for advance warning of approaching economic doom and the collateral damage to risk assets. The reality, however, is that reliable signals are far more difficult than meets the eye.

A decade ago investors were mesmerized by the concept of Black Swan events made famous by author Nassim Taleb. Today we realize that black swan events are happening continually; multiple times each year something can be identified that never happened before. We live in an environment prone to spawning the economic equivalent of the rare aquatic birds with Central Banks around the globe setting radical monetary policy trying to stave off the next recession. With data such as labor market growth and Leading Economic Indicators showing weakness, we are again asking ourselves if a recession is just around the corner.

There is a trifecta of reliable recession indicators that suggest a contraction may be far closer than most analysts are forecasting. The yield curve has remained negative for over 2 months at the time of writing. There are only a couple of rare occasions in the last 60 years when the yield curve was negative this long without a recession occurring within 12 months. Second, the weakness in job creation is concerning. When the economy slows employers slow hiring and often cut back on employee hours. We view the drop in average hours worked per week as a red flag. Lastly, the NY Fed publishes a Recession Probability model. The probability has risen to over 60% according to their model and only once in the last 35 years has the probability been that high without a recession occurring within 6 months (2000).



To suggest the economy is vulnerable today would be tantamount to predicting Trump will offend someone with a tweet this week. My view of the data suggests there is a 50% chance the slowdown in the 2nd half of 2019 leads to a recession in Q1 of 2020 and 50% chance we hit stall speed but avoid an outright contraction. Business investment is cratering and non-residential construction is already in a deep contraction. Demand for exports is weak, hurting manufacturing. Q2 GDP did come in above expectations, but largely because of the huge increase in non-defense government spending that rose 5% and consumption that grew at over 4%.

The markets are equally vulnerable from my perch but I do not expect a correction anywhere near the severity of the last two recessions in 2001 and 2008. Valuations are lofty from a historical perspective but not outrageous when you consider the 10-year UST trades at 2% and is likely headed lower. Financial repression from the Fed will continue and force investors into risk assets providing a floor under stock prices.

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Much is made of the record levels of corporate debt, but I do not see that as a risk. Corporate assets have grown faster than debt, so both debt to assets and debt to after-tax profits are within historical norms.

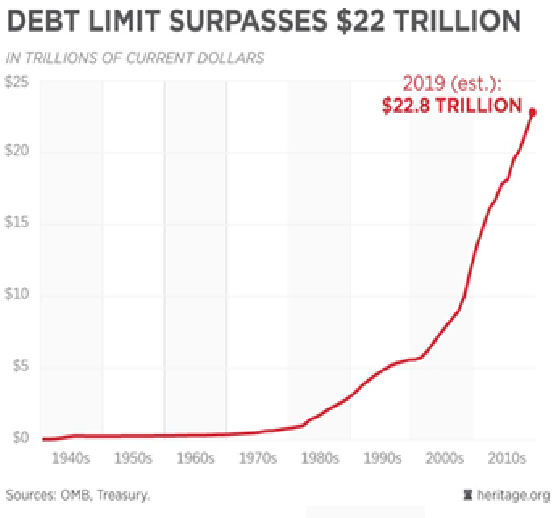
The bullish case for the markets hinges on the Fed aggressively cutting rates beginning at their July meeting. I expect we will see three ¼ point rate cuts this year (July, September, December) and that will support higher P/E ratios on equities. Bulls can also point to healthy consumers as the personal savings rate has increased above 8%, suggesting strong spending will continue. Household debt to income ratios are the lowest in 20 years falling from 136% in 2008 to 101% today (www.federalreserve.gov).

1999 Redux

Broad market indices have strong gains year-to-date, leading many investors to be frustrated with their results. A closer look at the S&P 500 reveals why few investors are keeping pace with the widely followed index. Just over 95% of the gains in 2019 can be attributed to just 4 stocks: Microsoft, Apple, Amazon and Facebook. That’s right, the cumulative contribution to the gains this year from 496 of the 500 companies is 1%. When you consider that the 4 companies delivering almost all of the market’s gains are in the crosshairs of Congress (see Q&A), the potential for a repeat of last year remains high. If the stock prices of “Big Tech” collapse, the market is likely to collapse as well.

Recessions are not enjoyable, but part of the normal business cycle, and impact people very differently. It has been said a recession is when your neighbor loses their job and a depression is when you lose your job. Investors are going to need strategies that hedge risk while still participating in market advances.

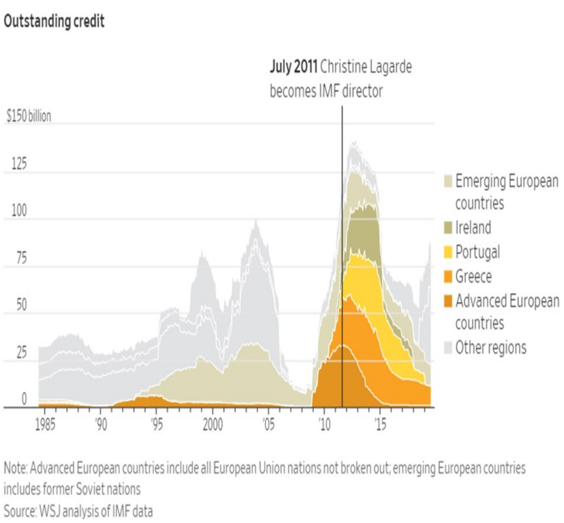
Done Deal



The White House and Congress have had difficulty agreeing on anything since 2016, but last week managed to find agreement on one issue: the debt ceiling. Legislation was passed to eliminate any discussion of debt levels for two years and removes any discussion of debt default for the next political cycle. With deficits currently forecasted at $1 trillion per year for the next two years, the national debt will increase by approximately 10%. This will mean a short-term reprieve from words like austerity and sequestration from the lexicon in Washington DC. The biggest irony of the legislation that balloons federal spending is who opposed the bill. The Freedom Caucus (Republican) and Progressives (Democrat), who agree on virtually nothing, both opposed the bill for obviously different reasons.

- The measure passed in the House by a vote of 284-149, but the party breakdown was interesting with Democrats voting 219-16 in favor and Republicans opposed the budget by a margin of 132-65, even though Trump supported.
- Military spending is scheduled to increase from the current level of $716 billion to $740 billion over the two year period, while government non-defense spending increases from $605 billion to $635 billion.
- There was an attempt to demonstrate some fiscal responsibility with $77 billion in cuts or revenue enhancements, but that pales to the projected $320 billion in new spending that will occur over the two years.

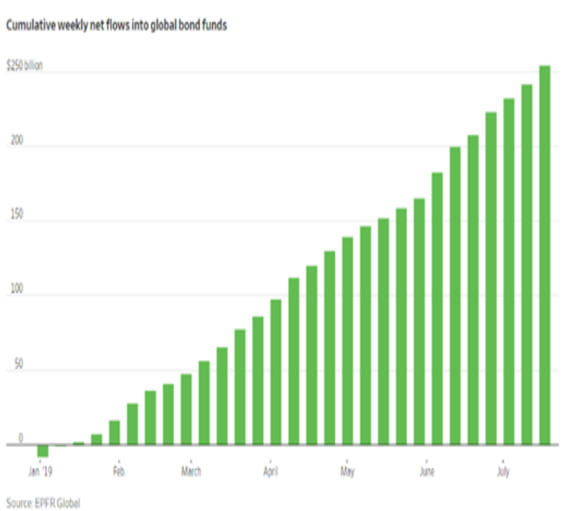
A New Sheriff in Town



Christine Lagarde is leaving her post as Director of the IMF to take the helm at the European Central Bank. She will take over for Mario Draghi in November. The ECB is historically led by economists. Lagarde more closely resembles a pragmatic politician with no formal training as an economist. Rather, her academic background is that of a lawyer. Analysts are beginning to hypothesize the impact Lagarde will have on the ECB, the Eurozone, and subsequently the global economy. She is pulled between one side vying for fiscal austerity and populism, and the other side pulling for further quantitative easing and accommodative policies. It appears that Lagarde may attempt to strike a balance between pleasing the Germans and their commitment to austerity, while creating an environment where southern Europe and emerging European countries can reduce unemployment, growing economically.

- Lagarde is not opposed to a bailout, supporting a crumbling Greece and Cyprus throughout the recovery post Global Financial Crisis.
- The WSJ chart shows IMF support since 1985. Leading up to Lagarde's role as Director of the IMF, the majority of support went to emerging markets. Under Lagarde's watch, tremendous relief went to European Nations.
- The level of support the IMF has shown to the EU since the Global Financial Crisis may indicate Lagarde's willingness to continue Draghi's accommodative policies.

ETF Fund Flows



Evaluating ETF fund flows can provide a snapshot of investor sentiment. In particular, net flows (i.e., the total amount invested in or sold out of exchange-traded-funds over a specific time horizon) gauges investor demand for various asset classes, such as stocks or bonds. According to Morningstar data, investors (typically retail clients) have invested roughly $69 billion net in passive exchange-traded-funds so far this year (as of June). One asset class of particular interest is bonds. The demand for fixed coupon investments is surging, which in turn sends yields lower. The chart to the left illustrates the monthly growth (cumulative) in bond ETF flows so far this year.

- The demand for bond funds is noteworthy. Investors aren't likely making an investment in bonds just for the income they generate, given current yields. The increase in aggregate demand is driven by an underlying notion that the equity market is somehow overvalued and due for a correction.
- Yet another scenario that might be driving demand for bonds is the notion that yields will fall even further. For example, if the 10-year Treasury falls to 1.5%, there is substantial upside return potential. That is, the combined income and capital appreciation (total return) on bonds could feasibly outpace the performance for equities.

Macro View – Trade Barrier Casualties

The St. Louis Federal Reserve Bank recently published research on some nuanced effects of strained relationships with international trading partners. The results of the research showed that trade tensions have often permanent implications for the companies that exchange goods and services across borders. Once the relationship is strained or broken, the findings show that it is not likely to resurrect the partnership. The World Bank performed a survey sampling manufacturing plants with 50 to 5000 employees across 12 countries between 2008 and 2009. The survey asked the direct and telling question, "If this establishment shut down its business, how long would it take your largest customers to find an alternative supplier for its main product?" The table below shows the results of how long the replacement took, broken out across all non exporters, exporters, and those with or without competition. The conclusion is that when the manufacturer is an exporter with a number of competitors, the relationship with importers is likely irreversible.

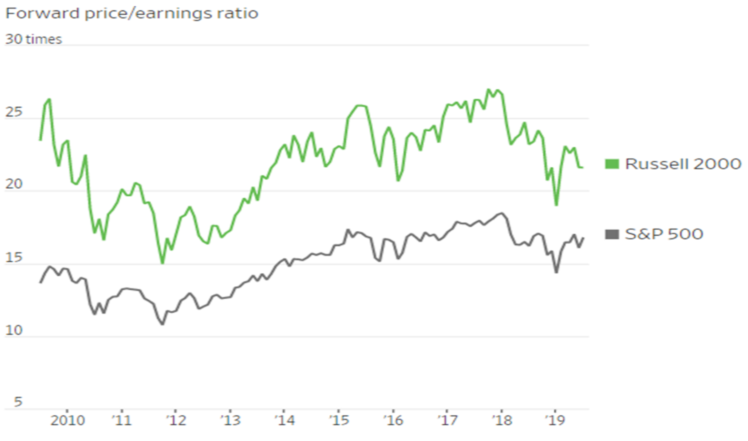
Time to be Replaced

Firms	Less than One Month	More than One Month	Never
All Firms	58%	36%	5%
Nonexporters	65%	30%	5%
Exporters	42%	50%	8%
No Competitors	14%	10%	76%
One to Five Competitors	57%	40%	3%
More than Five Competitors	65%	32%	3%

Source: St Louis Federal Reserve Bank

Taking Stock – Small Cap Smoke Signals

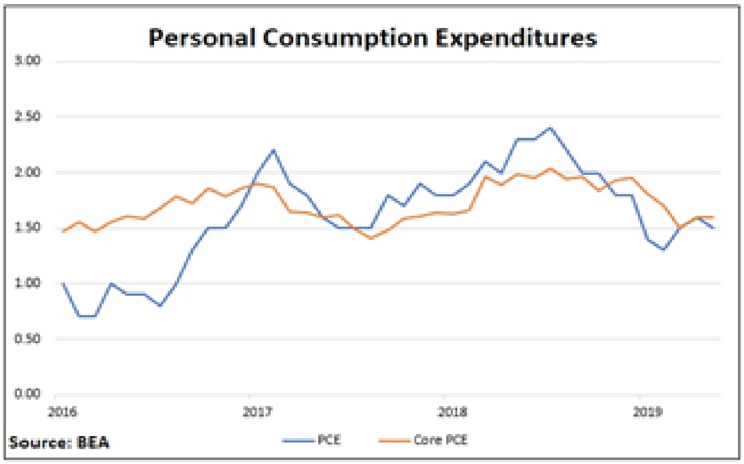
While the S&P 500 hits all time records, analysts are looking at the small caps for cues on the timing of when the economy moves from expansion to contraction. The Russell 2000 index dropped by nearly 20% in Q4 2018, with expectations that the Federal Reserve would continue to raise rates in 2019. The chart from Refinitiv shows that the forward price to earnings ratio has come down recently, currently around 21 times projected earnings. 82% of revenue for small cap companies is derived domestically (Goldman Sachs Asset Management). The downward trending PE multiple may be the canary in the coal mine of a slowing US economy and the conclusion of an economic expansion. Small companies tend to take on more debt than their large cap counterparts. Rising rates could further punish these companies.



Source: Refinitiv

Fixed Income - PCE vs. CPI

Even market novices are familiar with the inflation gauge CPI, or Consumer Price Index, but may not be aware the Fed all but ignores that data in favor of the PCE or Personal Consumption Expenditures. The Fed believes the PCE is more reflective of "true inflation" and consumer spending patterns. The PCE is more broad than the CPI, and thus a better macro monetary policy indicator. The CPI, calculated by the Bureau of Labor Statistics, runs higher than the PCE that is calculated by the Bureau of Economic Analysis. Since 2000, CPI has risen 39% while PCE has risen only 31%. The primary differences between the CPI and PCE is the weight of housing, 42% of CPI compared to 15% of PCE, and rural versus urban differences. The CPI is heavily weighted towards urban areas whereas the PCE encompasses a broader swath of the country.



Technical - When it Absolutely Has to Be There

Technical analysis centers on identifying correlations between disparate data points that provide insight to where the market is headed. No indicators are accurate all of the time, but the higher the correlation over long periods of time the more valuable an indicator becomes. The technical picture of the global economy is starting to look a bit scary. The correlation of world trade and FedEx stock has been strong over the last 17 years. It is reasonable to assume you could forecast future world trade, and correspondingly global GDP, by looking at FedEx price movement, and the picture it paints is not pretty. World trade has touched 0% year-over-year growth twice since the 2008 recession but always bounced above along with FedEx stock. The current trend appears to be heading to negative growth on trade even as FedEx's stock has plunged almost 30% from late 2018.

Source: CPB, Bloomberg Finance, LP, DB Global Research

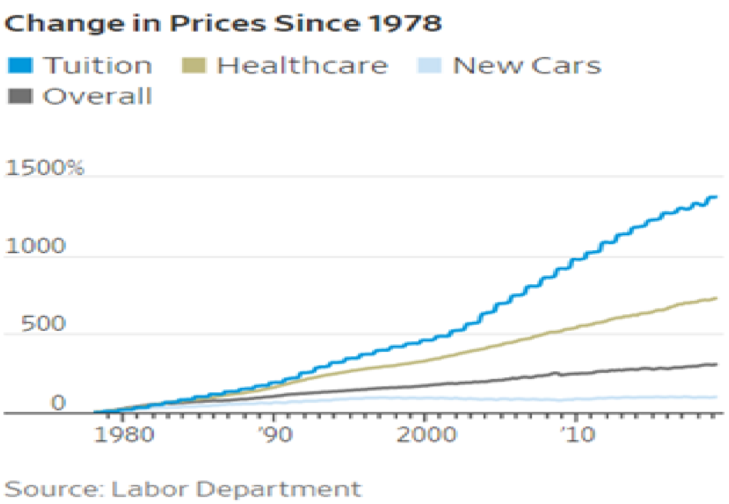
Examining the Student Debt Crisis

Clint Pekrul, CFA

The so-called student debt crisis seems to make headlines routinely, especially as the 2020 election season approaches. The issue is politically polarizing, with far-left candidates like Senator Elizabeth Warren proposing legislation that would forgive student debt and eliminate tuition at public institutions. However, such disruptive proposals are unlikely to pass through Congress. Indeed, college graduates achieve an education that will carry them through the rest of their lives. But, in may instances, they carry a financial burden that lingers for decades.

The fundamental issue is a question of economic value – is the degree a student earns worth the cost (i.e. the student loan) of achieving it? Certain fields of study, such as engineering, medicine or computer science, offer promising salaries that more than likely will cover the cost of achieving a degree. But for other fields of study, such as education and philosophy, the expected income might not sufficiently cover the cost of a loan, which in turn can make the degree quite costly. This economic reality should not preclude students from persuing their interests. But at a minimum, prospective students should carefully evaluate the financial implications of assuming a college loan.

According to a Wall Street Journal article (The Long Road to the Student Debt Crisis, Josh Mitchell, 2019), borrowers currently owe more than $1.5 trillion in student loans, or about $34,000 per person. Furthermore, college tuition has risen 1,375% since 1978, more than four times the rate of inflation, according to the Labor Department (see chart below). Moreover, four in ten recent graduates are in jobs that don't require a degree, according to the New York Federal Reserve. What's worse is that roughly half of enrolled students actually graduate within 8 years. Degree or not, the student loan must still be repaid.



Let's work through the math of a student loan in terms of a cost-benefit analysis. What follows is a simplistic – yet informative – exercise. Assume a prospective college student chooses an institution of higher learning that costs $20,000 annually (pick any number). A fortunate prospect has the ways and means to pay for the tuition outright. But for most, the tuition must be financed through a loan. Considering a four-year degree, that's $80,000 in financing. According to credible.com, the average interest rate on an undergraduate loan is roughly 5% annually. Furthermore, the typical loan term is 120 months (i.e. ten years). Let's assume that the monthly loan payment, based on the figures above, is $700 per month (principal plus interest).

According to the Bureau of Labor Statistics, the median weekly income of a high school graduate with no college degree is $718, or $37,336 per year. In comparison, the same statistic for earners with a college degree is $1,189, or $61,828 per year. The economic benefit of having a college degree is obvious – reasonably expect to earn roughly 66% more with a bachelor degree. Compound this differential ($61,828 versus $37,336) over decades and the cumulative effects are substantial. For example, over a ten-year period, an earner with a college degree makes roughly $250,000 above the earnings of an earner without a college degree.

On the surface, obtaining a college degree is quite valuable economically. But we must factor in the cost of achieving the degree. To earn, on average, the marginal $250,000 benefit of a college diploma over ten years, most prospective students must lay out the cost of a student loan. In our example, this debt service equates to $84,000 over the life of a loan. Pay the debt and ultimately you come out ahead after ten years (i.e. plus $166,000). The earnings potential after the loan expiration is exponential – a higher than average wage and no student debt.

The reality, however, is that the future earnings of a college graduate is uncertain. In a worse case scenario, a young adult entering the workforce cannot find employment that sufficiently covers the cost of the student loan. In other words, the investment today (i.e. the student loan) does not ultimately pay off. Instead, you are potentially under a debt burden that's not easy to pay off.

Q: Is Big Tech in Trouble?

In the short-term, yes, I think Google, Facebook and Amazon will come under pressure as scrutiny of their practices by the Justice Department becomes apparent. These three companies were all listed by name in the broad antitrust inquiry opened by the Attorney General. I think the antitrust argument, put forth by many in traditional media (newspapers/magazines) is weak and they are just trying to remain relevant. There is a separate inquiry led by the Federal Trade Commission that I think poses an even bigger problem for these companies. If these platform companies were to lose their immunity from lawsuits based on content posted on their sites, it would dramatically reduce their ability to monetize that content. Senator Hawley from Missouri introduced legislation to remove their immunity as well. Without immunity, these companies would have to ensure that no content that could be considered defamatory or libelous is posted to their site. As a result of subpoenas and whistleblowers, it is clear that many of the big tech companies have a clear political agenda and they actively seek to advance those agendas. The terms of the exemption under the Communications Decency Act of 1996 mandates the companies provide a forum that is free of political censorship. In a world where bots equipped with AI can appear as real as you or I, not everything is as it seems. Ultimately this issue will be determined based on election security and national security concerns.

I wouldn't call it trouble. Scrutiny is a better term. Politicians are scrambling to draft legislation using anti-trust laws from 100 years ago. Back then, monopolies, such as Standard Oil, could control the price of their product. The objective was to control the market, thus eliminating competition, and drive up prices. That's not the scenario today. Advances in technology and productivity go hand-in-hand. Companies like Amazon, Microsoft, and Apple are competitive enterprises that drive technologies that we use every day. Are they (i.e. technology companies we rely on) in trouble with regulators? My response is no, the tech sector is not in trouble. The owners of tech businesses have influence in Washington. That's to say, their influence sways legislation. Investors might look at the valuation on tech stocks (e.g. Facebook, Amazon, etc.) and think they are overpriced, but long-term, these companies might prove quite valuable. So overall, I don't think big tech is in trouble. They simply face a set of circumstances that are politically charged. At any rate, I think using anti-trust legislation from the past does not apply to what we see going on now, simply because prices are going down, not up, which ultimately benefits the end consumer. At a minimum, however, I think rules regarding data privacy and security will be more stringent going forward.

Q: How will new PM Boris Johnson impact Brexit?

Without a doubt the pendulum of political will has shifted away from the EU to the Johnson-led UK right now. Johnson is described, like Trump, as a wildcard, someone willing to do the unconventional to achieve what they believe is best for the country. Agree or disagree with them, something that can shift back and forth, you cannot assume they will simply do what politicians always do. The politics of Brexit are complicated with multiple factions positioning for different outcomes. Under Theresa May there was virtually no chance of a "hard Brexit" where the UK leaves without an agreement. The likelihood of that happening today is probably greater than 25% and rising rapidly. Johnson has said that the UK will leave by October 31 regardless of whether a satisfactory deal has been reached. Both sides know it makes sense to have an agreement similar to what Switzerland has negotiated. Britain benefits through the free trade agreements and the EU benefits from fees collected and modest concessions on immigration. The sticking point has been the Irish backdrop and the EU unwillingness to compromise. If you compare negotiations to a game of Texas Hold'em, when May was PM the EU's hole cards were superior and everyone knew it. Today, Johnson is holding the stronger hand and the EU knows it. I do not think the EU will be willing to go "all-in" on their hand, especially with their largest economies slowing today.

Well, the new prime minister has made it abundantly clear that he wants the United Kingdom (UK) out of the European Union (EU) by October 31st. Markets are pricing this in as an almost certainty. However, things could get tricky if the UK pursues a no-deal Brexit, or a "hard" exit from the EU. Under this scenario, there would not be a withdrawal agreement with the EU, and Britain's exit might not go smoothly. In addition, there is talk that the UK itself – a union of England, Scotland, Wales and Northern Ireland – could break up in the process. The newly elected Johnson isn't very popular in Scotland, a country that voted against Brexit. Likewise, Northern Ireland voted against Brexit as well. So, there are some anti-conservative factions that lean heavily against Johnson, and might view a no-deal Brexit as a way to essentially break up the UK. Should this scenario happen, I think markets might get a bit more volatile. Not only would you have the mess of a no-deal Brexit, but also the economic ramifications of the potential breakup of the UK itself. It would be interesting to see an independent Scotland or a unified Ireland. Certainly, a lot to work out if we go down this path.

All weights as of August 1, 2019

Income	
Mortgage Backed	42.57%
Investment Grade	15.20%
High Yield Bonds	9.25%
Preferred Stock	22.80%
US Dividend	3.48%
US REITs	6.70%

Balanced Income	
US Dividend Equities	17.02%
International Dividend Equities	18.79%
US REITs	10.28%
High Yield Bonds	27.34%
Long Term Treasuries	26.57%

US Growth	
Low Volatility Factor	16.06%
High Quality Factor	12.86%
Small Cap Factor	10.65%
Value Factor	13.51%
Momentum Factor	12.91%
Long Term Treasuries	34.01%

Global Growth	
Low Volatility Factor	8.53%
High Quality Factor	6.22%
Small Cap Factor	5.11%
Value Factor	6.13%
Momentum Factor	6.41%
Developed Market Equity	19.56%
Emerging Market Equity	13.18%
Long Term Treasuries	34.86%

Weights are approximations only and subject to change.

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