PCM
Peak Capital Management

Oil as a Weapon

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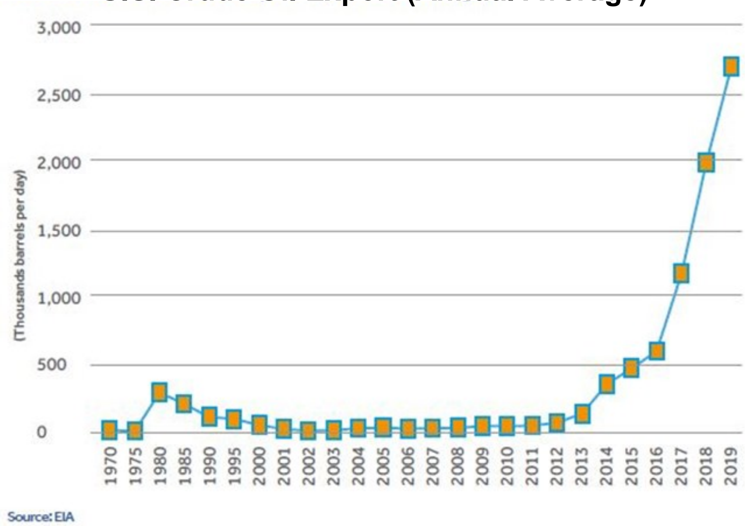
The shocking attacks on Saudi Arabia's oil production a couple of weeks ago highlight that warfare today is targeting economic impact as much, if not more, than military impact. Houthi rebels from Yemen, backed and financed by Iran, carried out the drone attacks that took 50% of Saudi production offline, equalling 5% of global oil supply.

With bleak economic data out of China, Germany on the cusp of recession, and the UK increasingly looking like they could crash out of the European Union without a deal, the timing of an oil spike is conspicuous for the global economy. Oil is like oxygen for the world economy, causing some analysts to suggest the 15% spike in crude prices could tip economies into recession.

While a price spike might cause concern, I do not think we are any where near a price per barrel that would warrant recession concerns. First, adjusted for inflation, oil remains about 50% lower than the process achieved in the 1980's, 2008, or 2014. In 2019 dollars, oil reached a high of $158/barrel in 2008 before the Great Recession. The total amount consumers spend on energy today is roughly equivalent to what was spent during WWII.

U.S. Crude Oil Export (Annual Average)



Energy expert Steven Kopits of Princeton Energy Advisors suggests that crude prices would have to reach $110/barrel to cause a recession today. The primary reason an oil spike is not the same threat today is that the world's largest economy, the U.S., is now a net exporter of oil instead of the largest importer of oil (an honor that now belongs to China). The U.S. briefly overtook Saudi Arabia and Russia as the largest oil exporter in the world in 2019. U.S. production has risen the 15 million barrels per day (BPD), 25% higher then the Saudi's uninterrupted production and more than twice maximum production from just 10 years ago, thanks to technological breakthroughs in shale exploration.

OPEC had seen their influence fall dramatically with respect to oil prices. The top 7 producing countries account for 50 million BPD according to the Energy Information Administration, and OPEC represents just 16 million BPD of that total (excludes Iran because of sanctions). The lack of influence is forcing some members to try and create havoc or economic terrorism. At this point, it seems unlikely they will be able to succeed in that except in countries that are particularly vulnerable to oil price stocks like China.

There is, however, a strong economic impact being caused by instability of the energy markets; just not what the perpetrators have desired. With the surge in U.S. oil production to more than 15 million BPD and becoming a net exporter of oil, the U.S. does not send dollars overseas in the same quantities as in the past. There is a growing USD liquidity issue that is negatively impacting emerging market countries who rely on USD for their economic growth. Because much of emerging market debt is priced in USD, they need access to dollars to service the debt. With fewer dollars available in global markets, the dollar rises compared to the emerging market currencies making debt servicing onerous. Just recently the IMF (International Monetary Fund) reduced forecasts for global growth in 2019 and 2020 as a result of slower growth in emerging markets caused by a U.S. dollar squeeze.

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The U.S. stock market shrugged off the attacks on Saudi oil and the corresponding 15% spike in oil prices as a non-event. Recent history has even shown that since the U.S. became a net exporter of oil, the markets are more vulnerable to a sudden price drop in oil more than increasing oil prices. The impact on corporate earnings for the S&P 500 of falling oil prices, particularly below $40/barrel, is much greater than the impact on earnings of oil prices above $60/barrel.

Consumers remain optimistic and their balance sheets on the whole support continued spending to keep U.S. economic growth in the 2.5%-3.0% range. The labor markets are unlikely to be negatively impacted by higher oil prices supporting continued domestic growth. The investment implications are most likely to be a pullback in allocations to China and emerging markets hurt by the dollar shortage and vulnerable European markets like Germany. New stimulus and quantitative easing by the ECB should soften the impact across Europe. Energy remains a critical component of economic growth, but the winners and losers have changed dramatically.

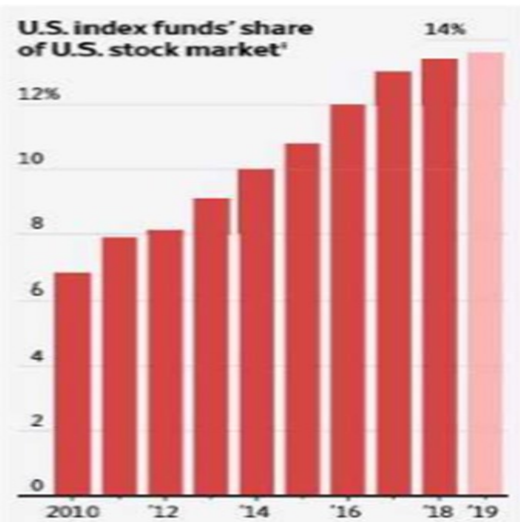
Repos Creating Havoc

Source: Zero Hedge

The internal plumbing of the U.S. banking system rarely makes headlines since the collapse of Bear Stearns and the 2008 financial crisis. That is, until last week when the IOER (Interest on Excess Reserves) rate spiked to as high as 15% at one point. This is a rate typically synonymous with the upper range of the Fed Funds rate. While some commentators panicked, believing another crash was imminent, that does not appear to be the case. Banks loan to each other overnight to meet their reserve requirements. In 2018 the repo rate went slightly above the IOER rate, so billions were funded into that market. In mid-September, when corporate taxes were due, $100 billion was removed from the repo market creating a massive imbalance between supply and demand.

- The spike in repo rates was the result of a short-term technical issue (Treasury auction settlement and corporate tax due date), and not a long-term fundamental problem.
- The Fed has many tools at its disposal to correct any imbalance between the IOER and repo rates, including giving primary dealers the ability to use repos as primary collateral at the Fed.
- Too much collateral at the Fed, not too little collateral, is the problem. If the Fed succeeds at increasing loan demand for banks, excess reserves will diminish and balance will be restored.

Passive Surpasses Active

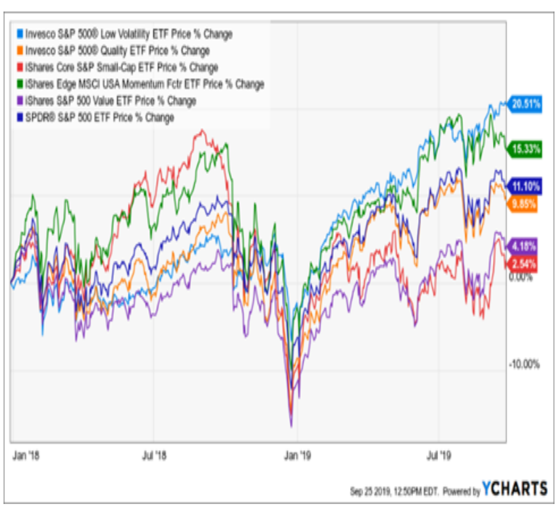


Source: Investment Company Institute

August 31st marked the first time broad U.S. equity indexes surpassed active managers in total assets. Morningstar reported that U.S. equity indexes totaled $4.27 trillion in assets, while active managers totaled $4.25 trillion. Over the past ten years, $1.36 trillion has come in to index based mutual funds and exchange traded funds, while $1.32 trillion has left actively managed funds. Concern among analysts and investors is that the flood of assets in to indexing exacerbates volatility. Three firms make up approximately 80% of the indexing market: Blackrock, Vanguard, and State Street Global Advisors (Wall Street Journal). The chart on the left shows that U.S. index funds' share of the U.S. stock market is approaching 14%.

- The three largest holders of index-based investments hold approximately 20% of the S&P 500 (Factset)
- The SEC has expressed concern over a concentration of ownership among the three largest holders of index-based funds, creating unintended consequences to indexing specific to corporate governance.
- S&P Dow Jones research through the SPIVA report demonstrates that active managers often struggle to provide outperformance over passive indexes for various asset classes.

U.S. Factor Returns

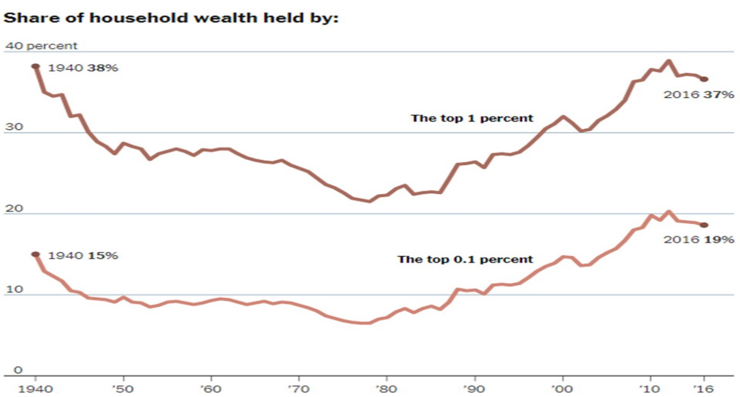


Despite talk of a global economic slowdown, tariffs, and impeachment hearings, the U.S. equity markets have rebounded nicely from the lows of 2018. Going back to January of last year through today (September 24th), the S&P 500 has yielded a cumulative return of roughly 11%. However, when we look under the hood at the factor exposures, the performance is quite dispersed. Based on the figures in the chart below, the low volatility factor has returned roughly 20% cumulative, versus a corresponding return of just 2% for small cap stocks and 4% for the value factor.

- The relative outperformance of the low volatility factor might be due to investor demand for equities that exhibit less price variation, especially after the drawdown in the fourth quarter of 2018. Likewise, some investors are wagering that large-cap, higher-growth names will continue to run, which has pushed momentum towards to the top of the factor rankings.
- Value has underperformed the broader S&P 500 for several years, which might be due in part to historically low interest rates that have helped inflate asset prices.

Macro View – Understanding a Wealth Tax

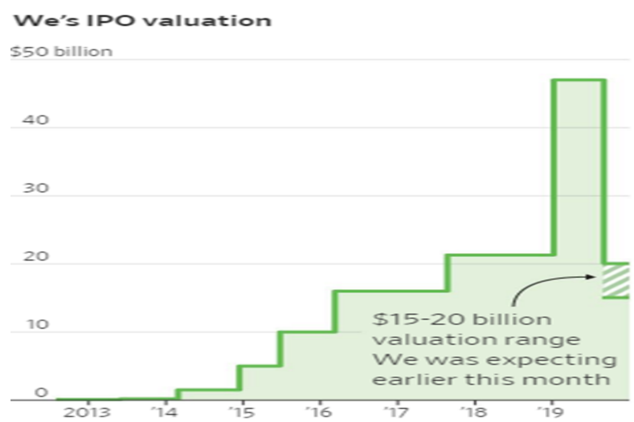
As we begin the presidential race, there is no shortage of solutions kicked around for whatever ails the nation. No doubt, different types of taxes are proposed as a piece of the puzzle. Both Bernie Sanders and Elizabeth Warren are suggesting a "wealth tax" to pay for government programs. Sanders' wealth tax, for example, targets individuals with a net worth of over $16 million and married couples with a net worth over $32 million. The critical difference is that currently realized gains are taxed. Realized gains occur when investors sell assets. A wealth tax taxes someone broadly based on their net worth. There becomes an inherent challenge each year with defining someone's net worth or managing those who attempt to move their citizenship out of the United States. The chart below shows the share of household wealth for the top 1% and top 0.1%.



Source: Thomas Piketty, Emmanuel Saez and Gabriel Zucman, "Distributional National Accounts: Methods and Estimates for the United States"

Taking Stock – WeWork Not Working

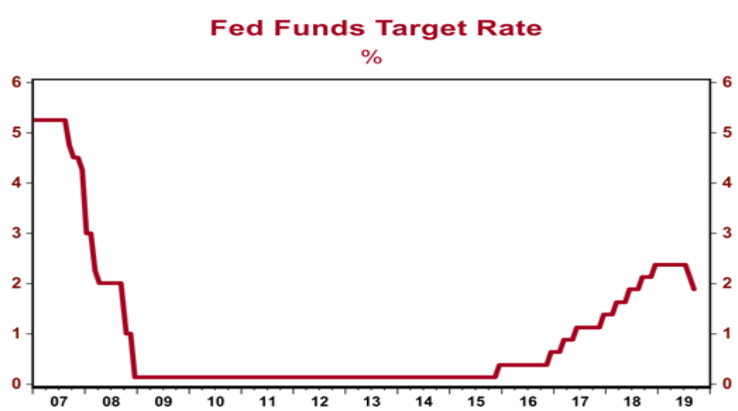
WeWork, a coworking company, filed IPO paperwork in August. Since filing, the IPO has been derailed as analysts scrub financials and begin to dig in to the eccentric activity of former CEO, Adam Neumann. After filing with the SEC, it became public that the company booked significant losses in 2016, 2017, and 2018. Furthermore, Neumann cashed in $700mm in stock options prior to when the company was to go public. Neumann stepped down as CEO, remaining as a nonexecutive chairman, also giving up majority control of the company. Conflicts of interest are disclosed in the IPO prospectus. That included Neumann selling the rights of the word "We" back to the company for $6 million. The valuation dropped from $47 billion to $15 billion, despite annual revenue surpassing $2 billion (Wall Street Journal). The Dow Jones Venture Source chart below shows the precipitous drop in the IPO valuation.



Source: Dow Jones VentureSource

Fixed Income - On a Mission

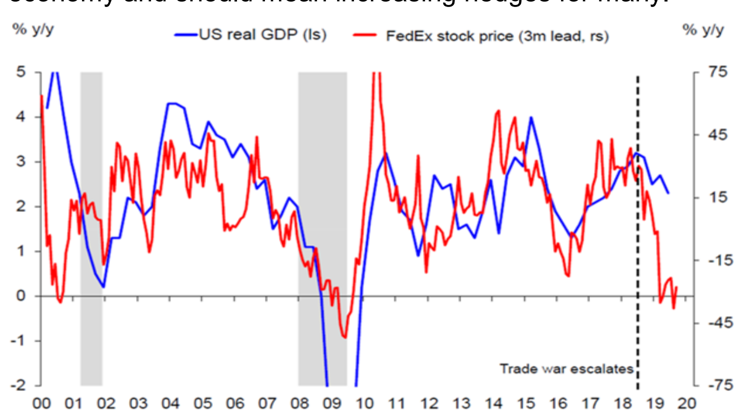
As expected in their September meeting, the Fed voted to cut rates another 25 basis points (1/4 point) to support continued growth of the U.S. economy along with making minor changes on the rate paid on excess reserves. The Fed typically operates with a high degree of consensus, so the dissenting votes are a new development as we typically only read about dissent in the Minutes released later. Two voting members voted to leave rates unchanged, while Kansas City Fed President Bullard, possibly after dinner at the White House, voted to cut by a 1/2% (attempt at humor). That there is not more dissent is what is surprising, given the different mandates of the Fed. Uncertainty about trade was mentioned by Chair Powell, but they also are aware the ECB is starting a new round of QE likely to drive the USD higher if the Fed does not act.



Source: Federal Reserve Board/Haver Analytics

Technical - Delivering on Data

One of the technical indicators for the macro economy that has a strong historical basis involves FedEx. It is intuitive to understand that the more packages FedEx delivers, the higher economic growth is forecasted to be. The high correlation between FedEx stock price movement and US Real GDP is still surprising. This chart supports the idea that 'markets know best,' and discount stock prices long before economic contractions can be identified. Over the last 20 years, FedEx stock has been a leading indicator for economic growth. It is possible that FedEx is overly impacted by the trade war and this indicator will prove to be less valuable than in the past, but the phrase "this time is different" has haunted many portfolio managers. FedEx falling 30% from its recent high is a flashing red signal for the economy and should mean increasing hedges for many.



Source: BEA, Bloomberg Finance LP, DB Global Research

Asset Class Volatility and Correlations

Clint Pekrul, CFA

We've often written about the importance of asset class volatility and correlations, and how the two influence long-term compound rates of return. In the portfolio construction process, we place emphasis on how variable returns are, and how performance across asset classes is related. Changes in volatility and correlations ultimately determine our asset allocation across various models.

Below we provide an overview of current markets and how it relates to our portfolios. Table 1 below summarizes the volatility of various asset classes at different points in time. Based on the data, we can see how meaningfully volatility has come in today compared to the end of last year. For example, US equity volatility has fallen from roughly 25% down to 16%. Noteworthy, however, is that bond volatility has roughly doubled from 2% to 4% for investment grade bonds, while duration (long-term Treasury) volatility has jumped from roughly 9% to 16%. The rise in bond volatility coincides with a substantial decline in yields. Credit conditions have been fairly stable, so high-yield volatility is fairly tame at 5% annualized standard deviation.

Table 1: Asset Class 60-Day Standard Deviation (Source: Peak Capital Management, YCharts)			
Asset Class	As of 12/31/2017	As of 12/31/2018	As of 9/25/19
US Equities	5.6%	24.8%	15.6%
Developed Market Equities	6.9%	17.8%	12.2%
Emerging Market Equities	13.1%	25.9%	15.9%
Investment Grade Bond	2.4%	2.3%	4.1%
Long-Term Treasuries	9.6%	8.8%	16.1%
High-Yield Bonds	4.0%	7.5%	5.1%

Table 2 below summarizes the current correlation of returns across various asset classes. Based on the correlation data, investment grade bonds and long-term Treasuries currently are a good diversifier to equity and high-yield bond risk. For example, the 60-day correlation between long-term Treasuries and US equities is -0.56, which is relatively low, based on historical levels. Likewise, investment grade bonds and high-yield bonds are negatively correlated by a factor of -0.10. When asset class returns are negatively correlated, overall portfolio risk, to a degree, can be diversified away.

Table 2: Asset Class 60-Day Return Correlation (as of 9/25/19; Source: Peak Capital Management, YCharts)						
Asset Class	(USE)	(DME)	(EME)	(IGB)	(LTT)	(HYB)
US Equities (USE)	1.00	0.88	0.87	-0.37	-0.56	0.82
Developed Market Equities (DME)	0.88	1.00	0.89	-0.23	-0.47	0.75
Emerging Market Equities (EME)	0.87	0.89	1.00	-0.28	-0.48	0.77
Investment Grade Bond (IGB)	-0.37	-0.23	-0.28	1.00	0.93	-0.10
Long-Term Treasuries (LTT)	-0.56	-0.47	-0.48	0.93	1.00	-0.29
High-Yield Bonds (HYB)	0.82	0.75	0.77	-0.10	-0.29	1.00

In general, when volatility is at reasonable levels (as exhibited in Table 1), and correlations across various asset classes are not at extremes (e.g. all positive), the asset allocation in our models tends to be fairly steady. That is to say, turnover may be infrequent. In contrast to last year, when we had several rebalances in light of heightened volatility, the risk profile of our tactical models this year has been more consistent. This is due in part to the decrease in correlation between stocks and bonds. In particular, when equity risk increased in May and August, the correlation between stock and bond returns decreased. The rally in bonds helped mitigate the decline in equities.

We could see heightened volatility going into the end of the year, particularly with uncertainty around tariffs and earnings growth. What will be key from a portfolio allocation standpoint is the correlation factor between stocks and bonds. If we see another leg down in yields and a corresponding jump in equity risk, our models could see a marginal rotation into bonds. Conversely, if equity markets close out the year with muted volatility, our models could call for a shift into stocks.

Q: Are we about to see QE4 initiated?

Yes, I believe the Fed will announce the next round of asset purchases before the end of the year and possibly as soon as the October meeting. I would hedge that statement with the fact that if a long term trade agreement with China is signed, Congress passes the United States-Mexico-Canada Agreement (USMCA), the UK agrees to terms with the EU on Brexit, and the Miami Dolphins win an NFL game, then QE4 probably is not needed.

Economies and Central Bank policy do not operate in a vacuum so what happens in one part of the world has implications elsewhere. German manufacturing, long the stalwart of Europe, is contracting at an alarming rate, causing the ECB to move aggressively to support European growth. The Bank of Japan is also adding liquidity to their economy, so if the U.S. does nothing the dollar will rise even further against other currencies, hurting U.S. exporters. The USD has risen more than 15% over the last 5 years, and the Fed knows it will negatively impact growth if not addressed. QE4 may not be justified solely on the basis of US economic growth and outlook, but in the context of what is occurring globally it is likely already late. Setting politics aside, if that is even possible, to remain competitive in the world today the dollar cannot appreciate much from current levels.

Not long ago, the Federal Reserve was supposed to engage in quantitative tightening by letting Treasury bonds roll off its balance sheet. Now, the central bank has reversed its policy and begun buying Treasuries again. QE4 would be just the latest round of quantitative easing programs. The central bank has recently purchased $14 billion worth of bonds after making no purchases since 2014. There's really no consensus as to how long the Fed will continue its latest round of bond purchases, but my guess is that they could continue down this path for a while, given the political pressure from President Trump for more accommodative monetary policy. Remember, at one point, Trump tried to appoint Stephen Moore and Herman Cain to the Fed board. I think many economists would question the Fed's decision to begin easing again, especially if the economy is on solid footing. It just seems counterintuitive that the central bank would go from raising rates in 2018 to QE4, especially if there's been no material change in the economic outlook.

Q: Will House impeachment hearings impact the markets?

Yes, they most certainly will. The important question, however, is HOW will the impeachment hearings impact the markets? There is probably little to be learned by Andrew Johnson's impeachment in 1868 over the disagreements on reconstruction after the Civil War. When Bill Clinton was impeached by the Republican-controlled Congress in 1998 the markets soared 29.63% in just 4 months (October 1998 - January 1999) and gained around 33% over the proceeding 12 months. (Source: Peak Capital Management.) Often overlooked in the discussion is that impeachment of Nixon was approved at the Committee level but the President resigned before it was voted on by the full House. The S&P 500 fell 33% in the aftermath of the Nixon scandal.

There are some things we can assume are true: Trump is not going to resign and the Senate will not vote to convict. Removing the potential of an actual change in the government, the issue is really about the state of the economy and whether growth will be sustained. Fortunately, political shenanigans are correctly ignored by the markets in almost all cases.

The initial reactions of the markets tend to be almost universally wrong. When Trump was elected in 2016 the futures crashed but the markets soared following the election. When Brexit passed the market's initial reaction was equally wrong. The drop in equity futures when Pelosi announced impeachment hearings would commence was probably a strong short term buy signal.

I think there will be some noise in the short-term, but the most likely scenario is that the market more-or-less shakes it off. My guess is that the impeachment hearings are nothing more than political posturing during an election year, and that it's unlikely that Trump will actually be removed from office (67 senators would need to side with impeachment). We've had a couple of impeachment episodes in recent memory. In 1974, president Nixon ultimately resigned amid the Watergate scandal. Equity markets fell sharply as the S&P 500 declined more than -30%. However, we were in the middle of a recession and rising inflation. The economy wasn't on very solid footing. Conversely, in 1998, the House impeached president Clinton, who was then later acquitted by the Senate. Despite the Asian currency crisis and Russian default at the time, the economy was riding high on the dot com boom. Markets held up reasonably well and ended the year higher. Bottom line is that today, the fundamentals supporting the market would likely override the noise coming out of Washington.

All weights as of October 1, 2019

Income	
Mortgage Backed Bond	42.57%
Investment Grade Credit	15.20%
High Yield Bonds	9.25%
Preferred Stock	22.80%
US Dividend Equities	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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