Capital INVESTMENT SERVICES of America, Inc.
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Perspective

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In This Issue . . .

- ✓ Since the stock bull market began in 2009, there have been five pullbacks of at least -10%.
- ✓ Yes, the wall of worry is high, but gloom and doom looks way overdone.
- ✓ Market feedback loops impact U.S. policymakers.
- ✓ But downward momentum can create negative speculative excesses.
- ✓ The Fed's not too tight, no "ice in the financial pipes."
- ✓ No economic recession appears to be on near-term horizon.
- ✓ Uptrend in earnings growth also likely to prove resilient.
- ✓ Inflation is not apt to be a big problem.
- ✓ A low expectations bar now exists.
- ✓ Reality is likely to measure up favorably relative to expectations.

Low Bar

> ***"The stock market has predicted nine of the last five recessions."***
> **Paul Samuelson, Nobel Prize Economist**

Samuelson's quip is decades old, but the perspective offered by its message is relevant.

Sometimes stock market declines are a leading indicator of economic recessions. Sometimes they are not.

Since the current economic expansion began nearly ten years ago, there have been five prior occasions when the stock market has declined at least 10% (see Chart 1 nearby). They are easy to forget because they now appear as small blips on the chart. Each time, **f**ears, **u**ncertainties and **d**oubts (FUD) intensified, and economic recession worries spiked.

But in each instance, as the upward trends in both the economic expansion and corporate earnings proved resilient, FUD faded and the stock market recovered as it overcame the existing *wall of worries*.

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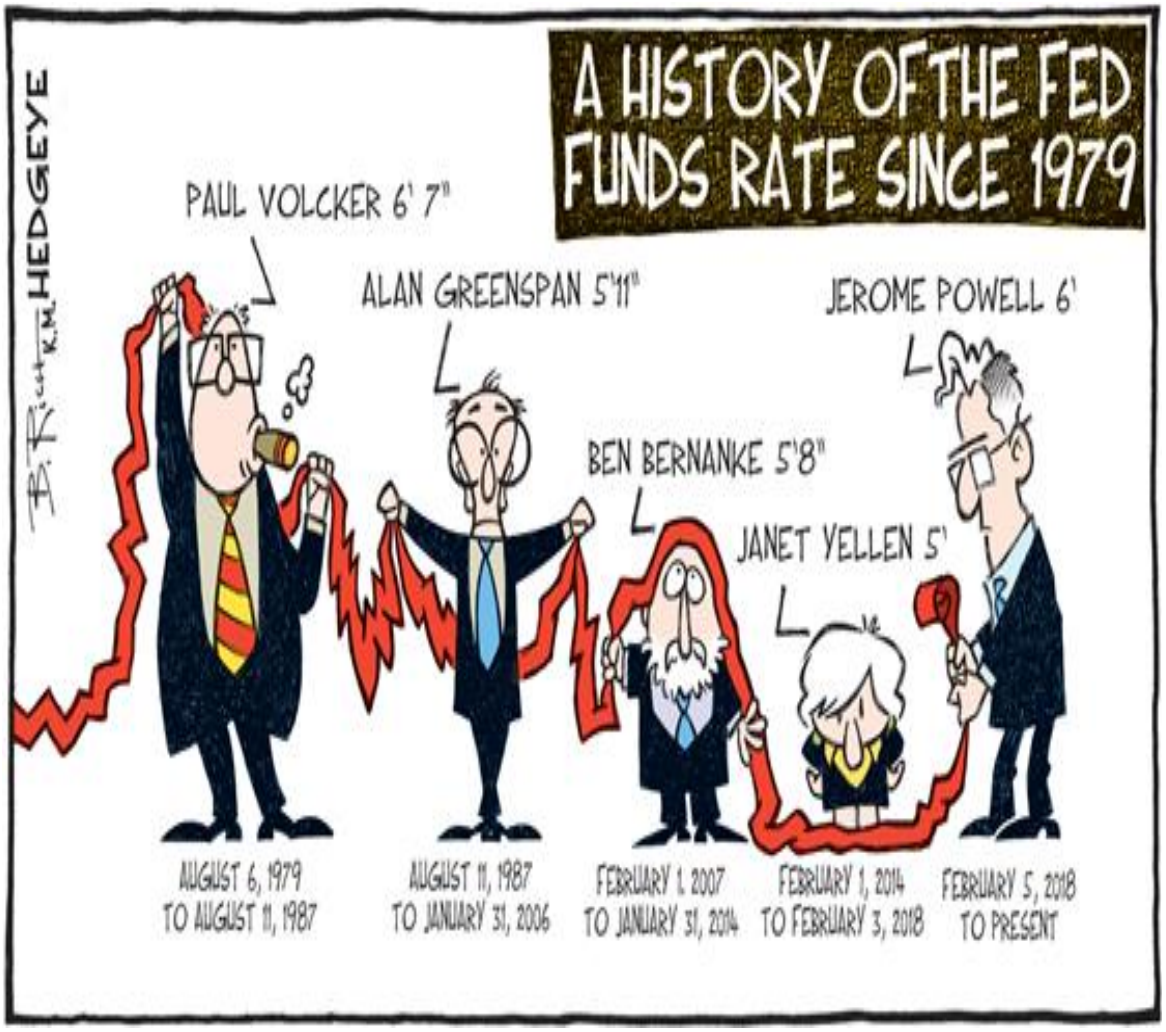
Cartoon: The markets have feared the Federal Reserve (Fed) is on ***auto-pilot*** towards still higher levels on the key interest rates under its control (like the interbank bank lending Fed Funds rate).



It's certainly not news to most, but once again FUD within the financial markets has intensified—big time!

Stock and bond markets are particularly worried that policies on two fronts are driving the U.S. towards recession. And even though the Financial Panic of 2008 is well behind us, many fear a repeat experience when the next recession arrives.

1. The markets fear the new Fed-Chair, Jerry Powell, is misguided, and the Fed's policy of interest rate "normalization" is squeezing the life out of economic activity.

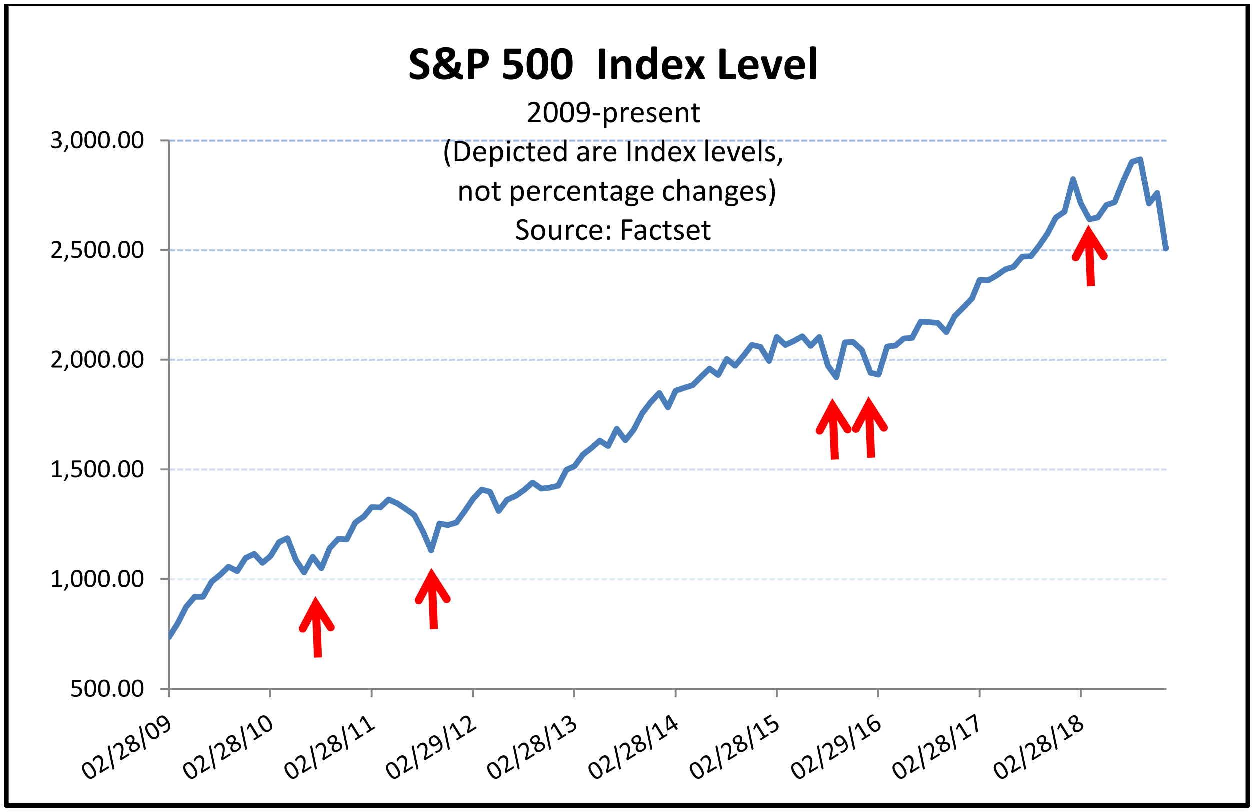
2. With images in mind of the Smoot-Hawley Tariff Act disaster that exacerbated the downward forces of The Great Depression in the 1930s, the markets fear Donald Trump's trade policy with China is sinking the economic ship.

As if that's not enough, throw in additional FUD contributors like omnipresent geopolitical tensions, falling commodity prices, a divided country and Washington D.C., unpredictable Trump tweets, slowing economies in much of the rest of the world, fear of zombie financial institutions in the Eurozone, Japan and China, raw nerves by investors everywhere, and this time around the *wall of worries* is insurmountable.

Or is it?

Can the economic expansion and the associated uptrend in corporate earnings again prove resilient? We believe the answer is “yes”.

Chart 1: Red arrows depict other scary declines when FUD intensified within the bull market.



To be clear, we are not saying the issues of today are not of concern, or that everything is fine and dandy. Recent events and market mayhem churn our guts too.

But a dispassionate assessment of the current situation and the underlying fundamentals, we believe, indicates the current gloom and doom is way overdone.

Here’s our perspective on the situation at hand.

Vigilantes and feedback loops

In the 1980s economist Ed Yardeni coined the term *bond vigilantes* in recognition of an emerging force in shaping Fed policy. The collective wisdom of increasingly knowledgeable investors provided real-time feedback on policymakers’ actions.

If the bond market thought Fed policy was going to generate “too hot” conditions, bond yields would rise in *anticipation* of rising inflation. Similarly, if the bond market thought the Fed was becoming too tight, bond yields would decline in *anticipation* of weaker economic activity.

The bond vigilantes may provide a governor of sorts on Fed Policy. Paying homage to the vigilantes, political advisor James Carville told newly elected President Bill Clinton, *“if there [is] reincarnation, I want to come back as the bond market. You can intimidate everybody.”*

The constant referendum on policy provided by the vigilantes, combined with a Fed that as an institution has learned a thing or two about its past mistakes, have translated into much longer business expansions in recent decades.

Bond *and stock* vigilantes?

There is no reason that vigilantes are limited to the bond market or the distant past. Are the Fed and Trump likely to be influenced by today’s market vigilantes?

It appears they are.

The Fed’s Powell has very recently acknowledged that they are “listening sensitively” to the markets. He noted the Fed will be “patient” in raising rates further. He also emphasized that “(the Fed) is always prepared to shift policy and shift it significantly” if need be.

We expect the Fed to pause its interest rate hike campaign (more on this later).

Meanwhile, Trump has already hitched his wagon to the stock market as a referendum on his policies. The “art of the deal” president has strong incentive to reach a trade accord with China.

China has strong incentives to reach a deal as well.

As the *Wall Street Journal* recently summed up the situation:

> “*China’s growth rate was slowing before Donald Trump was elected, but trade tensions with the U.S. have further depressed [Chinese] business investment and put a dent in [their] worker incomes, which has reduced their consumer spending. Retail sales growth in China hit a 15-year low in November…Prominent economist Xiang Songzuo shocked some China-watchers in December when he said China’s real growth rate may be only 1.7%.*

> *[Meanwhile] U.S. businesses across sundry industries have been complaining about the costs and supply-chain complications of the Trump tariffs. Trade uncertainty has a secondary economic impact beyond the immediate higher costs of tariffs. If CEOs aren't sure of their supply chains, or whether tariffs will raise their costs and limit their markets, they also postpone or reduce capital spending.*
>
> *The interdependence of the U.S. and Chinese economies means there is a joint stake in a trade deal. The two countries' economies are entwined…which is why there's a political and economic incentive for both sides to cut a trade deal that protects intellectual property, lowers tariffs, and above all reduces uncertainty."*

But, vigilantes can go too far

Just as vigilante "justice" often morphs into dangerous crowd behavior, momentum in markets can exaggerate the markets' message.

The big kahuna of stock declines—back in 1987—is a reminder of how herd behavior and market momentum can push to extremes and conditions of negative speculative excesses can exist.

As economist Amar Bhidé recounts:

> ***"Fortunately, a stock-market crash doesn't foreordain economic disaster unless it has a substantive systemic cause. On October 19, 1987, the Dow Jones Industrial Average fell 22.6%—still the largest one-day drop ever.***
>
> ***Thirty-three eminent economists issued a statement warning that without "decisive action" to "correct existing imbalances at their roots, the next few years could be the most troubled since the 1930s."***
>
> ***They were completely wrong: The crisis passed without any "decisive action." The real economy didn't miss a beat."***
>
> **Economist Amar Bhidé**

Feeding downside momentum back in 1987 was so-called "portfolio insurance". This strategy's intent was to protect large institutional portfolios from market declines. Instead, it simply triggered more (and more) selling as stock prices declined.

Today by some estimates, computer algorithm strategies are responsible for up to 85% of daily stock trading. Many of these auto-pilot programs are today's version of 1987's portfolio insurance. Recent downside momentum has very likely exaggerated the vigilantes' message.

The Fed's not too tight, big threatening excesses still appear absent and no recession yet on the horizon.

Some months back we noted that we included into our "big picture" economic assessment toolkit some new leading indicator series maintained by the Federal Reserve Bank of Chicago (Chicago Fed). The indicator names aren't exactly snappy and their charts are not snazzy, but their track record as leading indicators warrants our attention.

Here's a quick review of the indicators and what they are signaling.

The Chicago Fed's National Financial Conditions Index (NFCI) provides a timely assessment of the health of the *financial system* that underlies commerce.

Unlike many other financial conditions assessment indicators that are prone to flash "false" signals due to large weights given to movements in stock, bond and commodity prices, the NFCI encompasses over 100 measures of funding risk, credit conditions, volatility and debt and equity levels within the domestic economy.

The Index has a history of detecting stresses and strains that lead to systemic trouble at least a year ahead of time. The latest reading is reflected in Chart 2.

Chart 2: No signs of "ice in the financial pipes."
No signs of big time stresses or strains as the Fed raises rates and shrinks the size of its balance sheet.

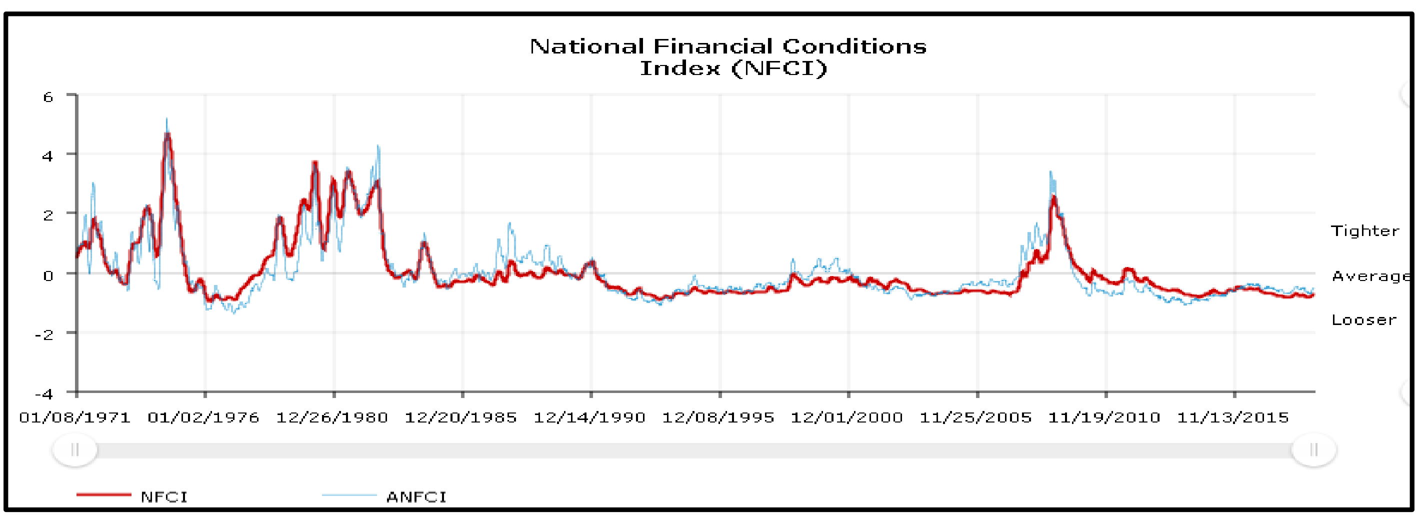


Chart source: Federal Reserve Bank of Chicago

How close is the economy to a recessionary tipping point? Not very close.

Chart 2 does not suggest that financial system liquidity is being threatened by Fed policy that is "tight". And just as importantly, strains and stresses from large dangerous debt excesses also do not appear to be lurking within the domestic financial system as was the case before the 2008 Financial Panic.

Chart 3, below, portrays the latest reading for the Chicago Fed's National Activity Index (CFNAI). This is a leading indicator for the "real" (goods and services) economy.

As highlighted in the commentary below the chart, the Chicago Fed indicates that readings below -.7 are consistent with recession, while readings above .2 (where the economy is currently) are consistent with a sustained economic expansion. No alarm bells going off here either.

Chart 3: No signs recession is on horizon.

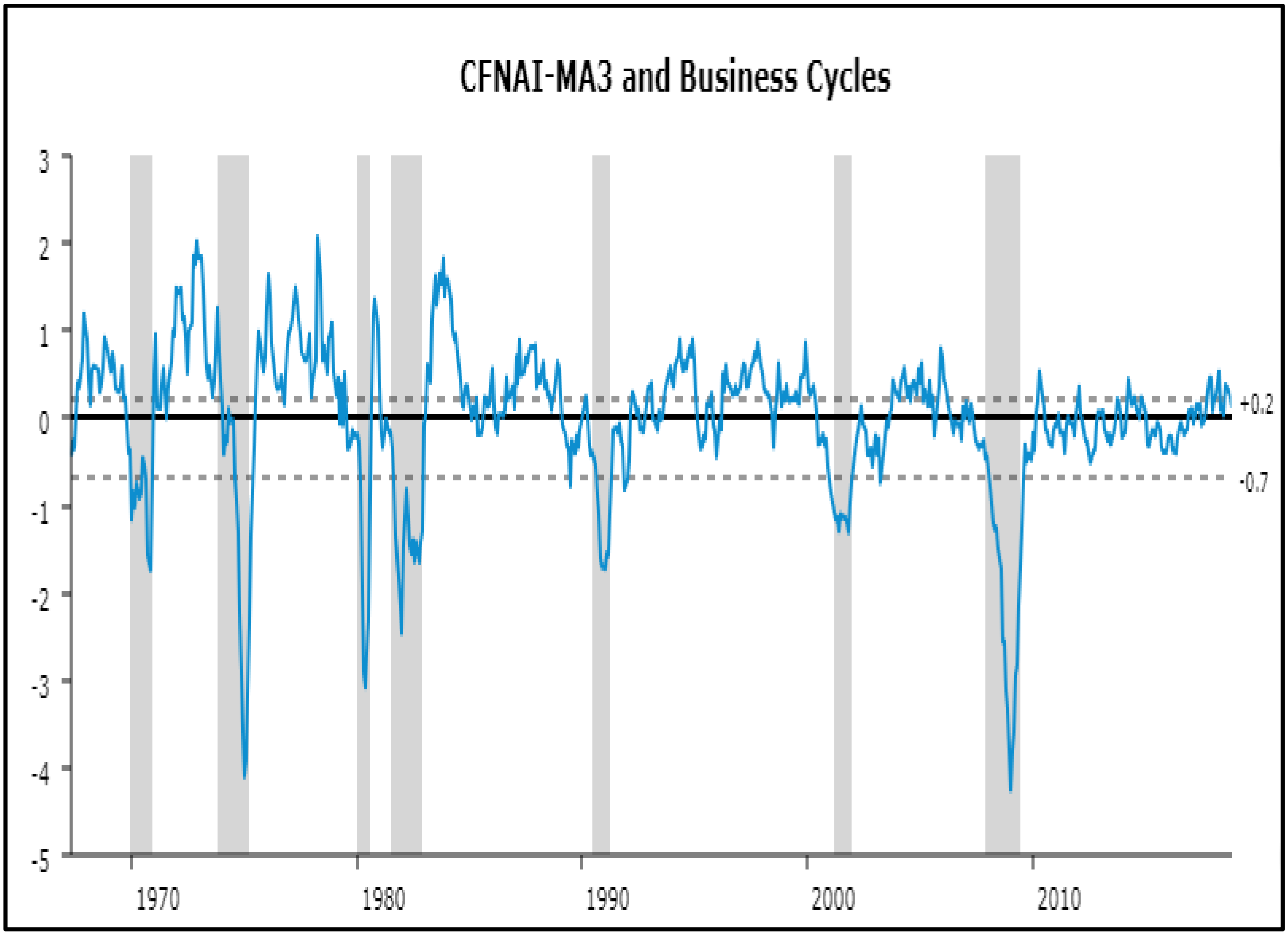


Chart source: Federal Reserve Bank of Chicago

How to interpret Chart 3: Shading indicates official periods of recession as identified by the National Bureau of Economic Research. Following a period of economic expansion, an increasing likelihood of a recession has historically been associated with a CFNAI-MA3 value below –0.70. Conversely, following a period of economic contraction, an increasing likelihood of an expansion has historically been associated with a CFNAI-MA3 value above –0.70 and a significant likelihood of an expansion has historically been associated with a CFNAI-MA3 value above +0.20.

What about inflation?

The final Chicago Fed indicator we'll look at assesses inflation potential. The next chart reflects the latest reading. We, again, highlight beneath the chart the comments most relevant to the current situation.

It sure doesn't look like inflation is a big problem either.

Chart 4: Inflation (or sinister debt deflation)…not a big risk.

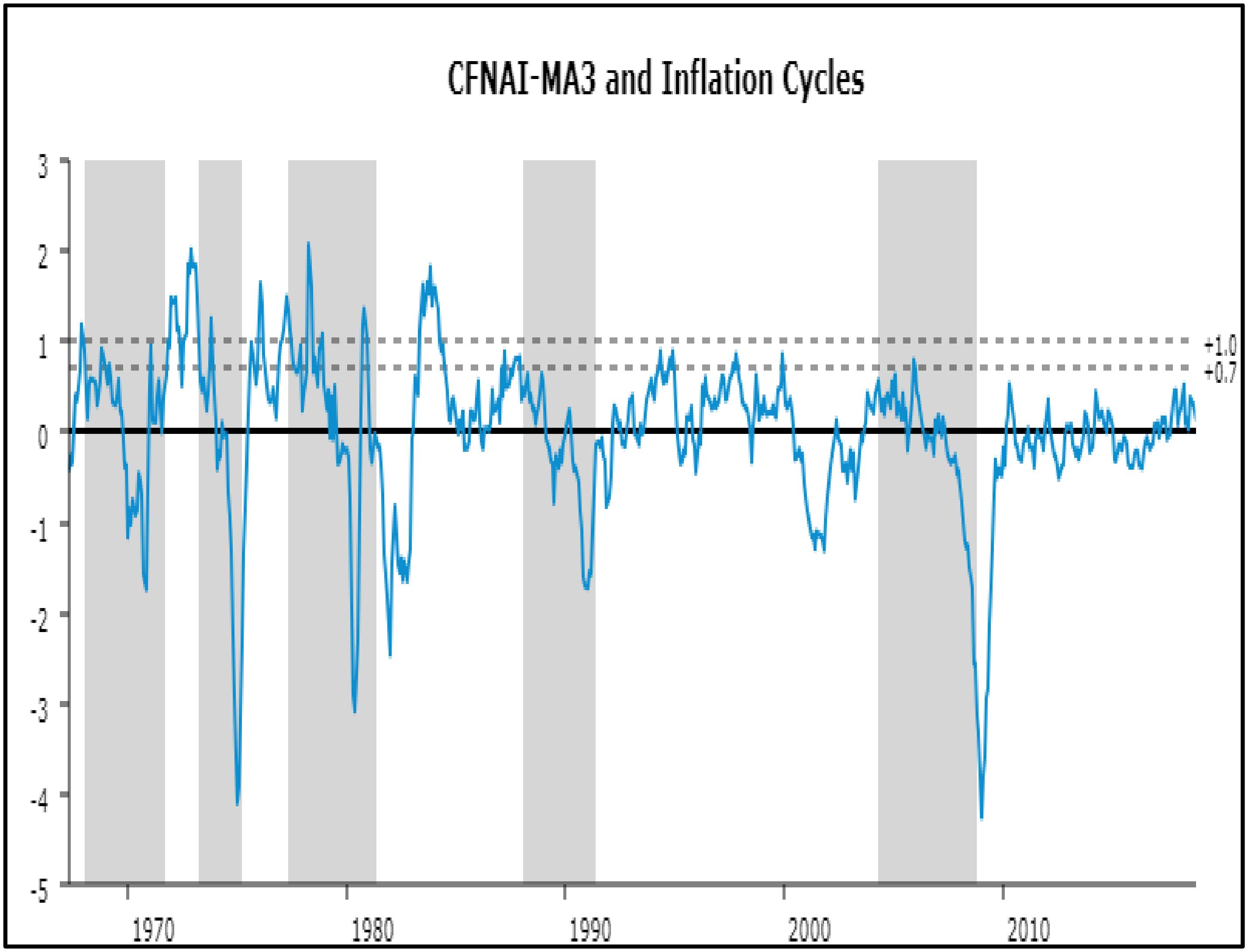


Chart source: Federal Reserve Bank of Chicago

How to interpret Chart 4: CFNAI=Chicago Fed National Activity Index. Shading represents periods of sustained increasing inflation. An increasing likelihood of a period of sustained increasing inflation has historically been associated with values of the CFNAI-MA3 above +0.70 more than two years into an economic expansion. Similarly, a substantial likelihood of a period of sustained increasing inflation has historically been associated with values of the CFNAI-MA3 above +1.00 more than two years into an economic expansion.

Durable trends within the big picture

Perhaps the factor providing the greatest resiliency for the economy, in general, and our stock investments, in particular, is the dynamism at work within individual businesses. We, again, provide a quote out of Amazon's annual report from a couple of years back for it captures the dynamism imperative facing businesses:

> ***"One thing I love about consumers is that they are divinely discontent. Their expectations are never static—they go up. It's human nature. We didn't ascend from our hunter-gatherer days by being satisfied. People have a voracious appetite for a better way, and yesterday's 'wow' quickly becomes today's 'ordinary'. I see that cycle of improvement happening at a faster rate than ever before….you cannot rest on your laurels in this world. Customers won't have it."***
>
> **—Jeff Bezos**

That dynamism imperative is what drives innovation. Over time, applied innovation is what pushes the aggregate standard of living higher.

Today an additional source of overall economic anxiety is being stoked by the structural change going on in the economy as the digital and the physical "worlds" converge. Human's "divine discontent" drives change…but the change in turn unsettles the human psyche!

Structural change represents a significant threat for those businesses that do not adapt. For investors, the risk for such companies will likely prove much more profound than troubles triggered by the impact of the next economic recession.

As Warren Buffett recently noted about the structural change underway:

> ***"The four largest companies today by market value do not need any net tangible assets," he said. "They are not like AT&T, GM, or Exxon Mobil, requiring lots of capital to produce earnings. We have become an asset-light economy."***
>
> **—Warren Buffett**

This implies the margin of safety of businesses lies not in their tangible assets but in the sustainability of their businesses.

The businesses we own are largely characterized by high recurring revenues, stable-to-increasing profit margins, strong returns on capital employed and an ability to convert earnings to free cash flow at a high rate.

Within their "asset light" operating structures—many of our companies have been emphasizing this for quite some time, by the way—their high-cash conversion attribute allows financial flexibility, the ability to fund R&D initiatives and return cash to shareholders on a consistent basis.

In the recent market mayhem, most every stock price has fallen and by similar magnitudes. This means there has been little, if any, allowance for different business models, sustainability of earnings, etc.

Which brings us, at long last, to our concluding comments.

A low bar now exists

The market research firm Bespoke recently made the following observation about the 4th quarter of 2018:

> ***"Stock price declines have been about as bad as they get even in the midst of the worst market shocks."***
>
> **—Bespoke**

They also note that past stock market declines similar to that just experienced have typically been followed by strong returns. The table on the following page documents the historical record:

S&P 500 10%+ Down Quarters Post World War II				
Quarter	% change	Next quarter	Next 2 quarter % change	Next year % change
9/30/1946	**-19%**	**2%**	**1%**	**1%**
9/30/1957	**-11%**	**-6%**	**-1%**	**18%**
6/29/1962	**-21%**	**3%**	**15%**	**27%**
6/30/1970	**-19%**	**16%**	**27%**	**37%**
12/31/1973	**-10%**	**-4%**	**-12%**	**-30%**
9/30/1974	**-26%**	**8%**	**31%**	**32%**
9/30/1975	**-12%**	**8%**	**23%**	**26%**
9/30/1981	**-12%**	**6%**	**-4%**	**4%**
12/31/1987	**-23%**	**5%**	**11%**	**12%**
9/28/1990	**-15%**	**8%**	**23%**	**27%**
9/30/1998	**-10%**	**21%**	**27%**	**26%**
3/31/2001	**-12%**	**6%**	**-10%**	**-1%**
9/28/2001	**-15%**	**10%**	**10%**	**-22%**
6/28/2002	**-14%**	**-18%**	**-11%**	**-2%**
9/30/2002	**-18%**	**8%**	**4%**	**22%**
12/31/2008	**-23%**	**-12%**	**2%**	**24%**
3/31/2009	**-12%**	**15%**	**33%**	**47%**
6/30/2010	**-12%**	**11%**	**22%**	**28%**
9/30/2011	**-14%**	**11%**	**25%**	**27%**
12/31/2018	**-14%**			
	Average	**5%**	**11%**	**16%**
	Median	**8%**	**11%**	**24%**
	% positive	79%	74%	74%

The bottom line is that market mayhem and gloomy forecasts have set the expectations bar very low.

Yes, the domestic economy may well slow due to the "uncertainty factor" (the *U* in *FUD*, by the way) noted in the earlier *Wall Street Journal* excerpt. The growth in aggregate corporate earnings will also, almost certainly, slow from the unsustainable 20%+ pace of 2018 as the corporate tax cut passes its anniversary.

But corporate earnings will likely still grow within the midst of a continued economic expansion. And, since over time stock prices follow the earnings prospects of the underlying businesses, earnings are THE key fundamental for stocks.

The resilient trends in economic growth and corporate earnings should allow the low bar characterized by FUD-filled expectations to be exceeded. This sets up the potential for favorable surprises—and a happier investment New Year.

"Though markets are generally rational, they occasionally do crazy things. Seizing the opportunities then offered does not require great intelligence, a degree in economics or a familiarity with Wall Street jargon such as alpha and beta. What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals."

—Warren Buffett, 2017 Annual Letter to Shareholders

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