“Follow the yellow brick road”

the Yellow Brick Road: a course of action that a person takes believing that it will lead to good things. It comes from the Yellow Brick Road in “The Wizard of Oz” which Dorothy and her friends follow to the Emerald City.”

(Source: Oxford Learner’s Dictionaries – Online)

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Source: advsolned.com

Much has occurred since our last paper “Stuck between a rock and a hard place” written on December 18, 2018. This paper is a needed follow up.

Yellow Bricks

Since the beginning of the year, the S&P 500 has appreciated steadily with four weeks of consecutive gains. This is due in part to easing concerns of an economic slowdown, optimism on US and China trade and a language from the Fed that is more “dovish” in nature.

Even after spending 26 years on Wall Street, it still amazes me at how fluid markets really are. The sentiment which was once negative has quickly turned bullish again. In fact, some of my counterparts (who will remain nameless) have suggested that the market’s rally is “just the beginning” or that the bull market in equities is “coming back because the US recession scare appears to be over!”

Since markets historically go up, at some point, they will be right. But, in between that time, is it really in the best interest of investors to think that the worst is over? They are asking a client to think like Irving Berlin’s song Blue Skies, “Blue Skies smiling at me…nothing but blue skies, do I see.”

I am not trying to rain (yes pun intended) on anyone’s parade, but I hope Lakeview clients think more like Dorothy Gale in the Wizard of Oz when she’s told to “Follow the yellow brick road.” She knows that she needs to do it, but after landing on the Wicked Witch of the East, she knows that it isn’t going to be an easy road to follow. So, she starts down the path, one step at a time.

“The Scarecrow”

As much as the Scarecrow needed a brain, so do both Republican and Democratic politicians. Both parties decided a “win” is better than a compromise and the US was left with a government shutdown that lasted 35 days. Last week, Democrats and Republicans decided to reopen the government for 3 weeks so they could “negotiate” border security, but at the time I am publishing this paper, the parties have each drawn lines in the sand, so I give the prospect of a compromise less than 50/50 odds of success.

The purpose of this paper is not to pick a side, but as politicians play politics, the reality is, they are putting a drag on the economy.

Previous experience shows, the price of long shutdowns is always high. There have been 18 budget stalemates since 1974 that forced at least partial government closures (under presidents Ford, Carter, Reagan, Bush Sr, Clinton, and Obama). According to the Congressional Research Service the 16-day shutdown in 2013 cost the federal government $2.5 billion in lost productivity, slowed GDP growth, and lowered consumer confidence.

There are several ways the government shutdown hurts the economy:

First, President Trump's own Council of Economic Advisors reports that the shutdown lowered growth by 0.13 percentage points per week. Second, economies that have a high concentration of federal employees and contractors are now starting to feel the effects as consumer spending among those workers slows. Even though those workers are starting back to work, their spending patterns have been changed for the foreseeable future, affecting those businesses in the community. Third, the broader business community is disrupted by a delay in basic economic (government) reporting. This can complicate future planning efforts for businesses both large and small. Lastly, this shutdown erodes what little confidence the public has in the government's ability to get anything done. As of the end of 2018, only 18% of Americans say they can trust the government to "do what is right." (source Pew Research).

Even if we can move past this issue, the parties have clearly taken a "fighting stance" against one other as power trumps (pun intended again!) their jobs of helping constituents.

So, I continue to believe that mean estimates of 2.6 GDP growth may be high for 2019 and earnings of US companies may continue to be revised lower. My GDP estimate is still in the 2.0-2.25% range and my EPS estimate between $165-170. I am still comfortable with those numbers but feel we may be closer to the lower part of that range on both.

But let's face it, even if the "Great and Powerful Oz" had a brain big enough for Washington, I am not sure it will be enough for Wall Street to have much confidence in these two parties for the foreseeable future.

Source: MGM Pictures

“The Tin Man”

Unlike when Dorothy and the Scarecrow needed to find the oil can to make the Tin Man talk, no such oil is necessary for Fed Chairman Jerome Powell. The Chairman has clearly gotten the attention of Wall Street, Main Street and the White House with his speeches. But, for the Fed and Chairman Powell to guide this economy forward, those inside that institution are going to have to find their “hearts” when it comes to communication.

The Federal Reserve had a bumpy first year under Chairman Powell when it came to talking policy. The chair has spooked investors even as economic data offered a different view of the economy. Since the last FOMC meeting when the markets and the White House criticized forward guidance, Fed officials have now shifted from one of “follow the dots” to one of “watch the data” which Wall Street interprets as the Fed is on hold for the time being. Earlier this week officials even started to float the idea of slowing quantitative tightening (QT).

This seems to be a coordinated message among policymakers. Wall Street has listened, and it seems to be a catalyst to the equity markets of late. So maybe the Feds new-found heart could be what keeps the markets moving forward. If you look at the chart below, the Implied Fed Funds Target Rate shows two potential hikes this year and one possibly next. I am still in the camp that the Fed wants to move rates higher, but I now think (with one shut down over and the next one potentially ahead of us in 3 weeks) the Fed can wait until June before lifting Fed Funds another 25 bps. Of course, that’s only if Washington can get their act together.

Source; Bloomberg

"The Cowardly Lion"

If you remember the book and watched the movie when Dorothy, Scarecrow and the Tin Man meet the Cowardly Lion he initially scares all of them with the wonderful phrase "Put 'em up, put 'em up." But quickly we learn that the lion is nothing more than a coward and he asked to join them in the pursuit of the Wizard of Oz.

To me, this seems to be similar behavior to that of the White House when it comes to trade. This administration has taken the unorthodox position of trying to scare trade partners into better deals; the result being less "deals" and more isolation for the US.

Now, if I am being agnostic to a political party (which I try to be), the White House's tariffs on steel and aluminum have been good for US producers. I would also concede that prior administrations signed bad trade deals which needed to be renegotiated.

However, this tariff causes steel or aluminum to be more expensive to US consumers. I realize that steel and aluminum imported from China comes to the US subsidized creating unfair pricing. Point conceded. But, my job here at Lakeview is to look at the economic and market impact of trade wars. So, having a trade war with any country (or multiple countries) can negative influence(s) on an economy (i.e.: inflation cost, etc.).

If you want proof, I point you to January 22, 2019, when Prime Minister Shinzo Abe drew a sharp contrast between his view of the world and that of White House in a speech in Davos, Switzerland. Japan and Prime Minister Abe have long been one of the best US trade partners. The US was the original architect in the Trans-Pacific Partnership (TPP) which lowers trade barriers significantly for 11 nations around the Pacific Ocean. But the current administration pulled out of that agreement and has not had serious talks with any of those countries since. This has clearly been a frustration to both Japan and our Far East trade partners.

Prime Minister Abe also announced in the same speech that effective, February 1, 2019, the E.U. and Japan will enter into a comprehensive economic partnership that will benefit all the economies involved and move away from any US-centric deal. This long-standing deal is without the U.S. and isolates us further.

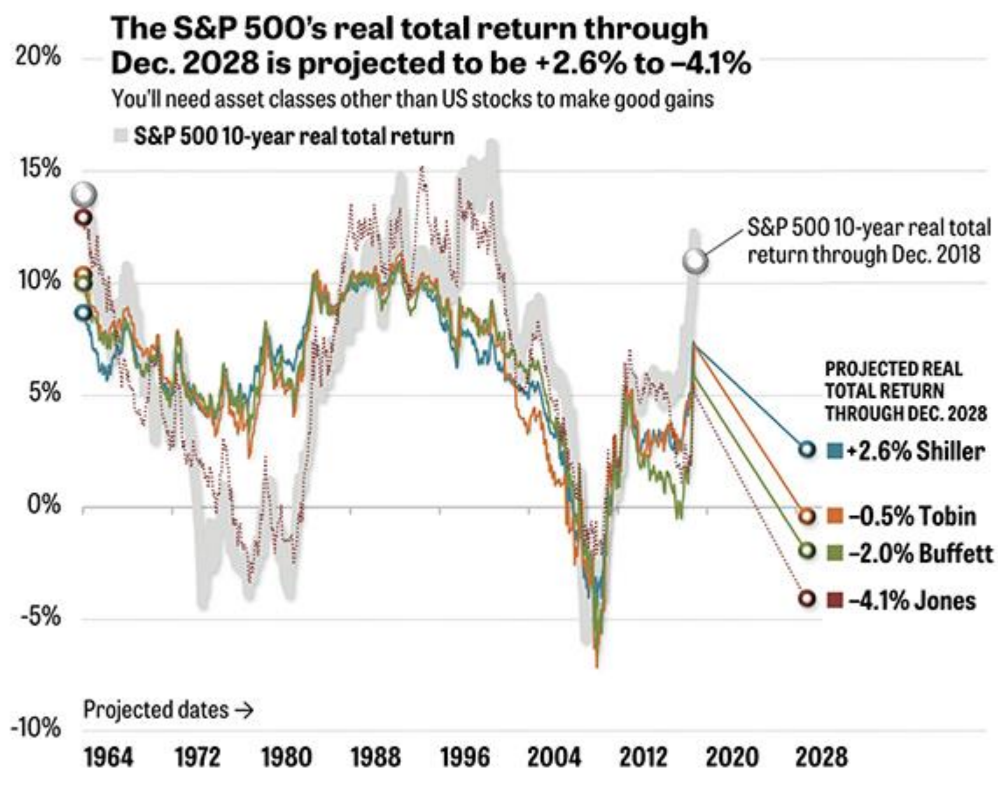
Secondly, the White House's biggest adversary China has recently announced they are pulling money from Silicon Valley. John Zhao, founder and chief executive of Hony Capital was interviewed in Davos last week and he was asked about Chinese companies pulling money from the US and his response was "by the numbers, that seems to be the case." This may not seem a big deal now, but innovation generally needs a lot of seed capital and we have relied on the Chinese as one source of that capital.

My point of bringing this to your attention; the world is doing business with or without the US. As much as we need to protect workers, we must have a global trade effort as well. If this administration doesn't have the courage to quickly try to resolve trade negotiations around the world, our economy, our companies, and our workers will eventually feel the effects over the coming years.

OZ

If they ever did a "Wall Street" version of the Wizard of OZ, only one person could play that character in my opinion and that would be Warren Buffet.

Warren Buffet has long been one of the most successful investors of my lifetime and he has successfully created a projection method with data that goes back more than a half a century. While writing this piece, I found the below chart from CBS Market Watch, which looks at Warren Buffet's forward projection as well as Robert Shiller (he won a Nobel Prize in Economics in 2013 partly for developing his forecasting formula). The graph below doesn't show S&P 500 price levels. Instead, it reveals how well the projection method estimated the market's 10-year rate of return in the past. The chart projects the markets on the right which forecast the next 10 years that are "potential returns" ahead of us. All the numbers include dividends but exclude CPI.



Source: Market Watch

As you can see, Robert Shiller's P/E 10 predicts a 2.6% total return. According to Shiller's projection if you buy one share of the S&P 500 (or ETF SPX) at $2650 per share, after 10 years that share could be worth (if Shiller's projections are correct) $3,490.

However, the "great and powerful Oz" has a little less bright projection as he is estimating (using his MV/GDP projection method) of a minus 2.0%. So, buying the same ETF at $2650 would be worth around $2200 in 10 years.

Now, take these projections with a grain of salt and if its only 11 am (or earlier) when reading this, happy hour starts in another 5 hours (I know…its 4 o'clock somewhere). The point is to say that even with the rally over the last four weeks, we believe investors (working with their advisors) should view this market as fairly priced and susceptible to a pullback(s) if markets get chased by a bunch of flying monkeys.

Source: Spingshoots.co.uk

The Power to Get Home

Finally, even though there are times as investors we seemed to "miss our balloons" (aka: opportunities) to get home, remember like Dorothy, you have a Glinda too. Lakeview advisors are here to remind you that you have always had the power to get home. But instead of tapping your heels, it's time to button up your strategy and allocation.

I am a fan of CNBC, Bloomberg and Fox Business (I have had the opportunity to be on their shows), but I caution clients to not fall for the hype of what talking heads are saying right now. Benchmarks and indexes are irrelevant without a plan, goals and a great non-correlated (as best you and your advisor can) asset allocation.

Regardless of what you see or hear, these markets are going to be challenging, and your Lakeview advisor will earn every penny over the next few years. But regardless of the witches, trees or politicians deserving of a good scolding, keep walking down that yellow brick road.

Until next time.

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