11.30.18

THE POWELL PUT – CHINA NEXT!

On Monday afternoon we added a 10% equity position in the First Trust Dow Jones Internet Index Fund (FDN). Macroeconomic conditions remain challenging but at the same time technical indicators were showing high probabilities for a temporary oversold rally in U.S. stock markets. As we outlined at the end of the letter last week, there were no less than six near-term catalysts that could send markets higher or continue another leg lower. By Friday afternoon, we closed our position in FDN for an overall gain of 3.7%!

At 11:58AM on Wednesday, recently ravaged equity investors had their prayers answered while experienced risk managers like ourselves watched with wide-eyed dismay. While the investing world was laser focused on our Federal Reserve Chairperson Jerome Powell's noon speech at the Economic Club of New York – which had not even begun! – the financial media started to leak the most market-enticing segments of the speech in a gift to algorithmic high-frequency computer trading terminals worldwide. Chairman Powell – who was viewed as Federal Reserve "hawk" as recently as early October – now became the "dove" that not only our President but the Jim Cramers of the world prayed for and sent the Dow Jones Industrial Average up 600 points for the day by saying that "interest rates were just below the neutral level" and that there was no set policy path for future interest rate increases. Stocks around the world burst higher in complete unison as they now only priced two interest rate hikes instead of four. With no other data point being released at that time (not economic news, earnings, tweets, geopolitical issues, debt issues, tariff issues etc. …), Wednesday's rise should make it perfectly clear that for the last few year markets have been orchestrated by mere words or a new stimulus (tax cuts), rather than being a gauge of the actual economic health of governments, corporations and consumers. It is simply an artificial construct for momentum traders with no experience in Economics 101 or risk assessments.

How did what a single individual uttered about interest rates become the fulcrum on which the financial world would base its biggest buy signal of the year? It's simple... With the "we must grow at any cost" mantra of public companies and governments, the only way to maintain such an idea is to borrow, borrow, borrow, and borrow again. As we all know, any debt that is or was created has an interest rate attached to it. When rates on debt are artificially low, borrowing happens with reckless abandon and often times the borrowed capital is misallocated – used to pay dividends and to buy back stock. When interest rates rise, it often stops corporations and governments from being able to tap debt markets and often reveals a painful level of financial mismanagement which results in having one's debt downgraded a notch or two or even all the way down to a "junk" rating. In the ensuing panic, liquidity dries up, borrowing slows, dividends are reduced, buybacks drop, companies go out of business or make large labor cuts, and the economy slows or drops into outright recession.

There was a time when stock markets weren't this insane. The business cycle ebbed and flowed and it was somewhat easier to gauge what the true value of a company or a bond actually was. In the past, companies didn't rely on debt or stock buybacks to the levels they do today. In fact, many companies who wouldn't normally have had access to bailouts, debt and stock buybacks, probably would not even exist in the same form today. Today, the literal obsession over Federal Reserve policy and the direction of interest rates has eclipsed nearly all other fundamental economic indicators. It should be noted that we could easily be sitting 1,000 points lower if Jerome Powell did a Paul Volker, who was the Fed Chairman under Jimmy Carter and Ronald Reagan, and suggested pushing interest rates back to historic levels or even higher!

The Federal Reserve most likely doesn't operate in a vacuum. In their lengthy and complex modeling, they obviously saw the same worries we've mentioned. Corporate debt markets are impaired, stock market valuations remain high, China's slowdown, tariff threats, lack of a palpable stimulus in 2019, a divided congress, Brexit, Italy issues, and an overly slowing of global growth.

Is the best thing to soften interest rates and push already overly elevated stock prices higher and reinvigorate excessively indebted companies to borrow even more? Our answer is resounding NO! Part of investing is reducing the appetite for outright speculation and black box investing. Part of investing is knowing that investments do not go up forever. Investing should be about aligning a portfolio with realistic outlooks and acknowledgement of risks to make sure that one's assets remain preserved when all the usual artificial mechanisms (unfettered debt creation/monetary policy/fiscal policy) no longer work at the level they once did.

Now all eyes shift to this weekend's G-20 international forum which brings together the world's twenty leading industrialized and emerging economies. With President Trump and President Xi of China expecting to cross paths, needy markets are praying for some form of resolution to the tariff skirmish. Look for massive volatility next week, based on the possibility of either some type of agreement or no agreement. From Friday on, look for rumors to swirl about how these two world leaders look at each other, if they wave to each other or even if they simply shake hands. The question will be if it's a real handshake or a hard goodbye. Our guess? Most probably it will be a soft embrace!

As always, we will continue posting articles that we believe to be of great informational value on our website, under the "Great Articles" tab, which is linked here:

http://summitplan.com/cgi-bin/htmlos.cgi/great_articles.html.

Additionally, the "Summit Planning Financial Hour" will be live this week on Radio 570-WSYR at 10AM on Saturday. Don't forget to tune in for a recap of the week's events. If you cannot tune in, check out our radio show archive on our website at http://summitplan.com/cgi-bin/htmlos.cgi/radio_shows.html.

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5. Investors FastTrack is the source for all quoted performance data.
6. The fast price swings in commodities and currencies will result in significant volatility in an investor’s holdings. Commodities include increased risks, such as political, economic, and currency instability, and may not be suitable for all investors.
7. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.
8. Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.
9. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.
10. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.
11. The Dow Jones Industrial Average is comprised of thirty stocks that are major factors in their industries and widely held by individuals and institutional investors.
12. The Standard & Poor’s 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
13. The NASDAQ Composite Index measures all NASDAQ domestic and non-U.S. based common stocks listed on The NASDAQ Stock Market. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index.
14. The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.
15. CBOE Volatility Index is a measure of the implied volatility of S&P 500 index options, calculated and published by the Chicago Board Options Exchange (CBOE).
16. All indices are unmanaged and cannot be invested in directly.