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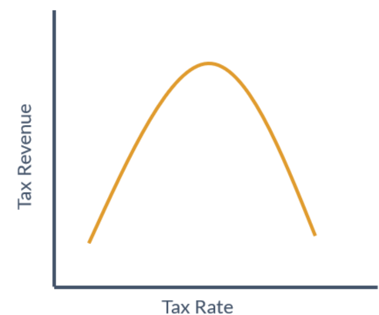
Bronfman Rothschild 2018 4th Quarter Review

Holidays, Goldilocks, Resolutions and Strolling Along the Laffer Curve

In the grand scheme of things, this holiday season was probably no different from those of the past. Like many others, my family went through some combination of joy, distress, kindness, alienation, reconciliation and everything in between (sometimes all in a matter of minutes). Ultimately, the kids were happy to be out of school and together with the family, and although they occasionally fought and complained, there were still glimpses of heartwarming Rockwellian moments.

On the other end of the spectrum, the adult dinner conversations were probably more Orwellian in nature, highlighting how polarized any discussion can become. The topics varied and I chose to stay out of it (for the most part) until the conversation turned to the economy and investing. It did not take long to realize that I was arguing (quite loudly) and repeating "it's not that simple". Whether it is China or the deficit, it is rarely just as easy as 'if-then'. There are, amongst others, timing, reaction, ramification, magnitude, all under everchanging underlying dynamics. In retrospect, we probably should have brought out a piece of paper, a pencil, and the Laffer Curve.

The Laffer Curve[1] was purportedly drawn in 1974 on a napkin by supply-side economist Arthur Laffer in a dinner with senior staffers for Gerald Ford. It looked like the chart on the right[2] and was meant to show the relationship between tax-rates and tax-revenues under different tax-rate regimes. Effectively, it showed that at a 0% tax rate the government would receive no tax-revenue; nor would it get any tax-revenue at 100% taxation, since people would be disincentivized to work, potentially barter instead or do something else.



Now the curve and the theory behind it have been misinterpreted, over-interpreted, under-interpreted enough that there is no reason to discuss its initial objective. Why I reference it here is because it is one of the simplest ways to show the benefit of a balanced view by moving away from the very polarizing and often misleading 'if-then' argument. Ostensibly, it charts the Goldilocks ideal of 'just right', even though unlike Goldilocks, we never really know exactly what 'just right' looks like. You may have heard over the past few years about the US enjoying a "Goldilocks Economy" - one that is not too hot to cause inflation or too cold to yield a recession. Sustained levels of 'just right' are generally unattainable in the real world (this is why we eventually get a visit from the bears, but more on that in the Markets section). Even so, thinking about market phenomenon in the context of Goldilocks instead of all bad or all good is a step in the right direction, and away from the linear thinking that is often the standard point of reference from talking heads in the industry.

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[1] As Laffer himself notes, the idea behind it goes back more than 700 years, to Ibn Khaldun, but the Laffer moniker stuck.

[2] I recently read a fun (for some at least) book by professor Jordan Ellenberg of University of Wisconsin Madison titled *How Not to Be Wrong: The Power of Mathematical Thinking*. The title may be a bit tongue in cheek, but it is a good introduction how to bring mathematical thinking to the day-to-day. His section on Laffer is the inspiration of these charts.

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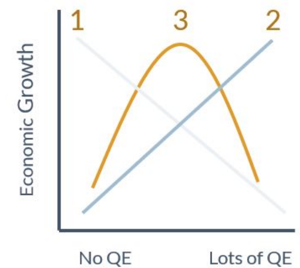
The investment industry, in practice, seldom deals in absolutes. Unfortunately that does not stop topics like Quantitative Easing (QE), trade, share buybacks, and many others from being hijacked by one side or the other and declared destructive/constructive. As an example, what would the world have been without QE?

1) Too Hot Viewpoint - No QE is good; any amount of QE is bad; let the markets figure it out no matter how long it takes.
2) Too Cold Viewpoint - No QE is bad; lots of QE is good; keep the spigot on ignoring the moral hazard and impact on asset values or inflation.
3) Just Right – Some level of QE is likely warranted to reintroduce liquidity and confidence back into the system. Unfortunately, we can never really know the perfect amount.



What about share buybacks, a topic that hit the Senate floor in 2018 after many US firms used repatriated dollars (associated with the recent tax law change) to buy back stock?

1) Too Hot Viewpoint – No share buybacks are good; they lead to short-termism; create perverse incentives for executives; they reduce investment in the economy and shouldn't be allowed (similar to pre-1982).
2) Too Cold Viewpoint – Share buybacks are good; they increase shareholder value; they are more tax efficient than paying dividends; they are a better use of the multi-trillion dollar cash hoard of US companies compared to investments in non-core businesses.
3) Just Right – Share buybacks are sometimes the right thing for a business, but not always. If the company is trading cheaply relative to their assessment of fundamentals, and the return generated by the buyback is better than what could be generated by a dividend or an investment in unproductive capital, then a buyback is best for all involved. However, buybacks financed by borrowed money at peak valuations to boost short-term earnings put the company and its investors at risk.

This is not to say that there are no investing absolutes, but a little bit of balance in the face of constant hyperbole keeps us from making rash decisions. We have written a lot lately about the human side of this industry from behavioral finance to how that plays into diversification and, finally, the need for long-term planning. This will probably be the last one of these for a while, and we will resume market and historical topics in 2019.

This leads to New Year resolutions, those hopeful goals and promises we make to ourselves but rarely keep. I am unlikely to lose weight by giving up bread or sweets this year, nor will I significantly increase the time I spend with my family by showing up to the office at 4:30am every day. Those options are either unhealthy or unsustainable. Instead, I will aim for moderation and maybe next year will be closer to moving towards the middle of the Laffer curve. Unfortunately with this curve, it is almost always uphill from here.

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Markets – Nowhere to Hide

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total	Q4
Higher Return	EM MKTS 8.00	FIXED INC -0.95	US SM 0.96	REAL ASSET 2.18	US SM 4.70	US SM 0.72	US LC 3.72	US SM 4.29	US LC 0.57	FIXED INC -0.79	EM MKTS 4.27	FIXED INC 1.84	FIXED INC 0.01	FIXED INC 1.64
	US LC 5.73	MULTI ST -1.78	REAL ASSET 0.68	INTL 1.53	US LC 2.41	US LC 0.62	EM MKTS 2.08	US LC 3.26	INTL 0.22	MULTI ST -2.60	US LC 2.04	MULTI ST -1.63	MULTI ST -2.58	MULTI ST -4.73
	INTL 5.48	HEDGE EQ -1.49	FIXED INC 0.64	US LC 0.38	REAL ASSET 1.46	REAL ASSET 0.23	INTL 2.15	FIXED INC 0.64	MULTI ST -0.07	REAL ASSET -2.91	US SM 1.89	EM MKTS -2.54	US LC -4.38	EM MKTS -7.44
	HEDGE EQ 3.41	US LC -3.69	MULTI ST -0.49	US SM 0.24	MULTI ST 0.70	FIXED INC -0.12	US SM 1.93	MULTI ST 0.32	REAL ASSET -0.58	HEDGE EQ -3.95	REAL ASSET 1.34	HEDGE EQ -4.23	REAL ASSET -8.48	REAL ASSET -7.59
	US SM 3.05	US SM -4.11	HEDGE EQ -0.69	MULTI ST 0.23	FIXED INC 0.71	MULTI ST -0.23	HEDGE EQ 0.72	HEDGE EQ -0.23	FIXED INC -0.64	US LC -6.84	INTL 0.85	INTL -4.65	HEDGE EQ -9.42	HEDGE EQ -8.59
	MULTI ST 2.39	EM MKTS -4.55	INTL -1.67	EM MKTS -0.40	HEDGE EQ 0.30	HEDGE EQ -0.66	REAL ASSET 0.40	REAL ASSET -0.52	EM MKTS -0.85	INTL -8.36	FIXED INC 0.60	REAL ASSET -6.08	US SM -10.00	INTL -11.88
	REAL ASSET 0.42	INTL -4.60	EM MKTS -1.78	HEDGE EQ -0.55	INTL -2.12	INTL -2.00	MULTI ST 0.23	INTL -1.94	US SM -1.52	EM MKTS -8.91	MULTI ST -0.57	US LC -9.03	INTL -14.76	US LC -13.52
Lower Return	FIXED INC -1.15	REAL ASSET -5.08	US LC -2.54	FIXED INC -0.74	EM MKTS -3.35	EM MKTS -4.44	FIXED INC 0.02	EM MKTS -2.64	HEDGE EQ -1.63	US SM -10.15	HEDGE EQ -0.63	US SM -10.96	EM MKTS -15.05	US SM -18.49

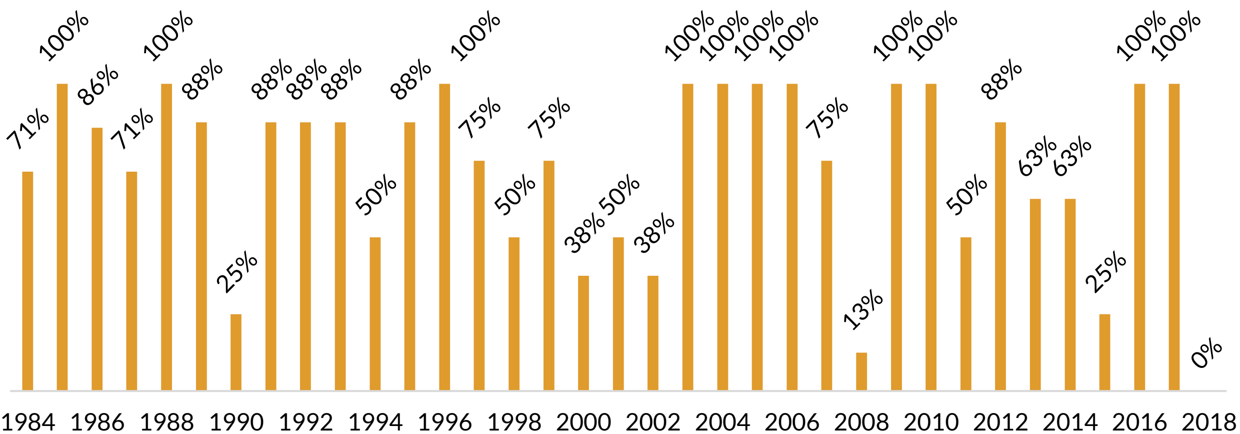
LEGEND

US LC – Domestic Large Cap	US SM – Domestic Small-Mid Cap	INTL – International	EM MKTS – Emerging Markets
FIXED INC – Fixed Income	MULTI ST – Multi Strategy	REAL ASSET – Real Assets	HEDGE EQ – Hedged Equity

Source: Morningstar, Bloomberg

This was not a good year for investors. In fact, as the chart below shows, no major asset class returned more than 1%. That is worse than 2008, where at least core bonds put up decent returns in the midst of the Great Recession. There really isn't much precedent for this level of futility over the past forty years. What makes it more pronounced is that much of the weakness was concentrated in Q4, when equity markets around the globe reached bear market territory (down more than 20% from peak). Although it may not feel like it, especially after such a calm 2017, this level of volatility is not atypical.

Percent of 8 Major Indices with a Greater Than 1% Return



Source: Morningstar Direct, Asset classes represented: US Stocks (S&P 500 Index, Russell 2000 TR Index), International Stocks (MSCI EAFE Index, MSCI EM Index), Bonds (Bloomberg Barclays US Aggregate Bond Index, Bloomberg Barclays US Corporate High Yield Index), Commodities (Bloomberg Commodity Index), REITS (FTSE Nareit Equity Index)

As we mentioned in our December note "The Market Grinch", there was no shortage of headline concerns domestically and abroad from trade, the Fed, Europe and beyond. US large cap stocks fell

13.5% in Q4, with some of the FAANG (Facebook, Apple, Amazon, Netflix, Google) stocks off nearly 30% during the quarter. Despite a Q4 reversal, growth stocks still beat value by more than 6% for the year. Interestingly, while the S&P 500 was off less than 5% for the year, the average stock fell nearly 8%, highlighting the strong performance from a select few (without Microsoft and Amazon, the S&P 500 would have been down an extra 1% for the year). To a degree, the Q4 decline was the US catching down with international. Foreign markets (particularly Emerging) fell less than the US in Q4, but still finished behind for the year.

In fixed income we saw a reversal of year-to-date trends in November, which accelerated into year-end. Up to that point interest rates were on the rise, but demand for safe haven assets seemed to overwhelm the curve. This resulted in the 10-year Treasury yield falling from a recent peak of 3.2% to 2.7% in a matter of 45 days. This helped Treasuries but was less supportive of corporate credit. The Barclays Aggregate Bond Index rebounded by 1.6% in Q4, to bring the calendar year return to zero. Market expectations for the Fed have changed materially over the past few months. After the latest hike in December the markets are now pricing in no hikes in 2019 and potentially lower rates in 2020.

The universe of alternative assets also struggled, although less so than equities. Investor hunger for yield helped global Infrastructure and REITs outperform traditional equities on the downside. Commodities lost money primarily due to a near 35% sell-off in oil, which offset strength in precious metals and select grains. Hedged equity funds (represented by the HFRX Equity Hedge Index) struggled for the quarter but more so for the year, as a bias toward shorting growth stocks in favor of value proved a major headwind.

Final Thoughts

We often fill the final thoughts section with interesting yet neutral tidbits. We kept some of those, but also wanted to highlight the impact of recent market volatility on fundamentals.

- With the Q4 2018 sell-off, and 2018 earnings growth in excess of 20%, equity valuations in the US hit average levels for the first time in several years. For 2019, earnings per share growth assumptions, domestically and abroad, range from +5% to +10%, which although low, are still positive. In other words, despite all of the focus on FAANGs we do not think this is a repeat of the tech bubble. The Price to Earnings (P/E) multiple on S&P 500 stocks peaked out north of 30x in the late 1990s. As we write this, US P/E multiples are hovering around 17x.
- The areas of the market that were stress points ahead of the Great Recession are much better off today. Specifically, bank balance sheets are in much better order than they were in 2007-2008. Add to that a much stronger balance sheet for the average household and significantly lower levels of speculative real estate debt.
- China owns $1.1 trillion of US Treasuries, followed by Japan at $1.0 trillion, and Brazil at $314 billion. The Fed currently has $2.2 trillion in Treasuries on its balance sheet. (source: Treasury Department)
- The total cost of the Social Security program in 2018 will be ~$1 trillion, slightly above its total income. The program is expected to see its first deficit since 1982. (source: Social Security Administration)

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- US oil production reached 11.5 million barrels per day in 2018, surpassing Russia and Saudi Arabia. US oil imports are down from 10.0 million barels per day in 2004 to 7.3 million per day in 2018. (source: Energy Industry Council)
- "The world is about 100 times wealthier than 200 years ago and, contrary to popular belief, its wealth is more evenly distributed. The share of people killed annually in wars is less than a quarter of that in the 1980s and half a percent of the toll in the second world war. During the 20th century Americans became 96% less likely to die in a car crash, 92% less likely to perish in a fire and 95% less likely to expire on the job." (source: Steve Pinker & The Economist)
- The ozone hole shrunk to its smallest size since 1988. According to the UN, the northern hemisphere upper ozone layer should be repaired by 2030. (source: United Nations)
- The number of people living under extreme poverty fell below 750 million for the first time since the World Bank began collecting statistics in 1990. It was more than 2x that only 15 years ago. (source: Wall Street Journal)

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