Noland's Notes 19

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2018 Re-cap / 2019 Outlook

For those of you who are new clients or those who are reading this note for the first time, I should explain. Each year I sit and write you a note. In it, I try to analyze the prior year in my own words so that you have an idea of what environment your accounts were active in. I also try to give you an idea of how I see the investment landscape as we enter the New Year. In our brief discussions throughout the year, time does not permit me to extol all of my thoughts and analysis with you. My hope is that the 20 minutes or so it takes you to read it my note helps you gain a better feel for how we here at Left Brain Wealth Management view the investment climate and how we think about Investment Markets, in general. ***Welcome aboard or welcome back, and I welcome your feedback!!***

(Before I forget, feel free to send our note to your inner circle of family, relatives or friends should you think it appropriate. Though we write this note for you, should you think of introducing us to your inner circle this will be a good way for them to get a "feel" for our work). Let's get started:

Here are the calendar year 2018 returns

Index	Close Price	Return (%)
DJIA	23327.46	-5.63
S&P 500	2506.85	-6.24
NASDAQ	6635.28	-3.88
Russell 2000	1348.56	-12.18
MSCI EAFE	1719.88	-16.14
MSCI Emerging Markets	965.67	-16.64
MSCI REIT	1057.28	-8.64
Aggregate US Bond Index	2046.60	+3.55
Gold	1282.2	-1.57
Oil	45.40	-24.45

(source: YCharts)

(For those of you wishing for the abridged version of this note, feel free to jump straight to the summary which starts on page 7. For everyone else, we have lots to discuss, it has been a whole year. So, let's jump right in!!)

What Happened???!!!

That's the question that we're asking ourselves after that dramatic fourth quarter. There were no shortage of headlines attributable to the fourth quarter sell-off either *(Chinese trade dispute, should the Federal Reserve be raising interest rates this much?, will Brexit get resolved?, global growth deceleration fears, declining oil prices, government shut down, etc).* Certainly, the way the year ended made it feel more dramatic than what we'd normally expect given the positive underlying fundamentals of corporate America. Going into the fourth quarter, the markets had withstood no shortage of mixed signals but still managed to post attractive year to date gains. What's more, the fourth quarter was the 2nd most volatile quarter since the great recession (2008-2009). December 2018 was the weakest December since 2008 in terms of price action. The violent downdraft took away all of the gains accrued through the end of the 3rd quarter, and then some. That's the bad news. The good news is that 2018 is history! 2019 has started with a much more positive backdrop. With last year's sell-off, the market has become much more reasonably priced. The S&P 500 now trades at a forward P/E of 15.3! It looks to us like the Q4 sell off was a dramatic overreaction. The excessive selling seems to be reversing itself as 2019 gets underway. We are still in awe of the many twists and turns that markets have absorbed the past several years as the S&P 500 has levitated ***376%*** from 666 at the March 2009 lows to **2507** at year end 2018. Though 2018 ended on a down note, we're looking for handsome gains in the years ahead. Keep reading for our thinking as to why.

Sizing Up the Investment Climate

I am often asked what I think of the current investment climate. We think it is important for you to understand how we size up the investing landscape at any given time. Here is the lens that we view the investment climate through. The lens never changes but quite often the view does:

1.) Interest Rates- In 2018, the Federal Reserve Board raised interest rates 4 times. The Fed Funds rate sits at 2.4% as we're going to press. While up from the lows interest rates are still unbelievably low. For context, consider that the Fed Funds Rate stood at a paltry .23% 10 years ago. However, 30 year Mortgage rates are still below 5%. They currently stand at 4.45%. There is good news for savers -FINALLY, in that it's now possible to receive 2% on one's FDIC insured savings. **Break out the champagne!!!** In the grand scheme of things, interest rates are still unbelievably low. With the markets' reaction to the Fed's determination to raise interest rates, it sounds like/looks like the Fed will be on hold for a while. *At least until some of these economic cross currents get resolved*. So it looks like interest rates will remain in this neighborhood for quite some time (unless the global economy makes a sudden lurch upward). Though rates are up over the past 12 months, they are still historically very low especially given the strength of the U.S. economy. We'll rate the Interest Rate environment as **Favorable!**

2.) Inflation- Inflation is still MIA. One of the big drivers of the Fed's Inflation readings is energy prices. With the recent downturn in oil prices (from $76.41 per barrel of WTI in October 2018 to the low of $42.53 on 12/24/18), the inflation gauges aren't aggressively pointing North. Surprisingly, even though we are at near full employment, wages haven't grown very much. This is good news for society and for investors (*but, not great news for workers*) as this gives the Fed a reason to not

be so aggressive on rate increases. The official inflation rate, as measured by the FED, is currently sitting at 1.99% (2.2% excluding food and energy), well in-line with the Fed's 2% target.
We think that this Trade war can have a major impact on inflation rates. When trade works best, goods and services are produced where they are made most efficiently i.e. the cheapest. Here at Left Brain we are free market believers (our views have been indelibly shaped by our time at the world's best "B" school 😀. Should countries start to regress and practice protectionist policies (We'll do what's best for our country, specifically without regard for the bigger picture), the economic principles get disregarded and replaced by other non-economic considerations. This won't benefit the global economy nor purchasers or sellers. The only people who hope to benefit are the politicians who are restricting trade to bolster re-election probabilities, showcase their power, or to save face.
In the case of China specifically, we are in favor of the U.S. protecting or at least being compensated for its IP (Intellectual Property). This includes it's trade secrets, patents and technology. Though free markets are never 100% free, we are not in favor of the R&D that U.S firms have invested hundreds of billions in being pilfered as table stakes for doing business in China. We are of the belief that the U.S. economy is on strong footing and that the risks are to the upside for the inflation gauges. Especially if some of these outstanding issues get resolved. **We're calling Inflation Neutral.**

3.) Earnings-This is where things will get interesting. We are smack in the middle of fourth quarter earnings reporting season. On an index level, analysts expect S&P 500 earnings to come in at $170 per share for 2019 which would represent 23% growth from 2018. Be aware that is the combined estimate for the 500 companies that are included in the Index. Some companies will inevitably disappoint and some will overachieve. *We want to own the latter.* But, earnings are expected to increase this year and that's a good thing!! The good thing about the Q4 sell off was that it drove earnings ratios lower. The P/E ratio *(price to earnings)* has averaged 17.5 since WWII. The forward P/E ratio is presently 15. Considering that we think it's likely that some of these macroeconomic factors will be resolved in due time, it looks like we can expect a firmer P/E ratio on an index level in 2019. On an individual company basis which is what we pay attention to here at Left Brain, we feel strongly that the companies that can deliver revenue, cash flow, and earnings growth should be rewarded with higher share prices since the selling was nearly indiscriminate to end 2018.
So far in 2019 the markets reaction to earnings has generally been met with applause. That's to be expected when businesses exceed expectations. But, the interesting thing is in the early going of 2019, even the companies that have announced results below expectations have been met with enthusiastic responses by investors. It looks to us like the violent downturn in share prices to end 2018 was a major overreaction that is being corrected, imminently. **We're calling the Earnings Outlook mildly Favorable.**

4.) Valuations-There is a big positive element to the way 2018 ended. For a lot of companies their business outlooks didn't change much, if at all. What changed was the price of their shares so businesses became cheaper to own. Sell-offs aren't all bad. They give us a chance to "high grade". That is, when selling becomes indiscriminate it gives the investor an opportunity to swap into shares of the best businesses at lower prices. Given the following: 10 year treasury rates are currently 2.72% vs. the 30 year average of 4.72%, the current forward P/E ratio of the S&P 500 is 15 vs. it's historic P/E ratio of 17.5, and given that the 10 year treasury rates are still below 3%, we are very

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attracted to today's valuations of securities. One of the ways to think about today's valuations is to compare what you'd earn as an investor in 10 year treasury bonds (the world's safest investment) to what you'd earn in shares by looking to the earnings yield. That is the inverse of the P/E (price to earnings) ratio. So, if the P/E ratio of the S&P 500 is 15, then the earnings yield is 7% - rounded (100/15=6.66). We'll take a **6.66%** yield from stocks that will be growing their earnings in the future vs. cash or safe bonds yielding <3% . **We're calling Valuations Favorable.**

When the Recession Comes

Including the mysterious "Boogie Man", fewer words have conjured as much terror from investors as the universally feared "R" word. That was the word used by media outlets to explain why securities prices were falling to end 2018. Let's spend some time unpacking the "R" word. More importantly, we'd like to explain the Left Brain position on **recessions**. A classical recession is defined as two quarters of negative GDP growth. That's it! The world doesn't end. It's not a sign of the apocalypse. The earth doesn't stop revolving around the sun. For some reason, investors inquire about a recession with the implicit notion that when we get wind of recession, we should sell shares BEFORE the recession sets in and then buy them back when it's over!! Hilarious! Let's thoroughly debunk this notion once and for all. At least I'm hoping that we can address this issue once and for all. But, since we know that human nature doesn't change, I understand this will be an uphill battle. My hope is that the clients of Left Brain will **GET IT!**

Here goes:

Here in the U.S., we've experienced 17 recessions since World War 1. The average recession lasted 13.6 months. For every recession we've eventually had a recovery. The recovery rate is **100%.** Now, for those of you who think that you have some advanced warning about impending recessions, I have some sobering news. Of all of the institutions that receive economic data, no one gets better data, fresher statistics and more timely information than the Federal Reserve. Not only is their information better, they are smarter. The Fed employs over 300 Ph.D's. Most investors who get panicky about an impending recession are getting this information from the news outlets. The worse source of all! Once it's spoken about on news broadcasts, it's popular, not advance information. **The market prices have already incorporated this news.** Here's a question: if the Federal Reserve Board doesn't have wind of an impending recession how can you or anyone else? *(Legendary economist, Paul Samuelson said in 1966 that the stock market has predicted 9 of the last 5 recessions)*

I recently reviewed an investor letter that was sent to clients of an Investment advisory firm. It was forwarded to me by a lifelong friend of mine and client of this particular investment firm. He sent it right after the New Year when markets were in a tizzy. The Chief Investment Officer was pretty emphatic that we were entering a recession. The news items listed were as long as rush hour traffic here in Chicago. It stated clearly that they've sold securities in client accounts and would wait for the economic "all clear" before they put clients' money back to work in the markets. I'm sure my friend, and all of the clients of this firm, felt reassured and comforted by this message. The note was well written. It was convincing and laden with reasons they were making this call. And, flat out wrong!!! Unfortunately, this reassurance has cost these investors dearly. *(The Markets are off to one* *of the best starts ever).* My initial reaction upon reading the note was visceral. Here were my thoughts:

A. If the Federal Reserve isn't expecting a recession with their trove of ADVANCED data and army of Ph.d's who scour myriad data sources for clues on the direction of the economy, how can you be so sure?

B. If you are so good at predicting recessions, why didn't you anticipate the 2008-2009 recession?

C. If you knew the recession was coming, why didn't you sell sooner?

D. If you sell now, when will you repurchase securities? (If it's after the recession has ended then prices will surely be higher, yes?)

This brings us to an important insight: ***You can lose a lot more money listening to really smart people than you can lose listening to really dumb people!***

The Federal Reserve didn't anticipate the economic crisis of 2008-2009! Recessions are officially declared by the NBER (National Bureau of Economic Research). The NBER declared the 2008-2009 economic crisis an official recession in December 2008, though it officially started in **October 2007!** That's not a surprise to us. Historically, once we have official confirmation that we've entered a recession, the upturn has usually begun in earnest. The worse economic setback experienced by today's investor was the Great recession of 08'-09'. That recession lasted for 18 months. I'm sure every investor knows about the downside of a recession: lower share prices, layoffs, weaker house prices, uncertainty, decreased consumer confidence, economic contraction, worsening business conditions, etc. What we'd like to focus on here are the benefits that can accrue to investors because of a recession:

1.) Because prices are lower those with a level head and nerves of steel can cherry pick investment opportunities at lower recession era prices. Believe it or not, there is a group of investors that wait and wait for bad times to arrive. They have cash available to take advantage of investors who panic and sell at the wrong times. They are looking to cash in on those who become forced/panicked sellers of stocks, bonds, real estate, etc. The smart money knows that the economic climate will return to normal eventually. You'd think sellers would learn from the past, but No! The dumb money continues to acquiesce to the smart money. *On a side note, we have many clients who'll call or send us a note after a violent sell-off and inquire about opportunities to buy the most attractive holdings that have fallen more than they should have. I'm not sure if we're responsible for their mindset. But, I do know their numbers have grown over the years. On the other hand, it's amazing how many more calls we get for requests for financial and portfolio reviews when the markets sell off. We're not sure if good investors are born or made. But, it shouldn't be a surprise as to which group experiences better portfolio returns* 😀 *.*

2.) Good companies can get stronger during a recession. For example, it is not uncommon for Company A to use a recession as an opportunity to buy Company B *(it's competitor)* at the then lower purchase price during a recession. Imagine Company A's pre-recession profits are $1 Billion per year. Now, imagine Company B's pre-recession profits at $500 million per year. But, remember they are fierce competitors. During a recession let's assume company A's profits slide to $500 Million. Let's assume Company B's profits slide to $250 Million. In normal markets let's assume

Company A would have to pay 10 times profits to buy Company B ($500 Million x 10=**$5 Billion**). *Using the same multiple Company A would have been valued at $10 Billion before the recession and $5 Billion during.* But, during the recession let's assume company A is able to buy Company B at 7 times deflated profits ($250 Million x 7=**$1.75 Billion**). Now, let's fast forward to the inevitable recovery from the recession. Let's consider a recovery in end markets for Company A+B. The combined profits of Company A+B are restored to $1.5 Billion ($1 Billion for Company A + $500 Million for Company B). Assuming multiples return to their pre-recession level, the combined entity is now worth **$15 Billion**. But, it gets better. The only reason A should be buying B is that they can be better together than apart. So, we'd expect profitability of the combined enterprise to be higher together than they were separately. *(This is usually called "synergies". Synergies is Wall Street speak for Layoffs! This can be terrible for employees but is often pay dirt for investors!).* With improved profitability, we'd expect the markets to assign a higher multiple to the combined entity. Imagine the business traded for 10X profits when company B was competing in Company A's end market. Now that profitability has increased it's likely that the combined company can trade at 12 times earnings. At 12 times earnings, Company A + B is now worth **$18 Billion** (12x$1.5 Billion). This is called multiple expansion. So, the business purchased for $1.75 Billion has enriched shareholders dearly as this increased the value of Company A by **$6 Billion** ($500 Million in profits x 12=$6 Billion). Remember, Company A only paid $1.75 Billion. Think about it from Company A's perspective— other than a recession how else would they have been able to buy Company B at a multiple of 7? What do you imagine the shareholder returns will be should this scenario come to fruition? Now, if you're a long term shareholder of Company A tell me why you should fear a recession again??

3.) Companies often use recessions and the lower share prices that show up to buy back shares. When a company buys back its shares, all things being equal, this increases earnings per share for that company. Shareholders then win two ways: 1.) Current shareholders own a higher percentage of the business as the number of shares outstanding shrinks. 2). When earnings per share increase, because of the lower share count, the markets often reward the shares with a higher price.

4.) Historically, recessions can be traced to excesses "bubbles" that have been built up in the economic system and then burst (inventories, housing price exuberance, S&L crisis, easy credit, etc.). This galvanizes Washington to put rules in place to ensure these issues don't show up again. And, they generally don't. So the system gets stronger after a crisis/recession. This is capitalism at its finest. The worse economic period in our countries' history was the Great Depression. Think of the many benefits we all enjoy today as a result of legislation passed in the aftermath of the Great Depression:

- ★ Social Security Act of 1935 (Social Security to retirees, children, established unemployment insurance)
- ★ Securities Act of 1933 (Ensured that buyers of securities receive complete and accurate information)
- ★ Securities Exchange Act of 1934 (Established SEC, regulated trading of securities in secondary markets)

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- ★ Investment Advisers Act of 1940 (Primary source of regulation of investment advisers, administered by the SEC)
- ★ National Relations Act of 1935 (Guaranteed basic rights of employees to engage in collective bargaining)
- ★ Fair Labor Standards Act of 1938 (Established 40 hour work week and minimum wage)

Here's the playbook for a recession: If you are an investor in the *Creating* wealth stage, you should be hoping for lower prices. By dollar cost averaging you are buying shares at lower prices. Lower, not higher prices, during the buying stage are an absolute gift to you. For those in the *Building* wealth phase, sticking to the Wealth Management plan is advisable. The group that are usually most concerned are the *Preserving* wealth group. These are usually those close to retirement, or those already in retirement. For clients of our firm, we have already built downturns into the financial model. We can do that by either holding cash of 6-12 months of income needs, owning income producing securities that make payments even in downturns, or some combination of both. What we don't want to do is to be selling in a selloff.

Summary - Our 2018 Playbook

Though the markets had a volatile fourth quarter 2018 and ended on a down note, we are of the opinion that this was a broad overreaction to the economic reality of business conditions. Since 2019 has started on solid ground, it looks like the investment world agrees. We are not expecting a recession anytime soon. Economic indicators show a slight deceleration but no recession. A lot of pundits point to the fact that since we've been in expansion since 2009 that we must be coming up on the 9th inning of this expansion. We'd not so politely disagree. Though we are in year 10 of the expansion, it's also true that this has been one of the slowest expansions from recession ever. GDP growth has averaged 4.2% in the 11 expansions since World War II. The U.S economy has only expanded at a 2.3% rate during this current recovery. So, although the length has increased, the magnitude of the recovery has not. That's one reason we expect the expansion to continue for quite some time. If you think 10 years is a long expansion consider what the Aussie's have been able to achieve in the Big Down Under. Australia hasn't had a recession in over 20 years!!

After underperforming the S&P 500 by 12.6% the last 2 years, we're looking for small caps, as measured by the Russell 2000, to have a good year and play catch up. Also, we're highlighting Emerging Markets and Energy as two sectors where investors can still find reasonably priced securities after several years of underperformance. *(We were keen on both last year too)*. Emerging Markets (EEM) are currently trading at a P/E ratio of 11 when the historic P/E ratio is 14.4. Energy is interesting in that in 2018 oil prices fell dramatically. WTI started the year at $60.42 and ended the year at $45.41 per barrel. Overall, energy shares as measured by the energy ETF (XLE) decreased by 18.2% while oil exploration company shares fell by 28.1%. Over the previous 10 years, oil shares (XLE) and the price of oil have experienced nearly identical returns of +20% (as we would expect). But, the trailing 5 years, they've diverged. Oil (WTI) has increased by an average of 23% while oil stocks have decreased by 4.9% annually. We wouldn't be surprised to see the Energy sector rise dramatically this year. Though energy stocks may do very well this year, we prefer buying energy company bonds to take advantage of the opportunity. An investor can get equity like returns at today's prices and be in a much safer security opposed to the same company's stock as the bonds are guaranteed by the company. Should oil prices fall and create tougher financial conditions for that particular firm, the bonds are a much safer place to be.

This year we're adding the semi's (Semi-Conductors) as our rebound sector of the year. Last year the semi conductor index decreased by 6.5% (Philly semiconductor index), but fell by 17% from it's August high through year end. We think that it's likely that we'll get some clarity on the China trade dispute situation and that should warrant a rebound in the shares of chip stocks as this was the major reason they experienced a sell off in 2018. A lot of bad news has been priced into the sector. They've been "de-risked". If there's anything we've learned over the years it's that when things go from bad to less bad prices can improve dramatically.

We are delighted by the prices we are seeing in the High Yield bond market. Because of the trading environment that existed in 2018, High Yield bonds posted negative returns last year. As far as we know they have never had two back to back down years. Today, we're finding attractive bonds with yields of 10%! That's **7%** more than 10 year treasuries. They carry more risk than "safe" bonds, but we think today's yields more than compensate investors given the current economic conditions we find ourselves in.

The markets have endured a barrage of nerve racking economic headlines (Brexit, the China trade dispute, interest rate increases, growth slow down fears, volatile oil prices, peak earnings scares, government shut down, etc.). Should even a minority of these issues get resolved, we think the economic expansion could continue for several more years. We've been criticized for being devout optimists. We're not pollyannas. We're not raging optimists. We go where the facts lead us. Here at Left Brain we're level headed optimists. We call things as we see them. So, yes, given the current economic background and the outlook for corporate America, we're optimistic about the year ahead. We tend to be a pretty cheery bunch. But, we're not nearly as optimistic as the man or woman on spouse #4! Here's to a great 2019.

As always, I will be looking for opportunities to profit this year and in the years ahead!!