HEYDON TRAUB
Traub Capital Management, LLC
97 Chapel Street
Needham, MA 02492

(781) 453-3929
Cell: 781-405-4410

April 3, 2019

Traub Capital 2019 Q2 Outlook

Stock Market Outlook

So far, in 2019, the stock market has been unfolding much as we anticipated. In the fourth quarter, the markets saw a decline of about 14% with a very steep dive in December coupled with considerable volatility.

Our forecast at that point was quite different from the consensus. While many “experts” forecast continued declines, we had gone back in history to identify similar periods of sharp declines coupled with high volatility. That analysis pointed towards a recovery with a mean time of nine months to get back to the former high point. We expected a similar pattern starting with a rapid bounce back and this is exactly what happened.

Since just before Christmas, the S&P500 has risen a bit about 22%. So far, since the September 2018 high, we are about six months in and we have another 2 1/2% to go to get back to the all-time high (using the 4/2nd close). The rest of the gain is entirely doable in another three months’ time.

We also noted that the path would not be smooth, which it certainly has not been. The path back is not a smooth upward progression and with the added volatility we expect, it is very hard to tell exactly where we will wind up right at the point of year-end.

As we will outline below, we believe a significant amount of the downdraft was created by automated programmed selling or by hedge fund liquidation. The timing of these kinds of downdrafts can happen most any time and can easily cause a very short term swing of more than 5 percent. Nevertheless, we remain generally optimistic and we believe 2019 will wind up being a good year for stocks.

The US economy remains healthy. Growth will slow down a bit from last year’s growth, but we still expect the Gross Domestic Product to grow by just under 3% in 2019 compared with a 3.1% growth in 2018. This growth forecast is a bit higher than the consensus. We expect inflation and interest rates to be supportive of good economic growth as outlined in their respective sections below.

Corporate earnings for 2019 should be 7% higher than 2018. This earnings estimate is a bit higher than the consensus, but at a 16x P/E ratio against forward earnings, an S&P value of 3050 could be easily justified by the end of 2019.

Fortunately, our forecast is not shared by most observers, most of whom are worried, and the Wall of Worry is exactly when the stock market climbs. The worries are many and include interest rate yield curve “inversion”, plus the usual litany of China, Brexit, tariffs and there is always "Trump" and the "unexpected." In previous reviews we have examined China, tariffs, Brexit and Trump, so let's look at the two new ones here.

New Stock Market Worries – Yield Curve Inversion and the Unexpected

There is considerable press coverage given to the "Yield Curve Inversion". It has been noted that an inverted yield curve has predicted the last eight of five recessions (yes, that's a bit of humor and suggests that three times the curve has inverted, there was no recession, but on a serious note the inverted yield curve did precede all of the other recessions) depending on just how you count it and there is much angst. So just what is the Yield Curve and how does it get "inverted".

When people borrow money, they can promise to pay it back tomorrow, next week, next month, a year from now, ten years from now or most anytime in between. The Federal government borrows the same way, except that the pay-back periods are tied down. The rate periods are: overnight, in one month, three months, six months, one year, three years, five years, ten years, twenty years or thirty years.

People who lend money want to get it back and they want it to be worth at least as much when they get it back as it is worth now. Loans to the Federal government are considered to be "risk-free" in terms of credit risk, so there is not a lot of extra premium paid for deadbeat risk. (You might think that Uncle Sam cannot cover his debts, but the big banks do not agree. They have a lot more money than you do, so it is their opinion that is important here.)

The interest rate paid on Federal government debt is just expected inflation plus a little bit more. Since inflation eats purchasing power it needs to be added to the return expected. Inflation needs to be estimated and there is a lot more estimation error looking out 10 years than there is looking out one day. As a result of the inflation uncertainty and people's preference for having money now instead of later, money lent for longer periods generally has a higher rate of interest than money lent for shorter periods.

The yield curve is simply a plot of the interest rate paid on government debt plotted against the maturity time periods. When this curve is "inverted", the interest rate paid for long term borrowings is lower than that paid for shorter term lending. Banks generally borrow very short-term funds, like savings accounts from individuals which can be withdrawn on a moment's notice or they borrow short-term funds from various sources including overnight lending from the Federal Reserve. The banks lend this money out for repayment in longer time periods and the banks keep the difference as profit. When long-term rates are lower than the short-term ones, there is much less incentive for banks to lend, so an "inverted yield curve" gives a disincentive for banks to lend and lower lending tends to slow down economic growth.

For the effect of the inverted yield curve to impact the economy, the extent of the inversion needs to be significant both in amount and in duration. So far, neither the amount, nor the duration of the inversion is the least bit significant. So far, only intermediate sections of the yield curve are inverted. The two ends (30 years and overnight lending) continue to show a positive yield difference. The only inversion is in the middle. The total amount of that inversion is less than 0.2% and the duration is less than two weeks so far – neither are especially significant, particularly in light of the continued positive slope marked by the two ends of the curve. And the most widely used measure of defining inversion, the 3 month vs. 10 year, is back to positively sloping as of now.

The only significant nature of the yield curve inverting on some of the intermediate points of its curve are the headlines proclaiming "Inverted Yield Curve." Those headlines are read, automatically, by computers that are programmed to make automatic trades. The "long-term" horizon for those automated trades is the end of the trading day. The volume of those trades is enormous. It is these programmed trades that result in the rapid declines we have seen this quarter followed by the slower recoveries. Those programmed trades react to the headlines while the market increases continue to reflect the overall health of the economy and the continued improvement in corporate earnings.

A similar effect was seen at year-end. This year was not a particularly profitable one and there were a considerable number of hedge funds that were significantly behind their highest value. Incentive fees of 20% for these funds occur only once they are over their previous high point. By year end, it was more profitable for these funds simply to close and reopen the following year, thereby resetting the high point and the trigger for a 20% fee. To close, the funds simply liquidated their existing holdings and this liquation was done before year-end to avoid annual costs like audit fees in 2019, and the liquidations were done without much concern for the prices realized for the holdings.

It is very difficult to get hard data on the magnitude of the impact of the hedge fund trades, but we are very aware of its existence and the potential for the type of major impact we saw near the close of 2018.

The conclusion from the yield curve inversion is that it is too early to start to worry but certainly something to monitor and possibly tamp down stock market exposure and risk if it continues well into next quarter. The conclusion from the programmed trades and the hedge fund liquidations is that both are very transient and we expect the overall impact of the good economy and the growth in corporate profits to dominate.

Conclusion

We are not concerned about the "yield curve inversion" unless the magnitude becomes larger and/or the duration longer. We expect long-term interest rates will increase some and it is possible that the very short-term ones that are controlled by the Federal Reserve (FED), will decline, or will at worst, remain stable. If so, those changes could end even the small partial inversion that exists today.

On the low end of the yield curve, the general consensus late last year had been for about three rate hikes by the FED this year, but now, we, as well as the consensus, expect to see no hikes or one at the most. The reduction in increases by the FED will anchor the low end of the yield curve at the existing values. The long-term interest rates on the yield curve are more controlled by the expected rate of inflation. At the moment, the consensus opinion on the expected rate of inflation is about 1.75%. We expect that the general expectation for inflation will start to increase as actual inflation in the US does finally begin to accelerate in 2020 and 2021. We will cover the reasons for and the amount of inflation in upcoming reviews. Once the increase in inflation is generally forecast, the longer term end of the yield curve will likely rise, giving a positive overall slope.

So, the markets are on track so far in 2019 according to our thoughts as we outlined in the Q1 review. We expect to recover to see a new high at some point in 2019. By year-end, based on the volatility we expect, the final market close could be easily be plus or minus 5% from that high value, but our view is, it will likely be a minus, in which case we will see very small market gains for the rest of the year. We are looking at the fixed income portions with the potential to pare back the average maturity a bit further, as longer-term interest rates begin to climb which would lower prices of bonds, particularly longer-term bonds.

Retirement Analysis

Many of our clients are in retirement, approaching that date, or are at least planning for it. That thought process can be very difficult. Many don't incorporate tax estimates properly but it is very important to make a reasonable estimate of the tax burden that you will be facing. Many retirees will have significant distributions from IRA accounts. These distributions are taxed at regular income tax rates. The new deductibility limits for local and state taxes are making an unwanted increase in tax liability for some. Capital gain planning is becoming increasingly important in order to take advantage of lower rates. IRA Roth conversions also offer an avenue to potentially reduce overall lifetime income taxes.

Just how all these variables interact is not intuitive. Nor is it easy to project the impact of these different variables. The impacts, however, can be large. Many higher income level retirees can see well over half of their income needs to be directed to Federal and State income taxes during their retirement years.

We do want to alert all of our clients of the capability we have to look at all of the variables that can impact your projected taxes. We are not tax accountants, nor are we income tax attorneys and our projections are simply projections. We have found, however, that very few of the various tax professionals that we have seen are very well equipped to make any sort of long term retirement analysis and related income tax projections, and few are equipped to offer even short term planning for optimizing Roth IRA conversions.

That said, we would be happy to take a look at your individual retirement situation. We can make a reasonable estimate of the potential gains on your assets including what additions you can make before you might be ready to retire. Overall asset planning along with estimated tax planning can determine various strategies for continued employment or what levels of investment risk to take going forward. A comprehensive look at investments, income and taxes can also lead to potential IRA Roth conversion strategies to take advantage of what are usually lower income tax rates that retirees often have between their chosen retirement dates and the dates of mandatory IRA withdrawals, which start when you reach the age of 70 ½.

Please let us know if retirement planning is an area of interest you might have and we can run an individual analysis for you.

As always, we do appreciate your continued trust in the firm to manage your investments and continue to look forward to serving in that capacity for your needs going forward.