

Take a second to think about all the different headlines and news stories you heard this year regarding financial markets. Presumably a lot about interest rates, all-time highs, winning/losing trade wars, best ever economy, Europe being a mess, triple digit Dow moves, and something about FANG¹, of course. Now what if I told you that the US market was down on the year, about 2% give or take? Does that reconcile with all those market narratives you've heard? And if it does, what if I told you that we have entered a bear market and are at the end of the business cycle? (You'd have to be in some deep reading of certain market strategists to have heard that one before.) *Further, the best performing asset class this year? T-bills (cash proxy).*²

Over the course of 2018, an old proverb has been on my mind more than usual and I'd like to think it is more than a coincidence: "Can't see the forest for the trees." The year has been full of trees – but do they make a forest? Said another way, every month a new narrative takes hold of markets – trade, rates, policy, inflation, etc. – each one of these represents a tree. Are we standing among few trees all coincidental and independent? Or are we standing among trees that are all intertwined and make one forest?

In our view, the past twelve months have all but confirmed we have entered an "end-of-cycle forest" and 2019 will be defined by navigating through it. The question remains however-how large (deep) is this forest – and – how many unforeseen dangers lurk inside?

Executive Summary

A 'rolling' bear market has begun. We expect continued volatility and a lot of divergences below the index-level surface. However as far as bears come, we expect this one to be pretty tame.

- As margin pressure works its way through supply chains, we see many sector/market divergences – hence the "rolling" bear.
- This bear looks more like the one from 2001-2002 than others. This means a difficult market environment but a fairly nonchalant economic one.
- Valuation matters. We believe investors' sensitivity to fundamentals will be much greater than in prior years as general sentiment shifts lower.
- We expect the [less global liquidity = continued high volatility] equation to continue, made worse by headlines & rumors.
- Our view **versus** consensus: S&P 500 earnings lower, cost inflation higher, GDP in-line.

What we like: pricing power, staples, healthcare, housing, energy, emerging markets.

What we don't: expensive tech & discretionary, elastic demand, corporate debt.

¹ Acronym for Facebook, Amazon, Netflix, and Google (Mega-large tech names).

² As of December 13, 2018. T-bills would have yielded around 2% this year, better than any other common asset.

2018 Lookback³

What we got right-

- ✓ **High volatility and flat to low single-digit returns in 2018.** Higher volatility gripped us nearly immediately late January as many “short volatility” positions were unwound.⁴ That volatility never abated and led to flat/negative returns on the year in the US.
- ✓ **China & a weaker US dollar boosted global industrial production in 2017.** China pulled their stimulus back and went tumbling in the first half of 2018. Commodity markets felt the ‘China effect’ as well. Global GDP growth peaked in Q1. Dollar strength slowed production across the world.
- ✓ **Wage inflation will impact corporate margins.** Low-end wages, trade, transportation, & energy are all impacting margins; this is slowly creeping through the system sector by sector. While many have already felt the brunt, others have not. Margin pressure will not abate until every sector is hit.
- ✓ **Global central banks are beginning to retract the liquidity underpinning markets.** This can be seen in the currency markets, starting with the weakest links: Turkish Lira, SA Rand, Argentine Peso, etc. This reduction in liquidity also plays a big factor in elevating volatility and reducing market multiples.

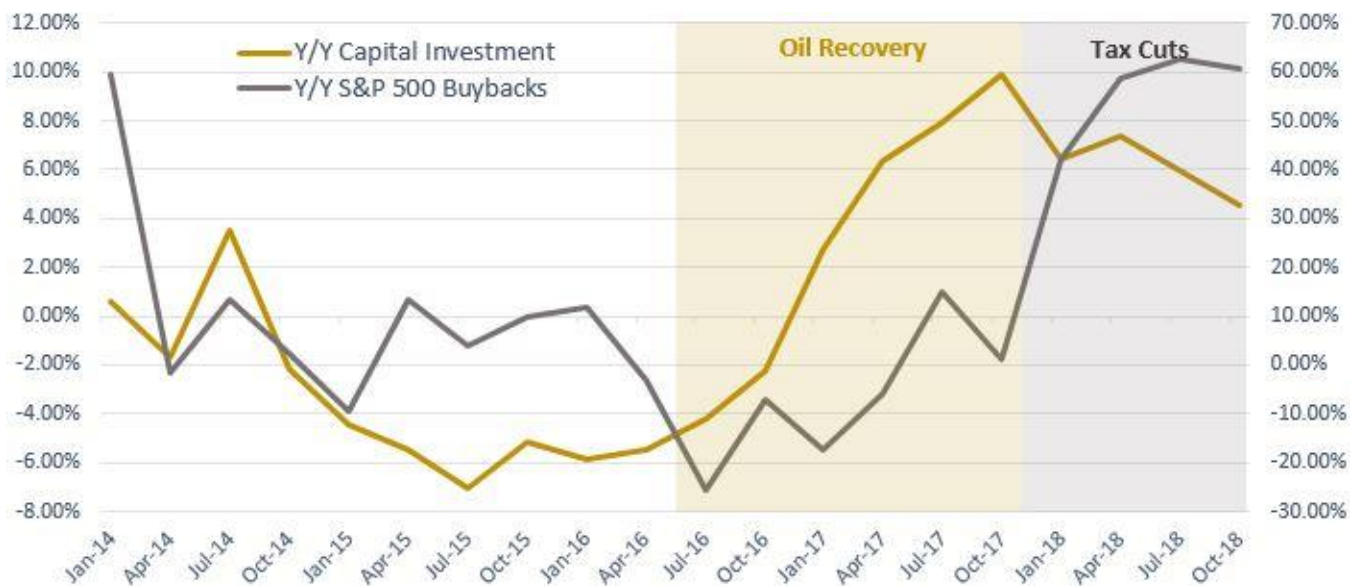
Index	YTD Return
Bonds (Barclay AGG)	-0.83%
Dow Jones (DJIA)	-1.30%
All U.S. Stock (W5000)	-2.64%
China (Hang Seng)	-12.78%
Germany (DAX)	-16.30%
UK (FTSE 100)	-11.34%
EM ETF (EEM)	-14.78%
Agriculture (DBA)	-7.01%
Precious Metals (DJGSP)	-15.68%
Base Metals (DBB)	-16.74%
Nat Gas (Henry Hub)	46.20%
Brent Crude	-2.46%
Sectors	
S&P 500 [®] Index	-0.86%
Materials	-14.89%
Financials	-12.73%
Consumer Discretionary	4.92%
Industrials	-10.74%
Communication Services	-12.13%
Utilities	7.35%
Energy	-12.44%
Information Technology	4.69%
Consumer Staples	-3.57%
Healthcare	11.10%
Source: Bloomberg	
12/13/2018	

What we got wrong-

- **We didn't expect the markets inability to see through the one-time profit boost from corporate tax cuts.** *Ok, we were wrong on the timing but right on the premise.* Through the first half of 2018, we were amazed at the genuine belief that corporate tax cuts would sustainably boost investment. However, over this past quarter it appears reality set in as data (chart below) confirms our ‘tax doesn't change much’ theory.
- **We believed margin pressure and reduced liquidity would hit all at once. It didn't.** However, both of these variables are providing very strong headwinds (noted above), but they have moved very slowly through asset classes and sectors – like a dense fog creeping its way through town. **90% of all asset classes in the world generated a negative return this year – the most ever recorded – but there was a large disparity in magnitude.**

³ Last year's outlook can be found [here](#).

⁴ A common short volatility ETF went under in January when the VIX Index spiked. The ETF was XIV.



Source: Doxa Research, US Bureau of Economic Analysis/FRED

***The chart above illustrates the year-over-year growth rates of core capital investment (ex-defense & aircraft) versus share buybacks. Said another way, it attempts to show how firms allocate capital. Tax cut = more investment? Not in the data.*

2019 Outlook

As we think about the year forward, let's go back to one of the 'what we got wrong' points:

"...these variables [margin & liquidity pressure] are providing very strong headwinds, but they have moved very slowly through asset classes and sectors – like a dense fog creeping its way through town..."

This can be especially seen in the year-to-date asset class returns on the previous page. Some markets are lower by high double digits, some mid, and a few positive. **This is very important because it is easy to see each market or sector as an individual tree instead of many trees all in the same forest.** We had to call this point out again as it is the foundation of our 2019

Outlook: *Working our Way through the Forest:*

- 1) Late-cycle factors continue the rolling bear.
- 2) The market & economic effect is reminiscent to 2001/2002.
- 3) Valuation matters.

The Rolling Bear continues.

Bear market⁵, downturn, slow-down – call it what you will – but 2018 brought that to Asia, Europe, most of the Americas ex-US, Agriculture, Financials, Materials, etc. However, living and working in the US, our broad indices like the Dow Jones or S&P 500 are roughly flat which doesn't sound like a bear market at all, right? Sticking with the 'old sayings' theme, these US indices are akin to "a wolf in a sheep's skin", "not all that glitters is gold", or "never judge a book by its cover."

Two prime factors contributed to the US outperforming the rest of the world this year, both of which may become a headwind in 2019: 1) tax cuts and higher government

⁵ Bear Market is commonly known as a market that depreciates by 20% or more, while a bull market is the inverse.

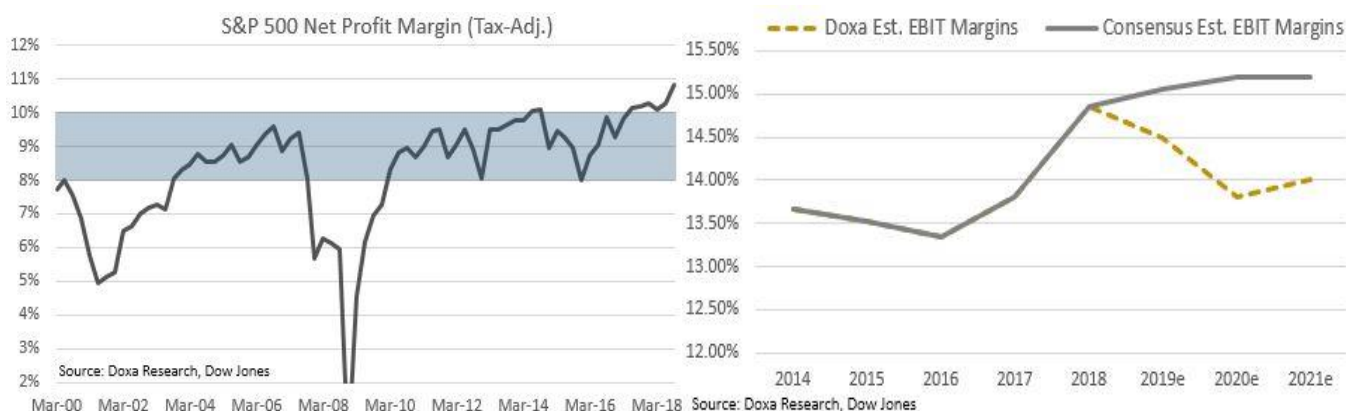
spending provided a short-term boost, and 2) sector weightings in the S&P 500 Index favor those who are last to feel margin pressure.

1) Fiscal Stimulus: As mentioned above, this stimulus was initially viewed as sustainable instead of being a “one-time” boost. *For example, a home improvement retailer will grow net profit 25% during 2018 – but profit before tax will grow around 6%. 2019 will not see that same 25% growth rate as taxes will not be cut again.* **However, it seems in the past few weeks the market has sniffed this out.**⁶

2) Margins are of utmost importance. Increasing margins = more profit per dollar of sales = higher multiple someone would be willing to pay for a share of that company. In contrast, declining margins can mean you actually make less profit even if you sell more stuff! As detailed out many times over the past few notes ([here](#) & [here](#)), we are seeing margin pressure all over the economy in the form of higher labor, input, trade, & financing costs.¹ This is where the ‘rolling bear’ or ‘dense fog creeping through a town’ comes in – **not all of these pressures affect business the same way.**

Sectors	
S&P 500 ® Index	-0.86%
Materials	-14.89%
Financials	-12.73%
Consumer Discretionary	4.92%
Industrials	-10.74%
Communication Services	-12.13%
Utilities	7.35%
Energy	-12.44%
Information Technology	4.69%
Consumer Staples	-3.57%
Healthcare	11.10%
Source: Bloomberg 12/13/2018	

Note the sector performances YTD in the chart. It is not coincidental that the positive return sectors are utilities & healthcare (who can pass through any rising cost as demand is constant) and discretionary & technology (disc. names benefit most from tax cuts & tech doesn’t have many input costs). So, will this continue? **For the defensive sectors with pricing power, probably. Tech & discretionary on the other hand, doubtful.** Where it would seem like technology companies could avoid many pressures other industries face – those other industries are the tech industry’s customer, spelling lower demand. In short, tech is just the last house in town to be covered in fog. For consumer discretionary, the y/y growth from the tax benefit will abate, making costs front and center. These two sectors make up nearly 38% of the entire S&P 500 Index, easily masking the movement under the surface.⁷



⁶ The S&P 500 is lower by about 9% since October 1, wiping out all the prior gains for the year.

⁷ Using the sector weightings before XLK split into two mid-year.

So what are we really saying?

The largest weighted sectors of the S&P 500 Index haven't seen the margin pressure other constituents have this past year, simply because it hasn't reached them yet. It will (and is)!⁸ From the all-time highs this summer, the S&P 500 is **-10%** while the average stock is **-21%**.ⁱⁱ **In short, we are saying that much damage has been done below the surface with many stocks and sectors pricing in a substantial slow-down already.** This is why we believe opportunity exists in the areas the bear has already mauled while staying away from the sectors the bear has yet to cross.

For this reason, our outlook for US equities is roughly unchanged from last year, but it wouldn't surprise us to see the broad index trade to our bull & bear case throughout the year at some point. We fully recognize that our base target of 2550 doesn't equal 15.5 x \$158, but see 2550 as a decent mid-point of sorts between the bull/bear levels.⁹ We see multiples relatively range bound between 14x-16x,ⁱⁱⁱ making the real story about corporate earnings. As seen in the margin charts above, we see margins falling from peak, whereas current consensus estimates see margin expansion continuing. **We feel very confident consensus estimates will come down** – the question becomes more about longevity rather than magnitude. Regardless, it appears the market is recognizing this earnings slowdown now; making timing somewhat irrelevant in terms of impact. **Simply put, we would be buyers at the low end and sellers at the high end over the next 12 months.**¹⁰

Scenario	Probability	2018e EPS	2019e EPS	2020e EPS	Fwd. P/E	2019 Target
Bull	20%	\$162	\$175	\$185	16x	2,950
Growth			8.0%	5.7%		
Base	40%	\$162	\$165	\$158	15.5x	2,550
Growth			1.8%	-4.1%		
Bear	40%	\$162	\$157	\$161	14.5x	2,350
Growth			-3.1%	2.5%		
Consensus		\$162	\$177	\$195	16x	3,100
Growth			9.3%	10.2%		

All numbers adjusted for comparison to consensus *Source: Doxa Research, Bloomberg*

2000-2002: History doesn't repeat, but it sure does rhyme.

We keep using those popular buzz words, 'late-cycle' and 'margin pressure', so let's dive into them a little more. First, margin pressure often happens during the late stage of a business cycle, e.g. businesses are very optimistic about the future and therefore invest (spend) money to grow. As more & more businesses do this, the demand for inputs moves higher and the supply of inputs can't keep up; therefore, input prices increase. This is what makes a market. At some level, these input prices will go up enough to make it uneconomical for the business to keep expanding; creating a downturn – then repeat. **Importantly, every cycle has unique characteristics and no cycle is the same.**

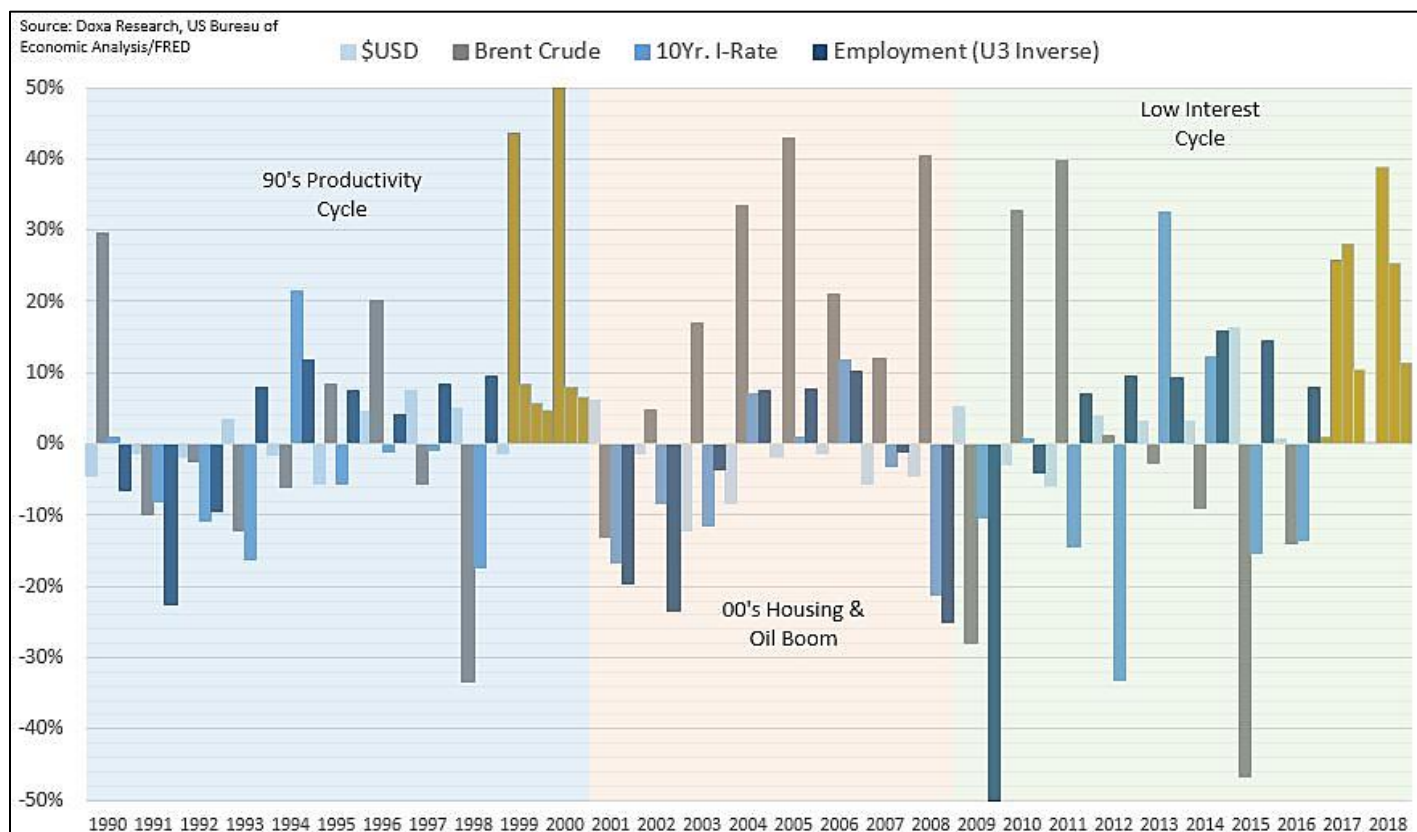
⁸ Technology is starting to show signs of pressures, discretionary will most likely be last as the holiday season should provide a near term tailwind.

⁹ 2550/2600 really represents 15/15.5x trailing 2019 earnings between \$165-\$172. This also lines up with our fundamental analysis.

¹⁰ Obviously, many variables can make us change this viewpoint from today.

At this stage in the current cycle, we see **deflation in things we want, inflation in things we need**. In other words, the necessary (or inelastic) things in your life like food, gas, daycare, etc. will cost more, taking money away from things you want (elastic), like home delivery, premium subscriptions, etc. However, we see many companies sacrificing price to retain business, meaning profit margins are due to disappoint.

At the highest level, the lifeblood of US corporate profits can be boiled down to four variables: trade (\$USD), energy, interest rates, and labor costs. Over the past 30 years, all four of these have concurrently been higher year-over-year only 5 times.¹¹ iv As the chart below illustrates, the most obvious observation is how this is a late-cycle event. However, as we look closer between the late 90s and today, the similarities are striking. **Between 1997 – 2000 & 2014 – 2017, the price of oil declined 50%, interest rates declined 20%, unemployment went from 5.5% to 4%, and the dollar steadily climbed.** Two eras twenty years apart, same results. Also, the outputs are similar as well – *emerging markets underperformed + tech sector outperformed during both 3 year periods!*



**** This chart illustrates the year over year change in the 4 inputs stated, with the gold bars representing when all were positive concurrently.**

Valuation Matters.

The 2000 downturn was really known as the tech bust seeing as the late 90's brought on the tech boom. In hindsight, every cycle can be seen through the lens of deflating something that became overheated. Commodities, technology, houses, etc. The magnitude (depth) of the

¹¹ Using quarterly data, year over year. The chart only shows annual data for readability purposes.

downturn really amounts to the systematic risk¹² held by these overheated assets. For example, the 2000 downturn was very mild – GDP slowed, unemployment went up a little, etc.,¹³ but unless you owned a portfolio full of pets.com or worked for a tech start-up, chances are you were relatively ok. In contrast, there was the 2008 recession involving housing – where roughly 67% of all households owned or financed a home.^v Housing is very integrated and critical to the US economy (unlike .com stocks in 2000); and as a result, we saw one the worst downturns in recent history.

And now? The economy will certainly slow as the recent fiscal stimulus dissipates through 2020, but in our view - there is no “financial time bomb” on the horizon. However, a general reset of financial markets seems very plausible (if not happening right now), as a higher cost of doing business becomes reality from the abnormally low cost environment experienced since 2008.

Therefore, we are in the camp of “mild economic slowdown, little systematic risk, and asset prices resets from high valuations.”

Something we hear a lot in talks with other investors: “valuations aren’t near what they were in 2000.” This is absolutely true looking at the general indices, but we advise to look deeper. The extreme valuation excesses are there, just not as broad as 2000. Money and information move much faster today than at the turn of the millennium, so assuming we will reach the same broad over-valuation as 2000 seems a little far-fetched. One look at cryptocurrencies, marijuana stocks, & “subscription-everything” valuations will show that excesses are very much present.¹⁴

In our last piece, [“Opportunities on the Horizon”](#), we detailed some secular trends that seem very attractive to us at current prices. *DEED – Demographics, Emerging Markets, Energy & Electricity, and Data Analytics*. Outside of the fundamental cases made there; these themes remain attractive due to their lower valuation relative to the past few years. To us, the classic Howard Marks saying applies now more than ever, “Value is found in what you pay, not in what you get.”

These categories fit our macro framework as we direct our focus to assets with both exceptional valuations and secular tailwinds; navigating our way out of this late-cycle forest.

(Continue reading for further explanation & variables we keep an eye on through our market analysis)

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¹² A risk that will have large spillover effects. Not an idiosyncratic risk.

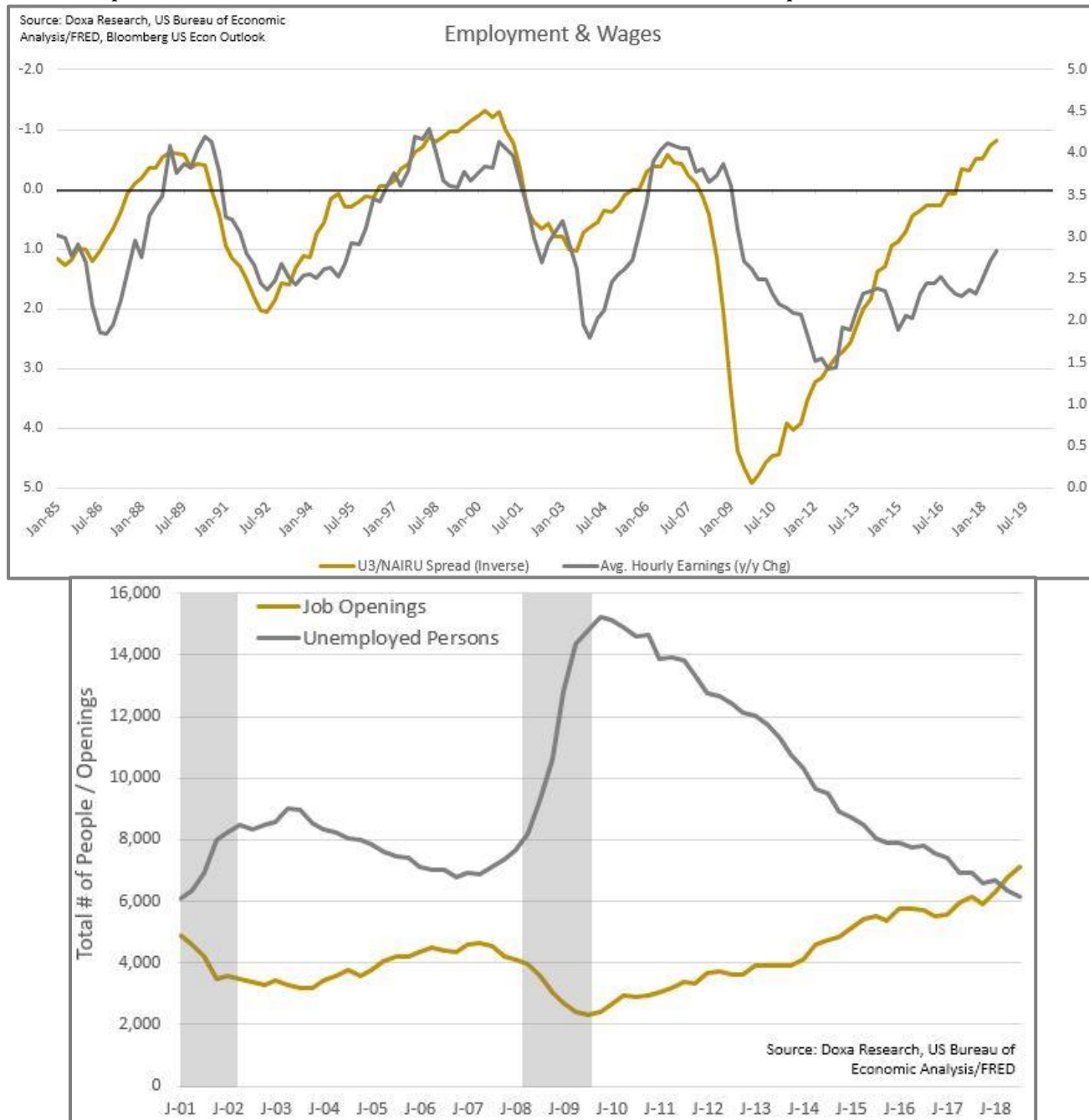
¹³ Real GDP was never negative through 2000-2002 (+1% was the low) & the unemployment rate peaked @ 6.1%, pretty low for recessionary conditions.

¹⁴ Given we were in the top decile of general market valuation across nearly every metric over the summer.

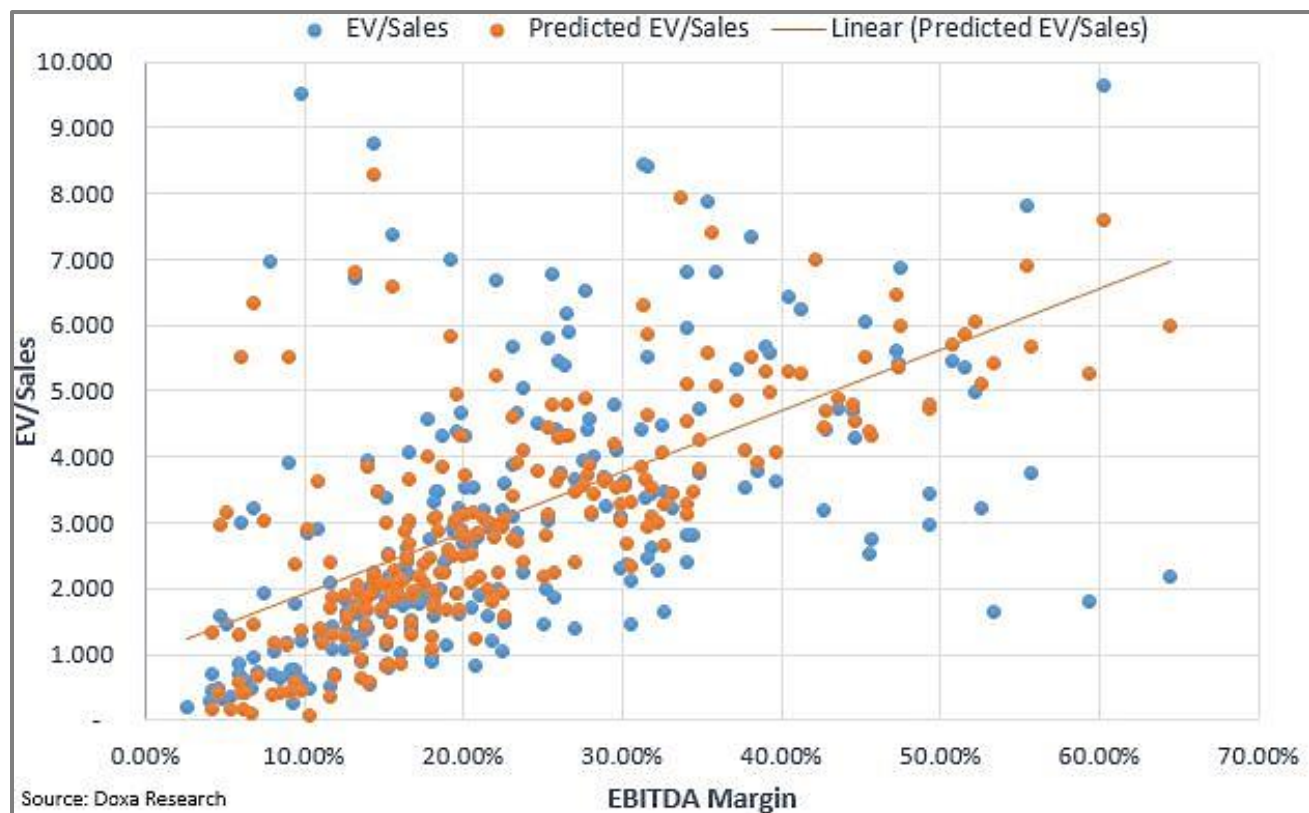
Forest for the Trees.

There are obviously many variables we look at as we discern what is just a tree (independent data) from what may be the beginning of a forest (dependent data), and there is no way I could effectively lay these out in 7/8 pages – nor would you want me to. However, I will try to marry all of these points through some select charts which hopefully will provide a clear picture of what we see today and how we see the future.

Show me the margin pressure. The chart on page six does a great job at showing the evolution of the four inputs of business over time, but here we will dive a little deeper into the labor market.



On top, we see full employment in effect and wage gains starting to close the gap. We expect this pressure to continue. *(Also note how mild job losses were in 2001 compare to other downturns.)*
The lower chart shows the number of people without a job vs. the number of job openings. Again, you can see the job market is very tight.



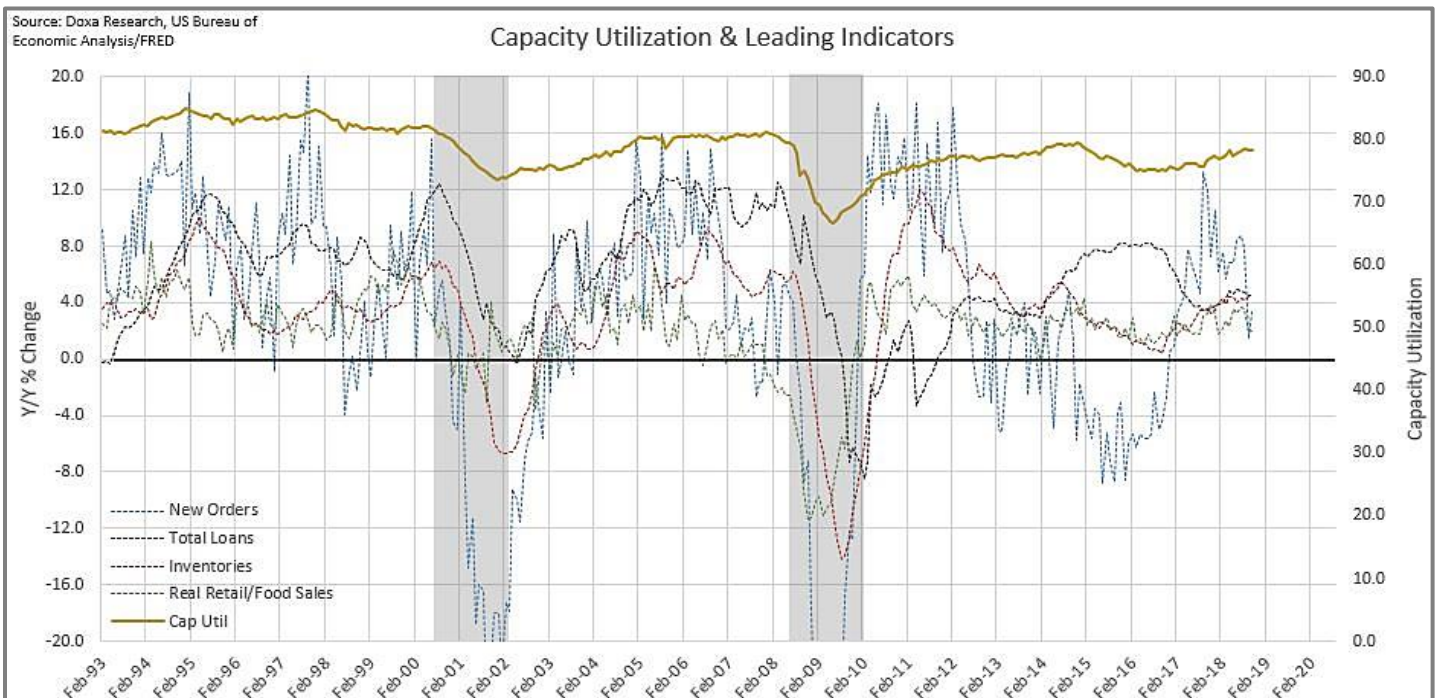
How does margin pressure effect valuations? There is no black and white answer here, but the regression below is a fairly good illustration. Although outliers reduce the correlation (R^2), you can see a good trend where lower EBITDA margins usually bring lower EV/Sales multiples.¹⁵

Another good example (**below**) of this can be seen in the financial sector. The less money you make (*return on equity*), the lower premium you have (*multiple over book value*).

¹⁵ EBITDA = Earnings before interest, tax, depreciation & amortization. Think solely operating profit. EV/Sales is a common multiple used that represents a multiple of current sales the firm is valued at.

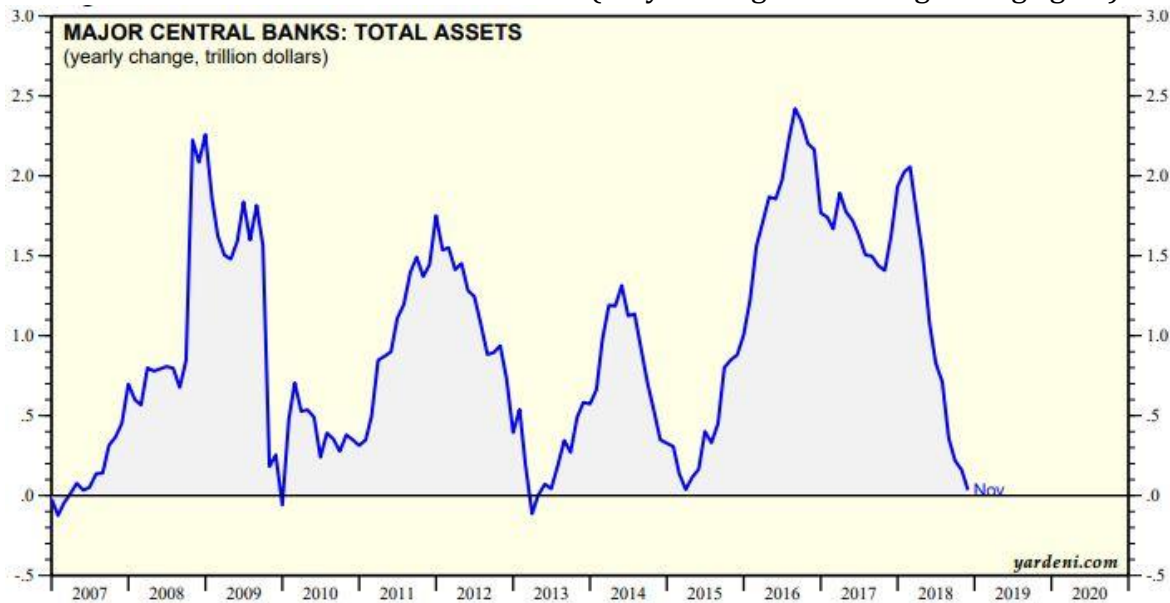


Is the economy about to be in distress? Or is it booming? Looking at some of the leading indicators we watch, *neither*. I know this chart looks noisy, but it's not showing clear signs of deterioration (very noticeable from 2006-2008), nor aggressive acceleration. Loans are slightly weak, inventories are a little high, retail sales are fine, and new orders are retracing from the energy recovery. To us, this isn't showing 'deep recession' nor 'big expansion'.

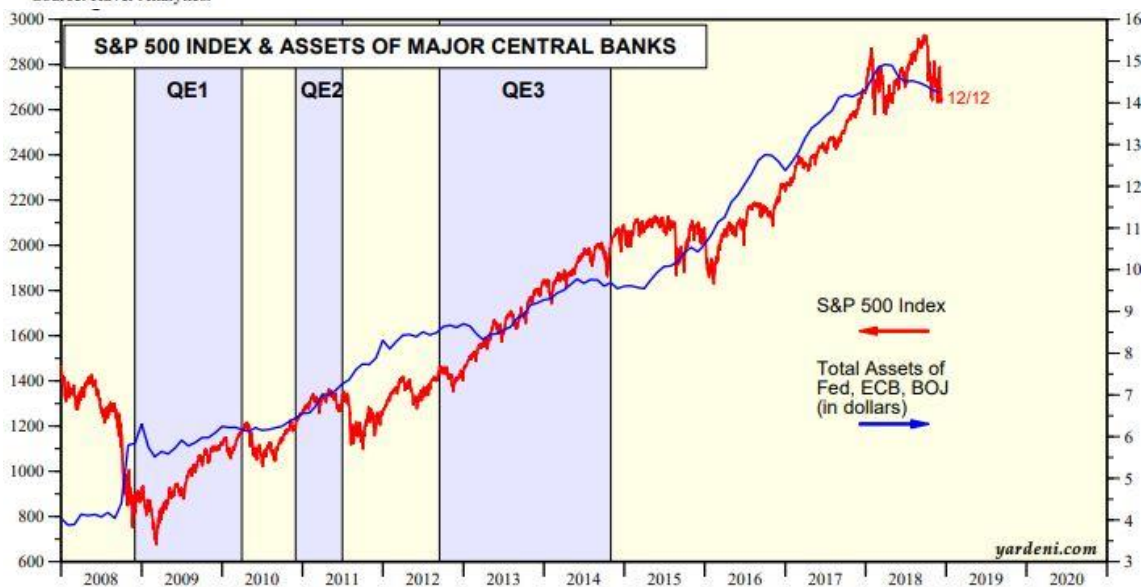


So we are in the forest (slowdown), it doesn't appear to be that deep (severity) – but what are the potential dangers lurking? Clearly this is a hard one to answer – but the two unknown problem areas out there are global quantitative tightening and corporate debt.

On central bank tightening:^{vi} This is hard as we are very far into uncharted territory of central bank balance sheets. In short, the Federal Reserve, ECB, BoJ, & others wanted to provide additional liquidity to boost global growth, *i.e. supply the world with money*. 2018 marked the first year that the money tree stopped growing globally. Clearly volatility rose and asset prices fell, but how much does this reduction of liquidity matter? **It is really hard to tell. This is a prime unknown risk to markets – in both directions (they could get the tree growing again).**



Source: Haver Analytics.

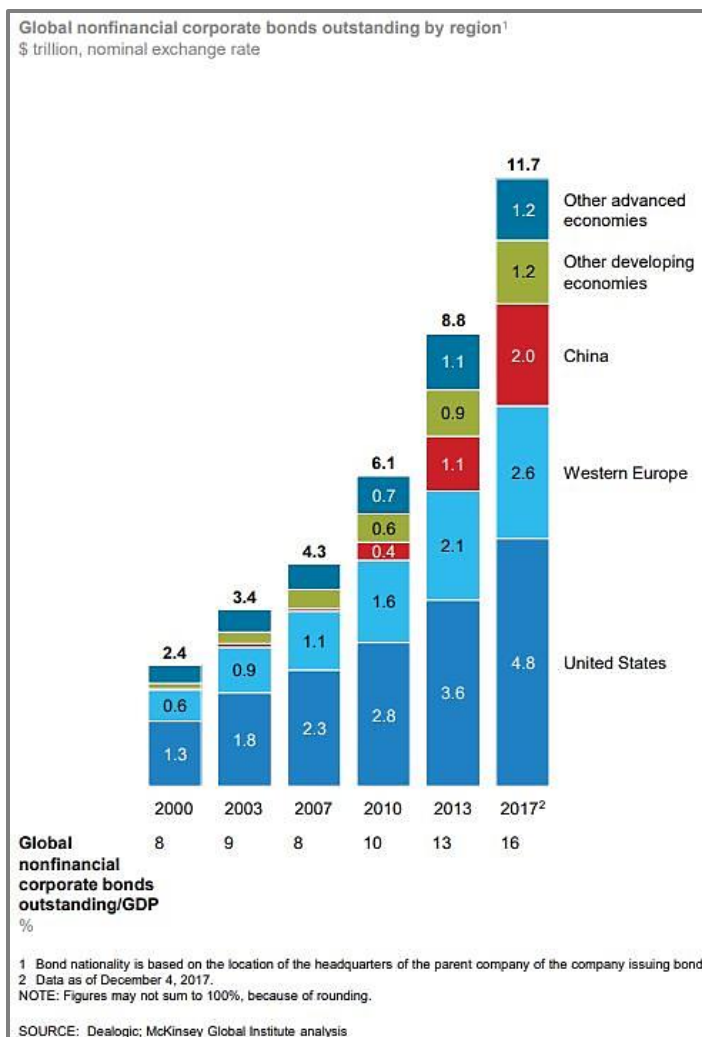


Note: QE1 (11/25/08) = Fed starts buying \$1.24tn in mortgage securities. QE1 expanded (3/16/2009) = Fed starts buying \$300bn in Treasuries. QE2 (11/3/10) = Fed starts buying \$600bn in Treasuries. QE3 (9/13/12) = Fed starts buying \$40bn/month in mortgage securities (open ended). QE3 expanded (12/12/12) = Fed starts buying \$45bn/month in Treasuries.
Source: Federal Reserve Board, Standard & Poor's and Haver Analytics.

Corporate Debt:^{vii} This is much more understood than the unwinding of QE. Corporate debt, especially levered loans & BBB-rated debt is very high. Companies have taken advantage of cheap money for nearly ten years. The problem here isn't necessarily with the level (although it's very elevated), it is more about what companies did with the debt proceeds.

For example, if you were given \$100 and invested in 10% yielding project, after one year you could pay back the \$100 plus interest, let's say \$2, and have \$8 left over. But if that project went wrong and yielded 0% or if you say, bought back shares (share buyback IRR = expected dividend yield), then you are left with debt you can't pay back – so you issue more to cover it.

The risk here is that this debt has been building up for 10 years now; any sort of external shock could really send waves through those levered to the loans affected. Not really 'money-center' banks per se, more non-bank lenders, insurers, shadow lenders, etc. **Nevertheless, this is something we are watching.**



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ⁱ Federal Reserve bi-monthly Beige Book report, Summary of Commentary on Current Economic Conditions. All 2018 issues. From Sept: https://www.federalreserve.gov/monetarypolicy/files/BeigeBook_20180912.pdf

ⁱⁱ Per Bloomberg & Capital IQ.

ⁱⁱⁱ Wilson, Michael, Morgan Stanley 2019 US Equities Outlook, November 26, 2018

^{iv} Taken from FRED and EIA data going back to 1988 – as far as series allow.

^v http://www.freddiemac.com/research/insight/20181205_major_challenge_to_u.s._housing_supply.html

^{vi} Both charts taken from Yardeni Research: <https://www.yardeni.com/pub/peacockfedecbassets.pdf>

^{vii} Chart taken from "Rising Corporate Debt" by McKinsey:

<https://www.mckinsey.com/~media/mckinsey/business%20functions/strategy%20and%20corporate%20finance/our%20insights/rising%20corporate%20debt%20peril%20or%20promise/mgi-rising-corporate-debt-discussion-paper-oct-2018.ashx>

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