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SBH NEWSLETTER

Thoughts on the Current Environment

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> ***"More money has been lost because of four words than at the point of a gun. Those words are 'This time is different.'"***
>
> -Kenneth Rogoff and Carmen Reinhart, *This Time Is Different: Eight Centuries of Financial Folly*

We enter the New Year a decade removed from the Great Recession. That is about the length of time that two economists, Kenneth Rogoff and Carmen Reinhart, in their 2009 book, *This Time Is Different*,[1] showed that it took for an economy to work its way through the rubble of a major asset collapse and expect growth to resume at or near pre-crisis rates. Today, we find the financial markets positioned in a truly remarkable fashion. Interest rates are priced at near Depression levels. Indeed, a working paper from the Bank of England published during the fourth quarter of 2017 showed that when the 10-year U.S. Treasury Note reached 1.37% on July 5, 2017, it represented a 743-year low in interest rates.[2] That number is not a typographical error. The study traces the yields on sovereign debt going back to the year 1273, and no interest rate is lower. At the same time, stock markets around the globe are reaching all-time highs. Valuations in the U.S. are at the higher end of "normal ranges" and, by some measures, are near all-time highs. And to wrap it up in a bow, measures of volatility are trading at or near the lowest levels ever recorded. In other words, bond investors and stock investors are blithely continuing to buy with little or no regard for any risks, sociopolitical or economic.

What's a poor investment manager to do? Normally, we receive many calls from clients at year end to see if there are tax losses to be harvested. But not this year. (In a strong year like 2017, losses? Hah!). Instead, they were asking if the time

[1] Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

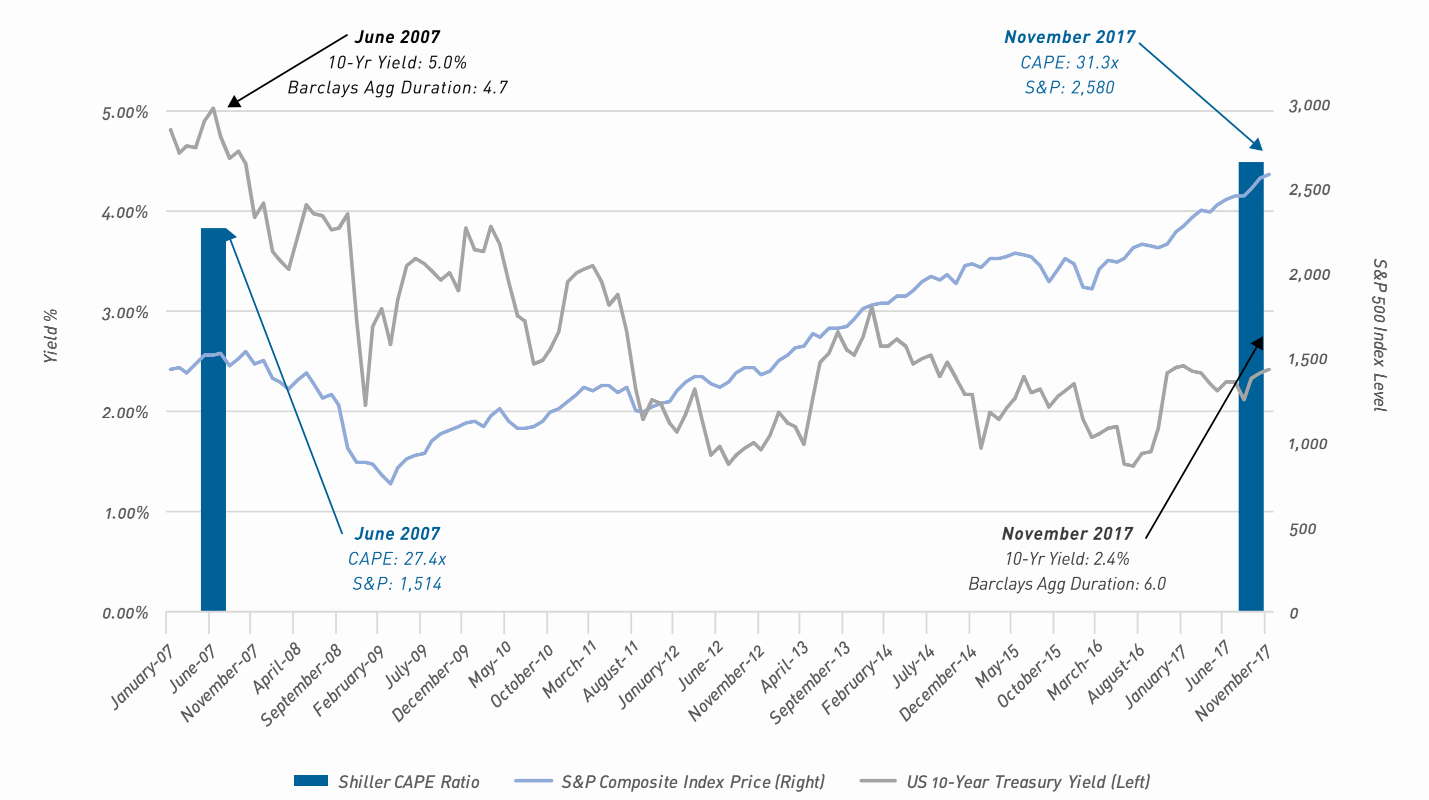
[2] Paul Schmelzing, "Staff Working Paper No. 686: Eight centuries of the risk-free rate: bond market reversal from the Venetians to the "VaR shock.'" Bank of England, London, October 2017.

was right to reduce their equity exposure in a meaningful way. The asset class one usually thinks of as the driver for a long-term portfolio—equities—aren't compellingly cheap unless one adjusts earnings higher due to the new tax bill, about which we comment further below. If one wanted to search for diversified sources of portfolio return, one would have to look long and hard. Fixed income holdings—bonds—are one such source. But interest rates are trading, as indicated, at historically low levels. It would be hard to protect the market value of bonds, other than those with very short maturities, if interest rates rose just a bit. The chart below lays out the problem. Prior to the stock market crash of 2008–09, the Shiller Cyclically Adjusted Price-to-Earnings ("CAPE") Ratio reached a peak of 27x earnings.[3] Interest rates at that time were 5%, as measured by the 10-year U.S. Treasury Note, a key reference point for bond market purposes. Not only was the yield in the range of "reasonable," the duration of the broad bond market was 4.7, as measured by the Barclays U.S. Aggregate Bond Index.[4] What this meant was that if one left the stock market and invested in bonds—and interest rates continued to rise—the value of the bond portfolio might fall by about 4.7% for every 1% rise in interest rates. Even if prices fell by 4.7%, the coupon yield would keep overall capital intact. Bonds, in other words, could function as a store of value and provide a relative safe haven.

Today, after 10 years of an almost continuous rise in the stock market, the Shiller CAPE Ratio is 31x, and the yield on the 10-year U.S. Treasury Note has fallen to 2.4%. The duration of the bond market has risen to 6.0. This means that, unlike the experience 10 years ago, bonds would provide much less shelter in a stormy stock market environment. The market value would likely decline 6% for every 1% rise in interest rates from their historic lows. If rates rose 1%, the price decline of 6% would not be fully offset by the coupon. This, of course, is not meant to suggest interest rates will go up. It is only to observe that it is harder today for bonds to provide their traditional "store of value" role as a hedge against a stock market decline.

Other asset classes to consider are either as expensive as bonds are or they have not demonstrated the capacity to provide a source of diversified return for quite a while. Private equity and venture capital are thought to be richly priced, which makes sense because their pricing is ultimately contingent on valuations in the stock market. Hedge funds are often viewed in a bad light these days. Investors have become unhappy about the high fees associated with hedge funds, and in many cases, hedge funds have not produced competitive returns on either an absolute or risk-adjusted basis.

U.S. EQUITY VALUATIONS VS. U.S. BOND MARKET RATES



Note: The Shiller CAPE Ratio is defined as price divided by the average of 10 years of earnings (moving average), adjusted for inflation. "Barclays Agg" refers to the U.S. Barclays Aggregate Bond Index, which is the most common index used to track the performance of investment grade bonds in the U.S.

Source: Bloomberg, FactSet

[3] The Shiller CAPE Ratio is defined as price divided by the average of 10 years of earnings (moving average), adjusted for inflation. The ratio was made popular by Nobel Prize-winning economist Robert Shiller.

[4] "Duration" is a bond-market term that measures the sensitivity of the market prices of a bond (or a portfolio of bonds) to a given change in interest rates. We are simplifying considerably.

All of these trends can be understood if viewed as part and parcel of the same driving force in the global markets: the Quantitative Easing (QE) programs that global central banks have implemented since the Great Recession. QE, keeping interest rates pinned near zero, has been in place for nine years. In that time, stock markets have generally gone in one direction (up) as interest rates have also generally gone in one direction (down). There was no need to hedge anything. The only direction a price could go was the one it went in yesterday and the day before that and the day before that, and so forth.

Change, however, may be in the wind. The U.S. Federal Reserve (Fed) is ending QE in this country and has begun raising short-term interest rates. The European Central Bank (ECB) is talking about the possibility of rate increases in 2018. Policymakers have concluded that the global economy may be able to sustain and perhaps increase growth without the need for the extraordinary stimulus that QE represented. If so, this would surely be good news for labor as it would mean continued growth in jobs and possibly more upward pressure on wages as unemployment falls. Paradoxically, such good news could be bad news for the financial markets. It is axiomatic that available liquidity in an economic system flows to the "real economy" first and only to the "financial economy" if "real" demand for liquidity is soft relative to the supply. If the needs for liquidity in the "real economy" stay strong or grow larger at the same time the Fed is reducing supply, the financial markets could suffer. Last year may have been Wall Street's year, but this year could belong to Main Street.

Questions Clients Have Raised:

We have been asked about the tax bill that was recently passed by Congress and its implications for the markets. The tax bill, to the extent it increases the federal deficit, is essentially a variant of Keynesian fiscal stimulus. Instead of the deficit rising due to increases in spending, this one will be driven by reductions in tax receipts. While both political parties have their own point of view on which method is more effective and/or equitable, the intended effect is the same: to stimulate economic growth. As for the question of "who wins" and "who loses" on the business side of the bill, we believe it is far too soon to clearly discern winners and losers. Milton Friedman famously said that corporations don't pay taxes, people do. By that he meant that the tax burden on a corporation (or correspondingly, the lifting of that burden) falls on customers, employees and shareholders in varying degrees, depending on the industry, the overall economy and a host of factors too complex to be able to sort out quickly. From our perspective, it is yet another factor to be considered in our fundamental assessment of a company and its prospects. In light of that, we would broadly suggest that those companies that we think have good competitive positions and smart management teams will be the beneficiaries of this bill and that some companies that might superficially appear to be beneficiaries, but are not well positioned or well managed, may see those benefits eroded away by market forces. As for individuals, it is also too soon to tell who will win and who will lose, but the benefits to most wage-earners will reflect itself in lower withholding very quickly in the new year.

We have also been asked our views on Bitcoin and the various electronic "currencies" that have been introduced in recent years. In late December, futures markets in Bitcoin became available. Bitcoin and its variants can be looked at either as an investment (like buying stocks, bonds or venture capital) or it can be looked at as a new form of money. If it is the former, some have suggested that it might be an asset class all its own. Our preference would be to consider Bitcoin as yet one more commodity. It is, after all, "mined," and there is a finite amount of it. If it is a commodity, it will be subject to the laws of supply and demand, which means that the price of a Bitcoin should converge towards its cost of production. The cost of "mining" (creating) a new Bitcoin is the electricity used to run huge computers through countless cycles trying to find the solutions. No one quite knows what that will cost, but some have tried to cast it in unusual ways. For example, the current cost has been compared to the electricity bills for nine typical homes in the U.S. for a year. Another forecast, likely far-fetched, suggested that the electricity consumption needed by 2019 will equal the total residential consumption of electricity in the U.S. (Perhaps we should think about investing in utilities! Or perhaps we should never forget the deflationary effects of technology. Development of a quantum computer could bring forth all the Bitcoin to be mined in a matter of a day or two.) Prices could rise above production cost if there are shortages relative to demand. But demand for Bitcoin is not an imperative for economies, unlike oil or grains, that exist almost irrespective of short-term price fluctuations. Mankind has made it for thousands of years without Bitcoin and could survive without it. As a commodity, it has all the trappings of "Tulip Mania" in Holland in the mid-1600s. To briefly summarize, tulips were introduced into Holland in the early 17th century and rapidly became a prized status symbol among the wealthy (the 1% of the day, if you will). As demand for rare versions increased, prices began to rise, and the trend fed on itself. The creation of an active futures market allowed speculation to easily flourish. The frenzy lasted about six months. At its peak, the price of a tulip was as much as the annual wage of a worker. When the craze fell out of favor and the bubble collapsed, fortunes were lost.[5]

Alternatively, Bitcoin can be thought of as money. As that noted political economist Homer Simpson has explained, "Money can be exchanged for goods and services."[6] Money is "money" because it is a commonly agreed upon and accepted medium of exchange. We see one major impediment in Bitcoin ever being considered money. Advocates of Bitcoin like to compare it to gold for the important reason that neither gold nor Bitcoin are dependent on the strength of any government—the ultimate backing for paper currency, be they dollars, euros, pounds or yen—to have value. To be a bit technical, that means that neither gold nor Bitcoin have any "counterparty" risk; their value resides intrinsically in each, while paper money is only as strong as the government issuing it. Governments, after all, have been known to print a lot of money to deal with their financial problems.

[5] Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds*, originally published in London, 1841.

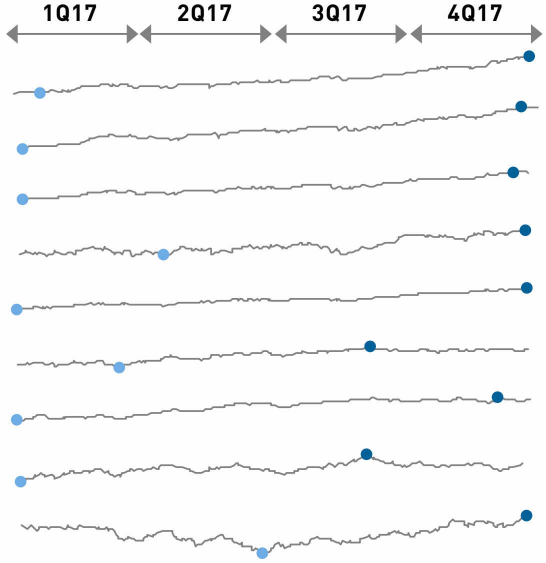
[6] "Boy Scoutz 'n the Hood," The Simpsons, Season 5, Episode 8. Originally aired Nov. 18, 1993.

Bitcoin, however, has one other risk that gold does not, and it would matter in a pinch. That risk is "agency" risk, which simply means that one may have Bitcoins which have value, but a holder may be unable to access them. Think of the following example as a stress test of this scenario. Assume you are traveling somewhere abroad. While you are there, civil unrest breaks out. Normal life is disrupted and foreigners are advised to leave. You discover that airports and train services are shut down and that roads are blocked. You head for the water (this city is located near an ocean or sea) and you find a small cargo ship whose captain is willing to take one more passenger before he leaves. You offer him some gold coins you are carrying to pay for your passage, but the person next to you offers to pay double that price, in the form of Bitcoin. He says to the captain, "I will pay you double that price in the form of Bitcoin. Can you give me a minute so I can find a good connection to the internet...." Who do you think the captain leaves port with?

We wish you smooth sailing on any voyages you may be making and a very happy and healthy 2018.

MARKET BAROMETERS
AS OF DECEMBER 31, 2017

	Dec. 31, 2016	1Q17 2Q17 3Q17 4Q17	Dec. 31, 2017	Low	High
Dow Jones Industrial Index	19,762.60		24,719.22	19,732.40	24,837.51
S&P 500 Index	2,236.20		2,673.61	2,236.20	2,690.16
Russell 3000 Stock Index	1,331.72		1,582.77	1,331.72	1,591.96
Russell 2000 Stock Index	1,357.13		1,535.51	1,345.24	1,548.93
Russell Midcap Growth Index	782.97		970.34	782.97	976.16
Barclays Aggregate Index	1,967.23		2,036.91	1,957.61	2,044.95
Barclays Muni Bond Index	1,139.51		1,201.59	1,139.51	1,205.11
Gold (Price/Oz) London AM Fix	1,159.10		1,296.50	1,148.65	1,350.90
Goldman Commodity Index	2,417.31		2,556.71	2,053.66	2,556.71



Source: Bloomberg

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