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Investment Strategy

"Not Afraid!"

We have used this story before, but we like it . . .

> Around the turn of the century a bandit rode in from Mexico, robbed a small Texas bank and fled back across the border. A Texas Ranger picked up his trail and nabbed him in a Mexican village. The bandit spoke no English and the ranger no Spanish, so another villager was asked to interpret.
>
> "Ask him name," said the ranger.
>
> "He says his name is Jose," said the interpreter.
>
> "Ask him if he admits robbing the bank."
>
> "Yes, he admits it."
>
> "Ask him where he hid the money."
>
> "He won't tell me."
>
> Leveling his pistol at Jose's head the ranger said, "Now ask him again where he hid the money."
>
> Jose quickly blurted out in Spanish, "The money is hidden in the well in the village square."
>
> "What did he say?" demanded the ranger.
>
> The interpreter replied, "Jose says he is not afraid to die!"

We have used the "Not Afraid" story many times over the past 48 years, but we dredged it up again this morning because of the many questions about "being afraid" we got in Boston two weeks ago and New York City last week. Said questions came from our financial advisors (FAs), their clients, and even some portfolio managers (PMs). The questions went something like this, "Hey Jeff, aren't you afraid of (you can pick one) valuations, trade tariffs, Turkey, the currency crisis, rising interest rates, slowing growth in China, the flattening yield curve, etc." Our response has been a resounding, "Not really." So, let's attempt to speak to these questions in order. On valuation, the most overvalued chart we know of is the S&P 500 Price-to-Sales-Ratio chart. We do not have a really good counter argument to this other than to say sales are surging - implying valuations, according to this metric, may be reduced in the future. The next most expensive chart is market capitalization to GDP, Warren Buffett's preferred market valuation gauge. Hereto, we do not have a really good counter argument other than to say GDP has been growing at a subnormal rate for eight years, but recently has increased rather dramatically. This suggests this indicator may look more reasonable in the quarters ahead. As for the price to book value, we have argued for a decade that book values are understated. For instance, until the recent corporate tax code, a company would buy a piece of capital equipment and depreciate for, say, seven years, even though the effective life of the equipment was 30 years (read: book value understated). Turning to price to earnings measurements, if you believe S&P's earnings estimate for 2019 (~$177), at the February 9, 2018 "undercut low," which we told folks to buy, the S&P 500 (SPX/2850.13) was trading at 14.3 times next year's earnings.

Moving on to trade tariffs, we have said we do not think a major trade war is coming; just read DJT's book, "The Art of the Deal" for the reasons. That said, so far there have been 25% tariffs imposed on roughly $110 billion worth of goods ($55 billion by the U.S and the same by China). Last year the total goods relationship between the two countries was some $635 billion. Ladies and gentlemen, 25% of $110 billion is $27.5 billion. Divide that into the total relationship ($110 ÷ $27.5 = ~4%) equals about 4% of the total goods relationship. No wonder the stock market is ignoring the trade tiff so far.

As for Turkey, we think it is non-impactful. The same can be said for the currency fluctuations. Interest rates are certainly up, but they are rising at such a slow rate, and from generational lows, hereto we believe it to be non-impactful. China's slowing growth is a much bigger risk than any of the aforementioned metrics, but China recently announced a bunch of new

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infrastructure projects ($11 billion) in an attempt to reignite its growth prospects. In past missives we have discussed why the flattening yield curve is not a problem because it is driven by short rates increasing at a much faster pace than long-dated rates due to international money flows. Moreover, we have argued that participants are currently using the WRONG yield curve. Back in the day, the yield curve was the relationship between the 13-week T-bill and some longer dated Treasury security (most often it was the 10-year T-note). Using that as our metric, the yield curve is nowhere near inversion, QED!

So, early last week, and late the week before, we wrote that our models suggested early weakness should show up last week with support coming at the 2790 – 2800 level basis on the SPX. We further opined that if we were at our trading turret, rather than doing gigs for our FAs and their clients, doing media, and seeing PMs in New York City, we would have bought the Wednesday Wilt. We also noted that if the SPX could better the overhead resistance in the 2850 – 2855 area new all-time highs should be forthcoming. Well, last Friday's intraday high was 2855.63, but it was not sustained into the closing bell with the SPX notching 2850.13. However, news surfaced that an agreement would be forthcoming with China on the tariffs by November, so we will see how the markets behave this week. Whatever the resolution, we will not be around to see it, having journeyed to California to see accounts and do some gigs for our FAs.

The call for this week: Last Thursday we did a 20 minute segment on CNBC from the floor of the NYSE. Our message was pretty clear in that our models "said" to raise some cash in January and put at least some of that cash back to work at the February 9, 2018 "undercut low," in expectation of new all-time highs in the months ahead. More recently we looked for weakness early last week that would be contained in the 2790 – 2800 level on the SPX, which should be bought. Over the past number of weeks we have tried two times to trade out to new all-time highs. As stated, typically the first few attempts to do so tend to fail. However, on their third attempt new highs typically are achieved. The energy models are all "charged up" as the equity markets enter an upcoming bullish time period. This implies the potential for a strong upside breakout this week. With short-sellers having major stop-loss "buy orders" just above the all-times highs, the stage is set for them to get "blown out" with a sudden rush to new all-time highs. The question then becomes, "Is this an upside breakout, or an upside fake-out?!" We think it will be a breakout as the specialists' stop-loss "order book" gets cleared out.

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