



PACIFICUS  
CAPITAL MANAGEMENT

INVESTMENT OUTLOOK – SEPTEMBER 2019

## Sex Sells, and So Does Fear

*“Be as smart as you can, but remember that it is always better to be wise than to be smart.” - Alan Alda*



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Fear sells. People rarely turn to their news source of choice to read or hear how everything is going great. For many of us, good news is just too boring. The public wants to consume drama – real life stories with good guys and bad guys, victims and heroes. As humans, our brains tend to over-react, placing far too great a weight on improbable events in the moment. The older we become, the more real-life experience we possess, which partly has the effect of mellowing us out a bit, as many worst case scenarios of days past fail to have been realized. These experiences we gain over time and ultimately learn from are commonly referred to as *wisdom*.

Today, almost everyone who reads or listens to financial media has been made aware that the yield curve for U.S. Treasury bonds is either flat or modestly inverted. As a quick reminder to readers, a flat yield curve is where short term interest rates barely differ from long term interest rates, whereas an inverted yield curve is one where short term interest rate are higher than long term interest rates. Both flat and inverted yield curves are considered abnormal as investors usually require higher rates of return for investing money over longer periods of time.

Market commentators wonder out loud how this could adversely affect stock prices, while some economists blindly use the yield curve factor as a predictor of a future recession. I look at things differently. To me, the yield curve simply signals that monetary policy in the U.S. (the Fed Funds Overnight Interest Rate) is too tight (too high) for our predicted economic trajectory. This leads me to conclude that in order to put things back into balance, the Fed will need to lower their target rate, which in turn will likely normalize the shape of the yield curve if done both decisively and aggressively.

Over the past few months, I have expressed mostly optimism regarding equity prices. The main reason being increased monetary stimulus from the Fed, as well as the other major central banks. My personal view on the economy is that we have clearly been slowing down, but not so much that we are likely entering a recession. Of course, should the Fed stay too far behind the curve for too long, the probability of a recession increases. My base case outlook is for lower economic growth, persistently lower than expected inflation, accompanied by lower bond yields and higher stock prices.

Fear mongering garners attention in the media, sells newsletters and usually sounds smart as it tends to appear critical compared to naive sheep blindly following the herd. But maybe we have it backwards? Maybe human beings are hardwired to avoid danger and so we see the potential for future hazards (both real and imagined) behind every rock. For me, it is usually not easy remaining optimistic on markets or many other things in life for that matter. It's a frequent internal fight which I consistently work to overcome. I am guessing I am not alone here.

For those, like myself who need a little nudge in the direction of optimism, I have compiled a short list of reasons why the U.S. stock market could continue to rise. I am actively considering the below factors into my broad analysis among others.

- The Fed through easier monetary policy is actively trying to support growth.
- President Trump, who is seeking re-election is also doing all he can to promote growth.
- Fiscal policy is expanding – The annual U.S. budget deficit is expected to be over \$1 trillion.

- Nominal rates in the U.S. are around 1.5-2.0% while inflation is also around 1.5-2.0% and unlikely to deviate much. Therefore, real yields are at 0%.
- Interest rates are at historic lows which means capital allocation decisions based on low hurdle rates are in favor of risk takers.
- People in the U.S. are employed with steady to rising wages.
- According to Cumberland Advisors, the projected P/E ratio for U.S. stocks in 2020 which assumes a 6.5% gain in earnings per share from 2019, trades around 16.4 times earnings, which is very close to the 50 year average.
- Inverted Yield Curve – According the blog [“Market Ear.”](#) the U.S. stock market rises 75% of the time by an average of 8% over the subsequent six months once the 2yr vs 10yr yield curve inverts. *(yes, I know not enough data points)*
- The gap between the dividend yield on global equities and 10 year bond yields has now increased to 1%. So, not only is there inherent and unlimited potential upside in stock prices relative to bonds, but also the annual dividend payout for owning stocks makes them a viable alternative.
- Sentiment is negative – According to BNP Paribas Exane, U.S, equity funds have seen \$150bln of outflows over the last six months – bull markets usually start, not end when sentiment is this depressed.

Update – Over the past week or so we have seen a significant back-up in yields after a monster bond market rally throughout July and August. I mostly view this as a healthy short term correction and have a hard time fundamentally making the case for persistently higher yields from here. Keep in mind on an unhedged currency basis, U.S. interest rates are significantly higher when compared to the rest of the developed world. According to NatWest Markets, Japan who knows their way around both zero and negative interest rates has recently been a large buyer of U.S. paper. Japan is one of the largest and most active investors in the U.S. bond market and produces demand from both the public and private sectors. From my experience, if Japan has wood to chop, they keep on chopping.

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	NEUTRAL	UNDERWEIGHT
U.S. Real Estate Equities	Materials Sector	International Developed Market Equities
Large Capitalization Technology	Communication Services Sector	Financial Services Sector
Emerging Markets Equities	Healthcare Biotech & Pharmaceuticals	Consumer Discretionary Sector
Healthcare Equipment	Consumer Staples	High Yield Corporate Bonds
Aerospace & Defense	Investment Grade Corporate Bonds	Leverage Loans (Floating Rate Debt)
U.S. Treasury Notes & Bonds	Mortgage Backed Securities	Treasury Inflation Protection Securities
Gold	Local Currency EMG Bonds	Small Capitalization Equities
	Energy Related Equities	

Sincerely,

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