Notes From the North: Market Outlook

August, 2019

Readers of <u>Barron's</u> may have seen the August 12th article entitled "Playing Defense as Bond Yields Slump." In it Joachim Fels, managing director of PIMCO, warns investors to prepare for a decade that looks little like the last. High returns on financial assets and low volatility may be turned upside down, resulting in low returns on financial assets and high volatility. This is a theme being espoused by a growing group of thoughtful investors.

Writing for Evergreen Gavekal, Louis-Vincent Gave provides the following list of the top 10 stocks by market cap at the end of each of the last 5 decades. His point is that changing investment conditions inevitably lead to the top stocks or stock groups falling out of favor. Over the last 10 years, investors favored the fastest growing firms and have paid up to participate in the FAANG (Facebook, Amazon, Apple, Netflix, and Google) and internet stocks. Gave thinks these issues could be vulnerable in the next decade.

The top 10 stocks by market cap seldom make it to the end of the next decade

1980	1990	2000	2010	2019 - June
IBM	NTT	Microsoft	Exxon Mobil	***Microsoft (US$1.035trn)***
AT&T	Bank of Tokyo-Mitsubishi*	General Electric	PetroChina	***Amazon (US$936bn)***
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple Inc.	***Apple (US$913bn)***
Standard Oil	Sumitomo Mitsui Banking*	Cisco Systems	BHP Billiton	***Google (US$766bn)***
Schlumberger	Toyota Motor	Wal-Mart	Microsoft	***Facebook (US$538bn)***
Royal Dutch	Fuji Bank	Intel	ICBC	***Alibaba (US$421bn)***
Mobil	Dai-Ichi Kangyo Bank	NTT	Petrobras	***Tencent (US$412bn)***
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	Johnson & Johnson (US$371bn)
General Electric	UFJ Bank*	Lucent Technologies	Royal Dutch Shell	JP Morgan Chase (US$360bn)
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	Exxon Mobil (US$320bn)

* Merged entities

Prominent beliefs: peak oil; US businesses are better run	Prominent beliefs: Japan is going to take over the world	Prominent beliefs: this time is different; US is big TMT boom winner	Prominent beliefs: peak oil, China is taking over the world	US is the cleanest dirty shirt; tech will deliver growth thanks to monopoly
Underweight the US and energy	Underweight Japan and banks	Underweight the US and TMT	Underweight China and commodities	*Fifth time lucky?*

Murray Stahl and his team at Horizon Kinetics address a similar thesis in their 2nd Quarter Commentary. While it is well known that information technology's weighting in the S&P has grown to 21.5%, Stahl observes that the over-concentration is actually even greater than that. He calculates that when you include stocks such as American Tower, at least 31% of the S&P 500 is highly dependent on the growth of the internet. These firms are expected to grow about 12% per year for an extended time period, but Stahl says this is impossible. As of March 2019, 57% of the world's population was using the internet. If growth were to continue at a 12% rate for the next five years, the global usage rate would be 100%. After which, growth would be negligible. Perhaps more to the point, the people who will gain access to the internet in the future are those with very low incomes, thereby limiting the amount of money they could spend on phones, online games, social media and goods purchases.

Ray Dalio, the founder of the extraordinarily successful hedge fund Bridgewater Associates, also believes the investment environment shifts significantly about once every 10 years. In his recent paper entitled Paradigm Shifts, Dalio makes the case that financial assets were pumped up in price by central bank policies. These policies have included a reduction in interest rates and the direct purchase of stocks and bonds. (The US Federal Reserve cannot buy stocks, but there are foreign central banks that can). He thinks central banks will continue to follow these policies over the foreseeable future, but that they will have diminishing effects on economic activity and asset prices. He believes that falling interest rates have given the illusion that investments are providing a good return, but in reality, the returns we have seen are just future returns that have been pulled forward. Future returns, by implication, then, will be lower.

Dalio is concerned that government debts and promised benefits have grown too large. At some point in the next few years, central banks will run out of stimulant to boost markets and economies at just the time when growth is weakening. If, as he suspects, governments are unable to meet their obligations, they will react either by sharply raising taxes (as Japan is about to do), or more likely by depreciating their currencies. Interestingly, currency depreciation has recently taken center stage in the investment world dialogue. As an aside, when all this happens, Dalio thinks investors will want to own some gold.

Of course, no one can know whether or when any of this will come to pass. As certain as Ray Dalio may be about his forecasted chain of events, even he admits he is uncertain about when the scenario will unfold. Similar warnings have been floating about for at least the last two years. For instance, in a 2017 article in the Journal of Portfolio Management, Robert Arnott (founder of Research Affiliates) claimed that price/earnings multiples tend to be lower when inflation-adjusted interest rates ("real" rates) are either too high *or too low*. Stocks do best when real rates are between 3% and 4%. In other words, perhaps investors should not have been buying these last two years on the basis of low interest rates. While Arnott may prove to be right in the end, his timing was poor. The S&P 500 has gained on the order of 40% since the beginning of 2017. In a recent update, he poses the intriguing question: "If the latest reduction in the U.S. Fed Funds rate is expected to push up stock prices, why haven't the negative interest rates prevailing in Europe and Japan helped *their* equity markets?"

Although frustrating, lower returns won't be disastrous unless one is counting on them to make up for overspending (or its corollary, under-saving). As well, going all-in on FAANG stocks in an attempt to achieve higher returns is likely to be a disappointing strategy (hopefully not woefully so, for those who try it). Furthermore, even wary investors should make note of where FAANG-type stocks might be lurking in places one might not suspect. For the record, none of our portfolios have a third of their equity investment highly dependent on continued growth in the internet, and although we have some FAANG stocks (and their ilk), most portfolios have nothing near a market weighting. It will be interesting to see what tops the list at the official end of the decade next year, and hopefully we'll all be around to see the top ten in 2030!

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