WILLIAMS
MARKET ANALYTICS

Weekly Commentary

For the trading week ending December 6, 2018

Three Landmines To Avoid In 2019

In a crazy trading week on equity markets, we saw the Dow Jones swing about 3,000 point between Monday's opening high, Thursday's panic low and the Friday high. For readers curious as to what news caused an extreme market movement, the answer will be disappointing: nothing. The Monday opening rally can be attributed to the Trade War truce declared over the weekend between the U.S. and China. For the rest of the week, this was just programme traders will sell algos. Some capitation after the Tuesday rout was likely due to uniformed investors being reminded that the U.S. Treasury yield curve is heading for inversion. However, the flattening of the yield curve has been occurring since early 2017, so it is presumptuous to blame this for the panic selling this past week. We did see the short-end of the curve invert (2 and 3 year yields slightly above the 5-year yield) but as a whole the yield curve is still upward sloping. Recall that an inverted yield curve is a tell-tale sign of impending recession.

Weekly Commentary

Macroeconomic data this week did not show any signs of impending recession, The ISM Manufacturing Index expanded to 59.3 in November, above expectations of a slowing to 57.5. Similarly, the ISM Non-Manufacturing Index expanded to 60.7 in November, again beating the consensus forecast for a slowing to 59.0. The preliminary December reading for the U. of Michigan Sentiment Index held at 97.5, suggesting that consumer spending should hold up through the Christmas season. On the weak side, Factory Orders and Durable Goods came in at -2.1% and -4.3%, respectively, for October. The November Non-Farm Payrolls report showed 155k job creations, below the consensus for 198k. Although, given concerns about Fed rate tightening, this should have been well-received by equity markets. Finally, as a rather comical aside, the Trade Deficit for October grew by -$55.5 billion, on track to reach $600 billion for the first time this year. The Trade Deficit has grown by more than $100 billion since Trump took office. Can Trump really claim to the winning the Trade War?

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Weekly Commentary

The Low-Hanging Fruit Has Been Picked

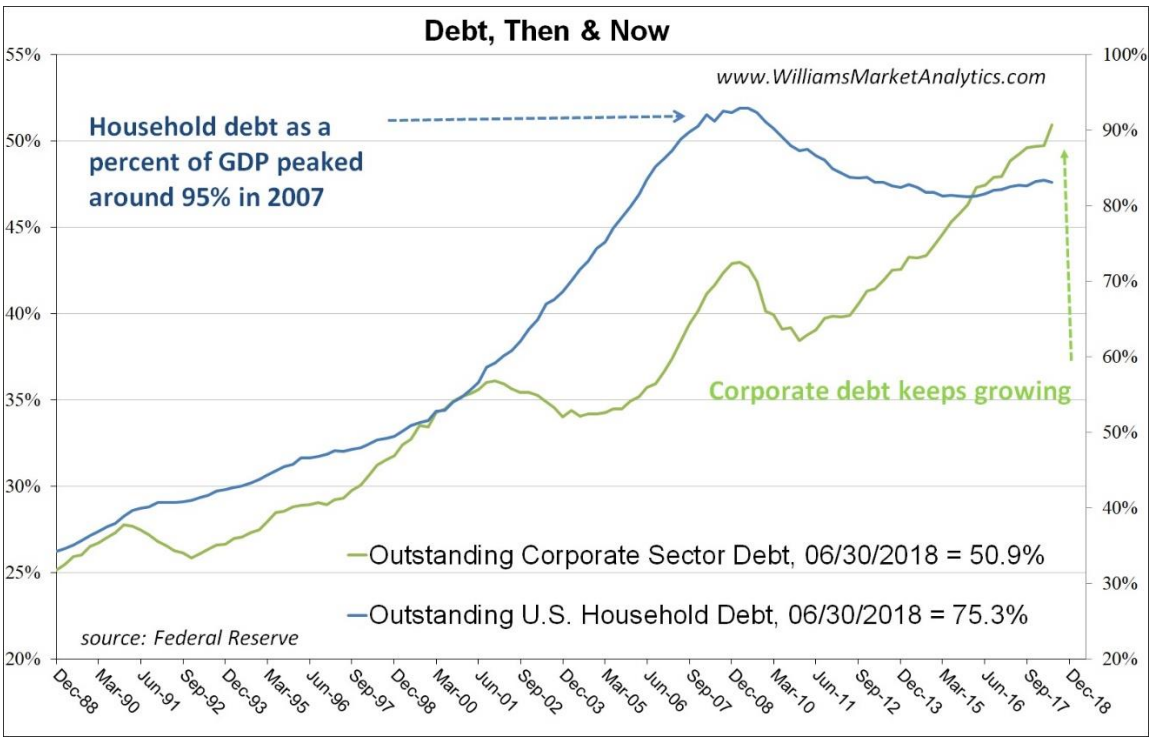
As we close out a challenging 2018 for equity investments, we now reflect on 2019 asset allocation. The "easy" one-way equity ride higher between 2016 and January 2018 will mostly likely **not** characterize the 2019 equity trade. In this week's Commentary, we identify the top investment landmines to avoid in the next year. 2019 maybe a year in which portfolio outperformance depends on what you don't buy.

1. Credit

Perhaps past is precedent. Twelve years ago, consumers refinanced home mortgages and borrowed against the (rising) value of their properties to buy big ticket items. Now it is corporations using cheap debt and the one-time Trump tax-cut windfall to take cash from balance sheets to pay shareholders in the form of dividends and share buybacks. The cash-outs have driven corporate debt to record levels. The similarities with the last debt crisis cumulating in 2007-08 are noteworthy. Expanding debt levels, like before, are juicing an already booming, late-cycle economy. And as before, the use of debt today by corporations is diverting capital from long-term productive investments to further inflate a financial bubble.

The end-game with the corporate credit bubble will likely be the same as 2007-08, and may be closer at hand than investment professionals believe. We could argue that credit markets have already attained bubble status. Over nine years of zero interest rate policy (ZIRP) nurtured an unprecedented thirst for yield on a global basis. The amount of covenant-less debt is now greater than just before the Great Financial Crisis in 2007.

According to Federal Reserve data, Outstanding Debt by Corporate Sector hit $15.38 trillion at the end of Q2 2018. Or, as a percent of real GDP, 50.9% (green line in chart below). The blue line shows the bust in household debt following the Subprime Crisis, which never recovered relative to GDP during this economic expansion.

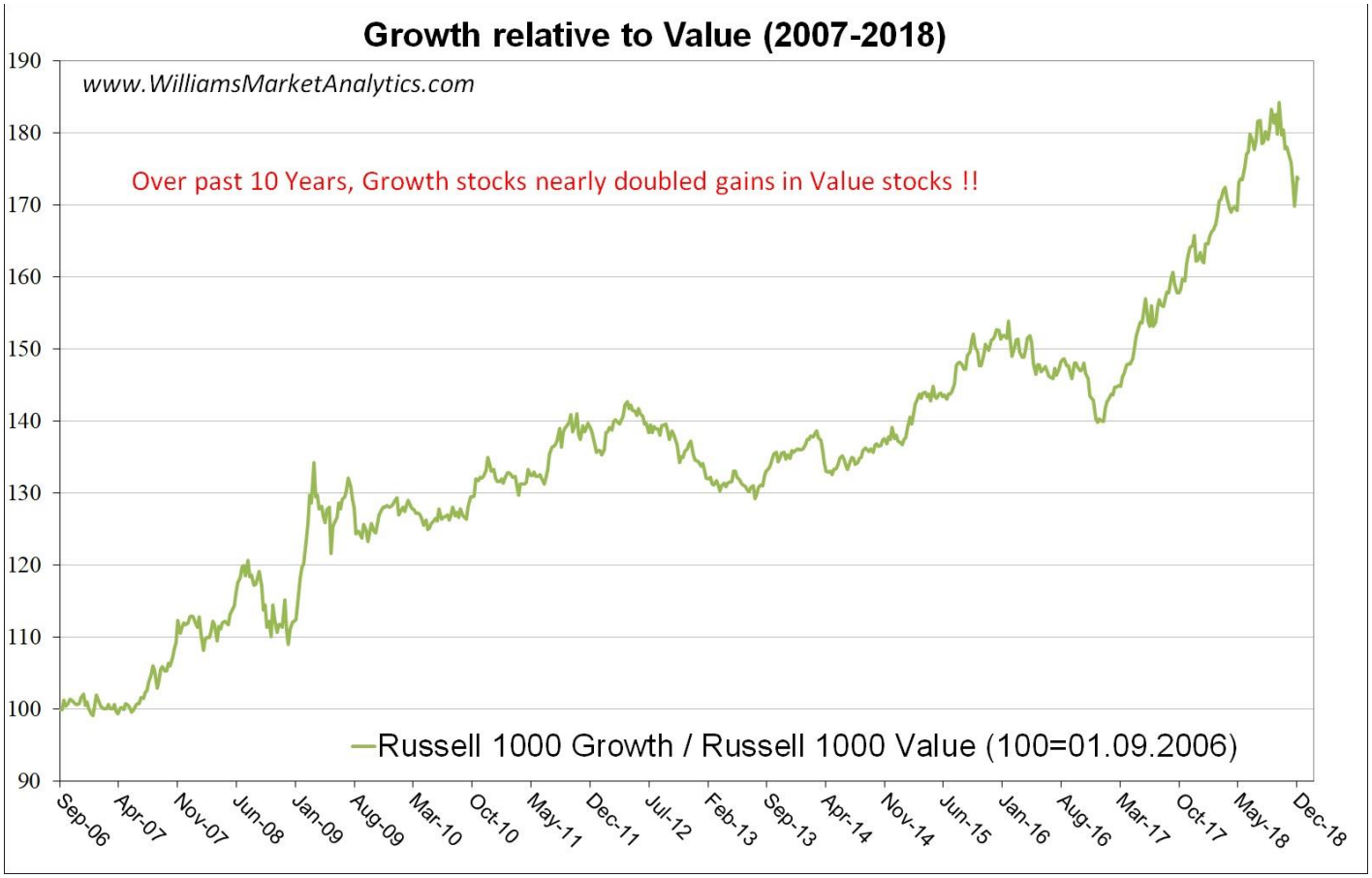


Holding corporate credit is therefore our first potential landmine for 2019. The first chart below is the popular iBoxx Investment Grade Corporate Bond ETF (LQD) and the second chart is the Barclays High Yield Bond ETF (JNK). We can see many triggers that can set off a massive corporate debt unwind (rising rates, rising inflation, corporate profits recession). While all risk assets will take a hit in the event of a corporate debt unwind, products like JNK and LQD will bear the brunt of a debt bust.

2. High PEG Growth Stocks

Investment styles go in and out of favour. At times Growth outperforms, at other moments Value outperforms. However, rarely have we seen a period so one-side in favour of one investment theme. Value mangers have either carried out a major style drift in their funds or gone out of business. And we know many value managers who have closed shop in this bull market.

Our chart below of Russell Growth vs Russell Value only partially captures the Growth frenzy over the past bull market. If we consider big Tech relative to traditional Bank and Energy Value stocks, the divergence is even more spectacular.



We do not believe that investors need to abandon Growth stocks entirely in 2019. But if readers choose to hold onto Growth stocks, homework must be done! In addition to considering revenue and EPS growth rates, revisions, profitability, and financial situation, at WMA we also require all of our Growth stocks to meet our Price-to-Earnings-Growth (PEG) criteria. We calculate PEG by taking consensus P/E numbers for the current and next year relative to our in-house calculation of each company's growth rate. In our fundamental ranking methodology, we only hold strong Growth stocks provided that our PEG score for the firm is above 50 (the stock is trading at a relatively less expensive valuation compared to at least half of the other stocks in our 5,000+ company universe).

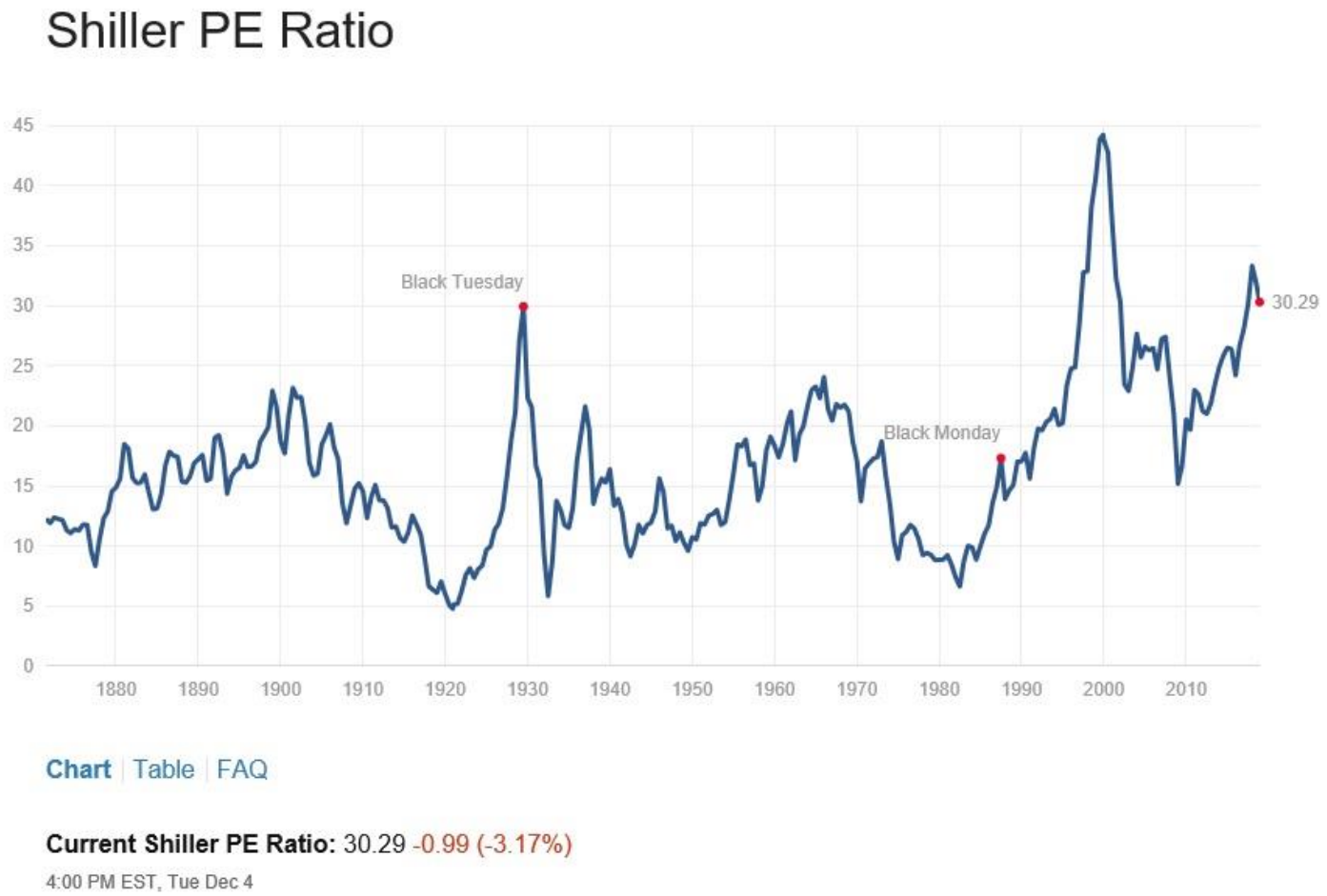
Our second investment landmine to avoid in 2019 is therefore high-flying Growth stocks trading at expensive valuations relative to their growth rate. When the next Bear Market bites, these stocks will experience vertiginous price declines.

Using the WMA Stock Screener, we created a short-list of dangerously expensive Growth stocks (low PEG scores) to avoid in 2019. Among the more household names companies, we would avoid Nvidia (NVDA), Live Nation Entertainment (LYV), Tesla (TSLA), Booking Holdings (BKNG), Starbucks (SBUX), Gilead (GILD), Qualcomm (QCOM), Twenty-First Century Fox (FOXA), Netflix (NFLX), 3M (MMM), and Nike (NKE). These overvalued stocks are potential landmines for investors once Value becomes once again a sought-after quality in the market.

3. U.S. Equity Index Funds

Our third potential landmine investment for 2019 is a big one: the major U.S. equity indexes. Indeed, entering the 11th year of the economic expansion, we don't forecast easy, buy everything equity markets. After many years of U.S. monetary policy stimulus from the Federal Reserve and a late-cycle (and untimely) fiscal stimulus measure from Trump, the possibility of peak profits is very real. Moreover, the passive indexing craze has drawn the majority of American investing households into passive index tracking products. Compared to 2009, passive investing's share of assets under management in U.S. funds has increased from about 20% to 40%. Vanguard, leader in index fund investing, reportedly collected $1 billion on average for each day of 2017, with 90% of net inflows directed to passive funds. Talk about a crowded trade! Recall that as indexing receives more fund flows, the large companies within the index receive *proportionally* more of those funds than the smaller ones.

Valuations of large-cap index stocks are at the second highest level in history, according to the Shiller Cyclically-Adjusted P/E ratio. The chart below shows that the S&P 500's Shiller P/E ratio of 30.29x places the current earnings multiple above the Black Tuesday 1929 multiple.



In a Commentary written last year, "Looking Into Our Crystal Ball", we demonstrated that assets who price inflation ends in a bubble (and crash) *also* suffer major underperformance relative to other risk asset classes during the subsequent cycle. Moreover, no asset class out-performs over each cycle. This is a market truism and the contrary would be a violation of efficient markets. Looking at U.S. vs. World Ex-U.S. equity performance, we see that the S&P 500 has enjoyed an exceptional stretch of outperformance versus the MSCI World Ex.-U.S. since 2009, just as we saw in the 1990s during the run-up to the Tech bubble. However, in the intermediary bull market of 2002-2007, it was non-U.S. stocks that out-performed. This reflects Benjamin Graham's analogy that in the short-term the market is a voting machine, but in the long-term it is a weighing machine. Once valuations of one asset get sufficiently attractive (non-U.S. stocks) relative to an alternative asset's expensive valuations (U.S. stocks), relative outperform between the asset classes tends to invert. We believe that the point of inversion between U.S. index stocks and other world equity index is at hand.

While there are many opportunities within the U.S. stock market for a research-driven stock-picker, there are also many landmines to avoid, mostly among index component stocks. The passive investing craze is therefore our third landmine to avoid in 2019. Yes, saving 50 to 100 basis points by using an index tracker is great when everything is rising. However, in the late stages of a bull market (and especially in the slowing-into-recession phase), individual stock selection and risk management is paramount. A skillful active manager can save an investor hundreds of basis points per quarter, making the difference in fees well worth it.

Conclusion

The credit bubble, growth stock investing craze, and U.S. passive index investing are three investment landmines we see on the horizon. Avoiding these landmines may prove to be the key to running a successful portfolio in 2019. We continue to recommend holding core portfolio positions in select Developed and Emerging Market equities, Emerging Market bonds and Natural Resources stocks.

Trade Recommendations

On Monday we bought a position is PCTEL (PCTI on NYSE), a U.S. wireless telecom equipment manufacturer. PCTEL qualifies as a Yield company in our rankings. Our Stock Screener shows strong EPS revisions (despite weak growth of late) accompanying the high Yield score (5.26% dividend, increasing each year), strong Financial Situation, and decent profitability (above the mean of all 5,000 companies we track). Valuation is in the middle of the pack, although the current multiple is cheap on a 5-Yr historical basis compared to peers (P/E vs Avg Historical P/E in 94th percentile). The stock is not liked by the Street (Consensus score of 37), making this more of a contrarian bet. Finally, the chart of PCTI presents an interesting entry point:

a double bottom in 2018 and a quadruple bottom adding 2016 lows. This is a very defined risk trade (stop out below the quadruple bottom lows) with an attractive upside potential. During the major selling this week in the indexes, PCTI gave up no ground, reaffirming this stock selection.

Trade Recommendations of the Week							
Week ending	**Trade**	**Entry Level**	**Upside Potential**	**Downside Risk**	**Horizon**	**Last Price**	**P/L**
Dec. 7, 2018	Long PCTI	$4.20	$7.50	$3.95	Long (> 3-years)	$4.12	-1.9%
Nov.30, 2018	Long EMLC	$32.83	$60.00	$28.00	Long (> 3-years)	$32.74	-0.27%
Nov.24, 2018	Long BCEI	$26.60	$40	$23.25	Long (>12-18 months)	$25.50	-4.1%
Nov.16, 2018	Long TKC	$5.11	$10.00	$4.20	Long (>18-months)	$5.73	+12.2%
Nov. 9, 2018	Long Oil via calls on USO (strike $13.00)	$0.21	$2.00	$0.21	Short (1-month)	$0.02	-90%
Oct 29, 2018	Long VT	$68.50	$72.50	$67.00	Closed @ $72.38 on 08/11/18		+5.6%
Oct. 19, 2018	Long EPHE Long EIDO	$29.29 $21.42	$40.00 $30.00	$28.00 $20.00	mid/long (9m-18m) mid/long (9m-18m)	$31.80 $24.85	+8.54% +16.1%
Oct. 12, 2018	Long CAGDF	$4.04	$8.00	$3.75	mid/long (9m-18m)	$4.20	+1.12%
Sept. 21, 2018	Long QQQ put options ($178 strike)	$1.30	$5	$1.30	closed @ $4.98 on 10/19/18		+283%
Sept. 14, 2018	Long AM	$30.05	$50	$29.00	stopped out at $32		+6.49%
Sept. 7, 2018	Long EWZ	$32	$46	$30.50	closed @ $39.40 on 21/11/18		+23.1%
Aug. 31, 2018	Long Gold	$1200	$1350	$1180	mid/long (9m-18m)	$1244	+3.66%
Aug. 4, 2018	Long FB	$177.69	$220	$170	closed @ $179.25 on 08/15/18		+0.87%
June 29, 2018	Long HBM	$5.60	$18	$1.50	closed @ $5.05 on 08/13/18		-9.8%