INVESTMENT COMMENTARY: Q4 2019

December | 2019

2010-19 Reflecting on the "Teen Years"

Easy money + low rates + low taxes + low reinvestment = record cash flows & an exploding stock market!

Since this year is also the start of the 2020s, we thought we'd take some time to reflect back on the "teen years." While many of the themes have been discussed widely, some of the numbers may surprise you.

- In the last 10 years, the US labor force was basically flat, rising from 158.0 million to 158.7 million (a 0.4% increase).
- The number of people outside the labor force (defined as not working and not seeking work) grew from 80.7 million to 95.5 million. This is consistent with an aging population.
- The 1.8% average GDP growth rate for the past decade was well below average.

Note: Real GDP; 5-Year Moving Average
Source: BEA, Haver Analytics®, Credit Suisse

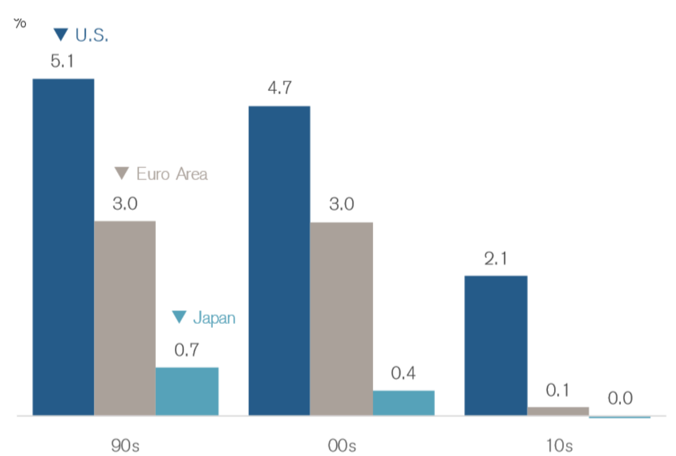
But despite this low economic growth, asset values did something extraordinary. They decoupled from the economy and rose dramatically. Total US National Assets (which includes personal, corporate, small business and non-profit assets) grew from $87 trillion to $145 trillion (a 66% increase).

US stock prices rose by 13.5% annually during the past decade while corporate revenues grew less than 4%. On the surface, the disconnect in asset prices (including stock prices) and economic activity makes little sense. But several factors combined to produce outsized asset price gains. So let's dive below the surface and learn what happened.

Factor #1 : The Federal Reserve

A balance sheet is comprised of assets and liabilities. Add up all the assets, subtract the liabilities and what is left is net worth, the equity value. This is true for individuals, for businesses and for the country. We already mentioned the $58 trillion rise in total US assets. But is that an increase in equity value? Did the country suddenly become THAT much wealthier? Well, no. Because the Fed flooded the markets with cheap money and the government issued more debt and spent more than it earned.

A number as large as $145 trillion is staggering and hard to even conceive. Another very large number is the $127 trillion in unfunded liabilities (social security, Medicare, federal pensions, etc). And national debt (total principal value of marketable and non-marketable securities) rose from $10 trillion to $23 trillion during the decade. The annual government spending has risen from $2.7 trillion to $4.8 trillion. The US monetary base rose from $0.8 trillion to $3.3 trillion. You get the picture. Much of the rise in the value of total assets can be attributed to cheap money and additional debt. After all. the Federal Reserve dropped rates from 4.7% to 2.1% during the decade.

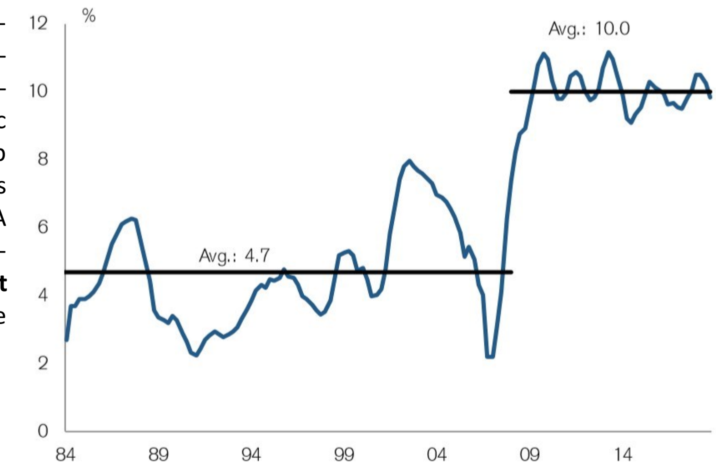


Note: German base rate used prior to 1999 for Euro area
Source: Federal Reserve, ECB, BOJ, Haver Analytics®, Credit Suisse

Low rates encourage borrowing and leverage, which in turn are allocated into assets and ventures, pushing up asset prices. Corporations also borrow at lower rates and are able to reduce interest costs and buy back shares of their own stock.

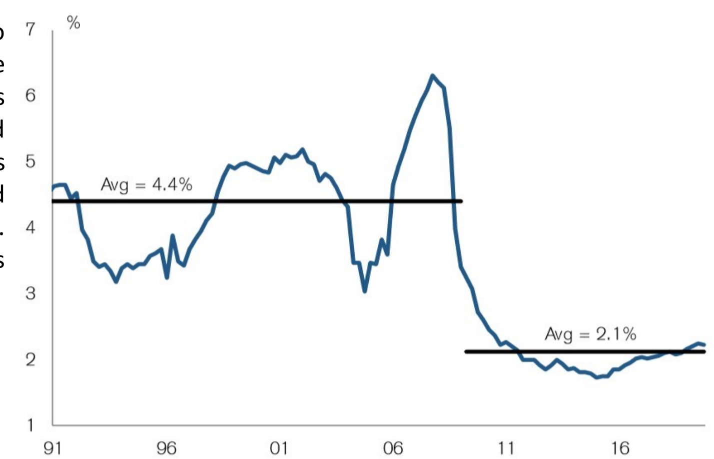
Factor #2 Corporate Cash Flows

This chart showing the change in free cash flow (FCF) inside US corporations. After decades averaging 4.7% FCF, suddenly US companies had substantially more cash flow. While there are many reasons for a rise in cash flow, a few stand out. In a slower economic environment, businesses tend to shift business models to free up cash flow. Free cash flow has historically correlated with dividends and share buybacks. As cash flows have risen, so have buybacks. A share buyback reduces the number of outstanding shares and raises the value of the remaining shares. While this action does **not** increase the value of the entity, it does raise the “per share” price of the stock.



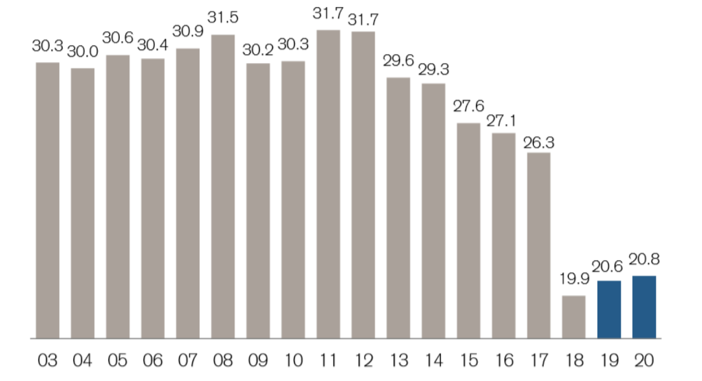
Note: Russell 1000 prior to 1990, S&P 500 after 1990; Trailing 4Q basis; 4Q Moving Average
Source: Standard & Poor’s, Russell, FactSet, Credit Suisse

Interest as a Percent of Sales declined from an average of 4.4% to 2.1%. This drop is due to the lower interest rate decisions by the Federal Reserve and increases corporate profits. As asset prices rise, the ability to borrow expands. More money can be borrowed (at low rates) without over- levering the company. During periods of rising stock prices, additional borrowing can appear benign and be used for acquisitions, buybacks and other corporate actions. But when prices turn lower, and asset values decline, those debts quickly become magnified and quickly erode equity value.



Note: S&P 500; Trailing 4Q basis
Source: Standard & Poor’s, FactSet, Credit Suisse

Additionally, corporate taxation dropped from an average of 31.7% in 2011 to 19.9% in 2019. Despite making more money in 2019, corporations are expected to pay roughly $120 billion less in taxes than they paid in 2008. In case you are wondering, personal income tax rose to $1.725 trillion from $1.158 trillion (2008) and payroll taxes rose to $1.256 trillion from $0.858 trillion. A combined $965 billion increase. So, while not an exact offset, individuals are paying more and corporations are paying less. This again translates into higher profits and higher stock prices. If you are fortunate enough to own a large portfolio of stocks then perhaps your gains outpaced your taxes. But for many people, this is not the case. and asset values decline, those debts quickly become magnified and quickly erode equity value.

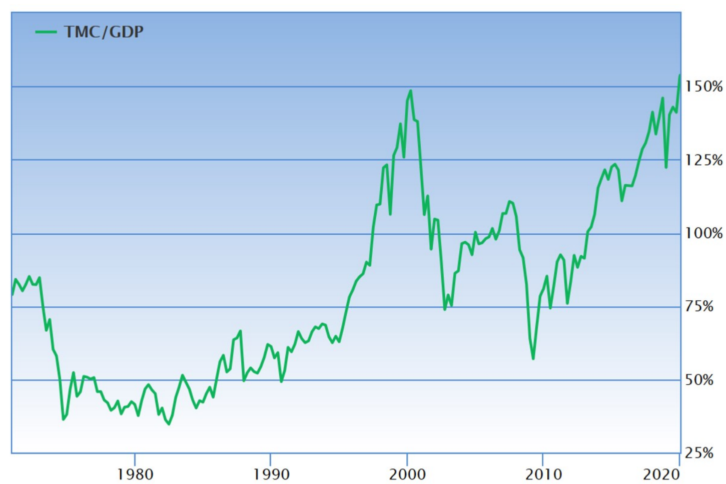


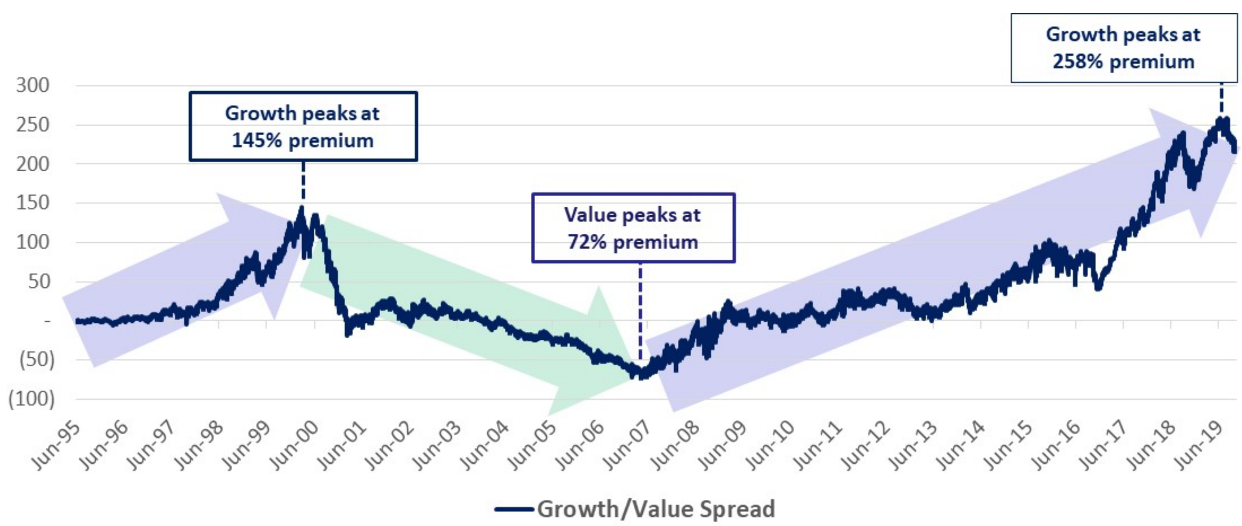
Note: S&P 500; Pro-forma effective tax rate, estimates for 2019 and 2020
Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

This All May Be True, But Isn't The P/E Still Reasonable?

Despite a P/E ratio that is only somewhat overvalued by historic measures, it is important to remember that much of the margin expansion has come from low interest rates and low tax rates and an abundance of easy money.

Other measures are not so benign. One of the broadest measures of market extremes is to compare the size of the US total stock market to the size of the US economy (GDP). Historically, the stock market has been slightly smaller than the total economy. In the chart to the right, the 2000 "dot- com" bubble reached a level where stocks were 48% larger than GDP. At the end of 2019, stocks reached an all -time extreme level of 153% of the size of the GDP. And let's not forget how we got here. The last 4-5 years have been all about Big Tech. The top five tech stocks (Apple, Microsoft, Alphabet, Amazon & Facebook) make up 18% of the total market cap of the S&P 500. These stocks have fueled a record dispersion between growth and value stocks, a phenomenon we've highlighted many times. Not only do these types of dispersions typically normalize, but this kind of concentration in a small number of stocks is not healthy for the overall market. In the past, it has led to under-performance.





It would be wise to recognize that the central bank will continue to be a major player in asset prices. Central bank activities in developed countries have taken a much more active approach to stabilizing asset prices. We consider central banks to be the ultimate backstop for markets during recessions and market crashes. But it is unusual for central banks to be engaging in such large open market operations and easy money activities during a time when employment is high and asset prices are rising.

In addition to the Federal Reserve, consumption is extremely important. Below are some interesting data points with regard to the health of the consumer. While employment is high, debt levels are rising rapidly. Total consumer debt has passed $4 trillion. Much of that is backed by assets like houses, but the fastest growing segments include cars and tuition debts. Wages are not keeping up with expenses. Despite reports of low official inflation, the cost of major purchases are certainly outpacing income. As we begin the 2020's, asset prices still have support from a very accommodating Fed, high employment and easy corporate conditions

- Consumers are feeling confident and spending money. Stock prices can continue to rise absent major unforeseen problems. On the other hand, margins are at extreme levels, multiples are high and much has been priced into stocks.
- The strong US dollar makes foreign investment difficult.
- Emerging market stocks are far cheaper than US stocks, but a strong currency reduces returns and has been a drag on portfolios for several years.
- The election cycle is likely to produce social polarity and could test consumer confidence.

THEN & NOW	FY 2000	FY 2019
MEDIAN INCOME (+10%)	$30,423	$33,600
NEW HOME COST (+94%)	$161,121	$313,926
NEW CAR COST (+74%)	$22,067	$38,432
TUITION COST (+112%)	$11,260	$23,857
HEALTH CARE COST (+117%)	$5,332	$11,573

Long periods of rising asset prices tend to lull investors to sleep. And no one ever went broke taking profits. After a great year like last year, taking some risk off the table – perhaps by shifting some of your "full risk" equity allocation towards covered calls – can be a very prudent move.

Sunday Morning Quarterback

We believe 2018 marked a new cycle of volatility, which could persist for several more years. Markets are likely to be choppy and sideways moving, an environment which is ideal for covered calls (because option prices rise when volatility is elevated). We are not calling for an imminent recession or a major market crash. But we do believe there will be some significant pullbacks in the coming years. We continue to be cautious and believe that in times like these, investors should reduce risk and focus more on income than growth.

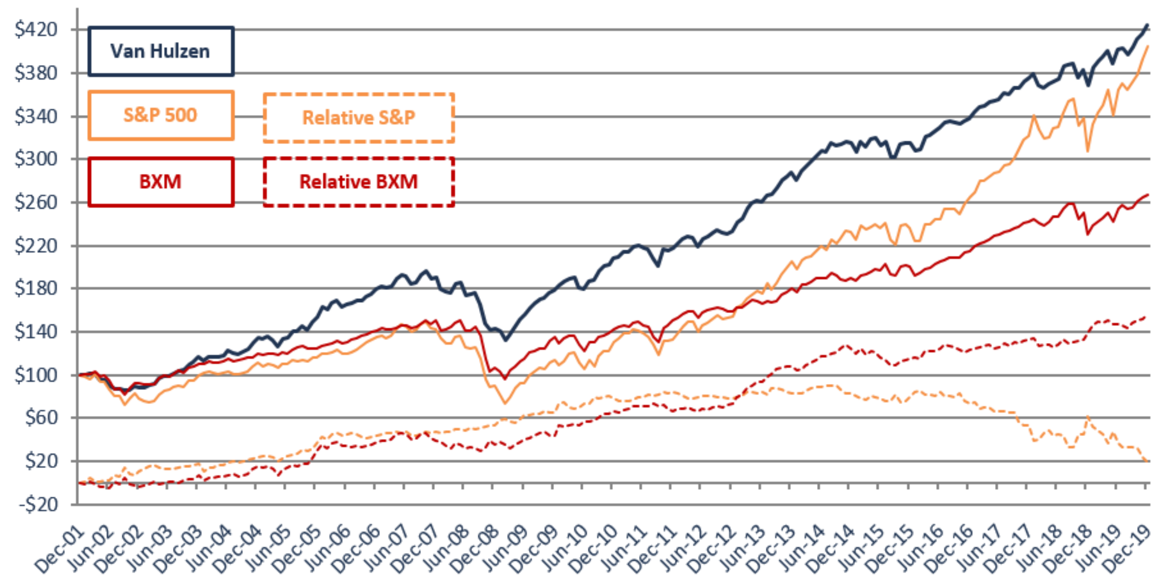
Nobody likes a "Monday Morning Quarterback" who goes on about decisions the coach should have made in Sunday's game. We think it's more productive to make some adjustments to our approach in preparation for the difficult game. Maybe call us Sunday Morning Quarterbacks.

Wishing everyone a very Happy New Year!

Van Hulzen Covered Call Strategy

The Van Hulzen Covered Call strategy invests in US companies that we consider to have high shareholder yield (dividends and share repurchases) and uses call options with the goal of reducing portfolio volatility and creating incremental income. The goal is a portfolio that has equity exposure while seeking higher than average annual income (target of 6-8% annual), although there is no guarantee that the strategy will achieve its objective, generate profits or avoid losses. Below you will find the graph of the Van Hulzen Covered Call Strategy and the Covered Call Index BXM.

Covered Call Strategy Performance (gross as of 12/31/2019)



Returns (annualized)*	Dec 2019	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	1.7%	4.8%	5.6%	14.9%	14.9%	7.8%	6.1%	8.9%	9.0%	8.4%
Van Hulzen (Net)	1.7%	4.6%	5.3%	14.2%	14.2%	7.2%	5.5%	8.2%	8.2%	7.4%
BXM	0.9%	4.3%	4.9%	15.7%	15.7%	7.6%	7.0%	7.7%	7.0%	5.6%
Difference (Gross-BXM)	0.8%	0.4%	0.7%	-0.8%	-0.8%	0.3%	-0.9%	1.3%	2.0%	2.8%

*Inception date : 12/31/2001. Figures greater than one year are annualized. Van Hulzen returns represent actual returns from composite of accounts

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