The Quarterly Report

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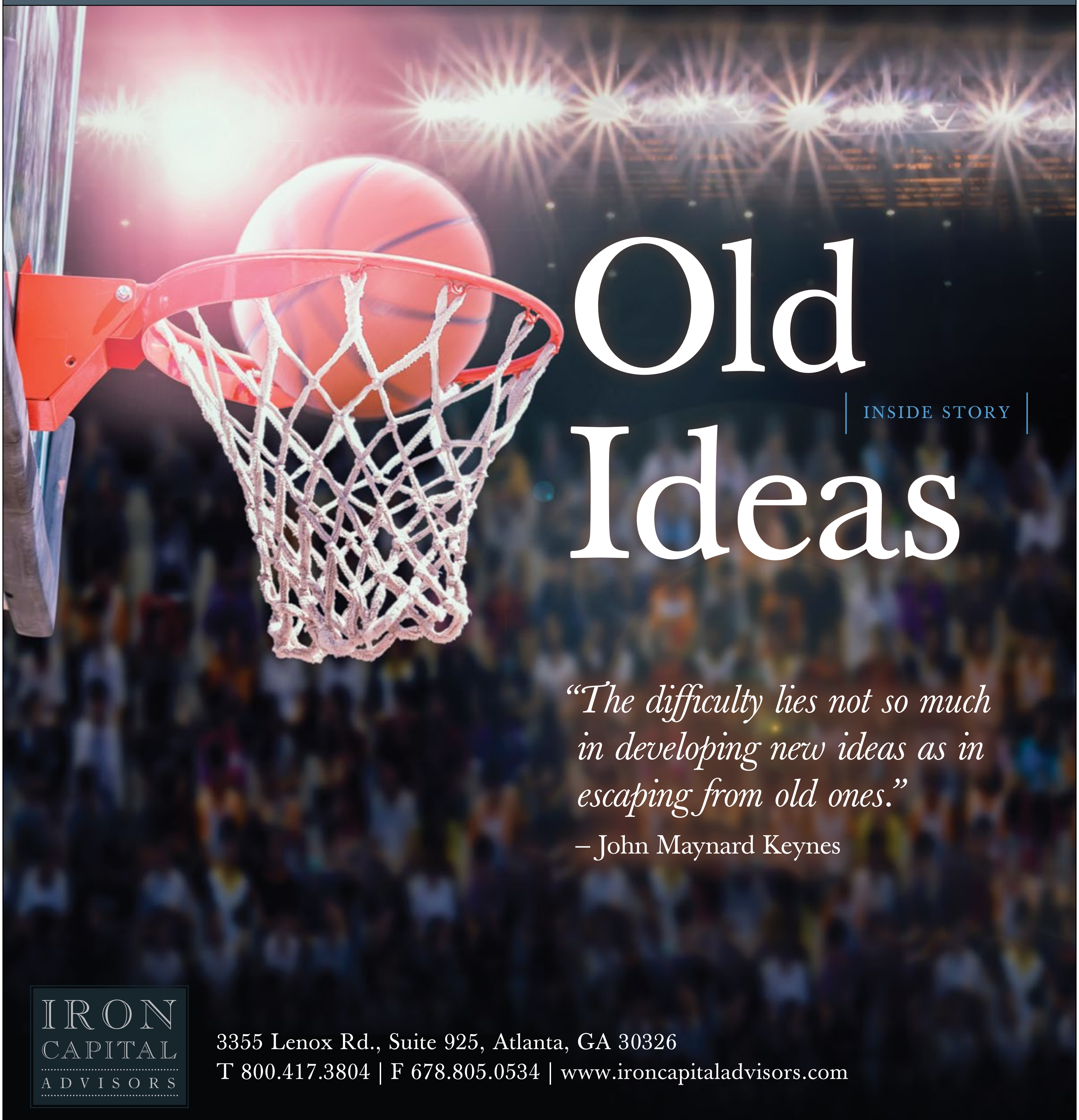

Old Ideas

INSIDE STORY

"The difficulty lies not so much in developing new ideas as in escaping from old ones."

– John Maynard Keynes

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Old Ideas

The University of Virginia Cavaliers are the 2019 NCAA Men's Basketball Champions. They defeated the Red Raiders of Texas Tech. Both teams got to the final game with a similar formula: tough-as-nails defense and patient ball control offense. In other words, they play slow. A lot of basketball fans don't like it, and I will admit that I prefer a faster pace game myself, but I suspect that coaches Tony Bennett and Chris Beard would agree with Dean Smith who once said, "I wasn't trying to make it a good game, I was trying to win."

The strangest thing about the game to me, other than that it didn't even start until after my bedtime, was the halftime commentary. I usually love the banter supplied by Charles Barkley, Kenny Smith, Clark Kellogg, and Ernie Johnson Jr., but after the first half in which Texas Tech did not make a single shot from the field for the first seven minutes, Kenny Smith set out to explain why neither of these teams could win the championship. You see, there is an old idea in basketball that if you have the better team then you want to play fast, and since the best teams usually win, most champions have played at a faster pace.

The idea stems from basic strategy. Dean Smith used a golf analogy to explain it and I'll borrow from that: If I were to play Tiger Woods in golf, my odds of winning decrease with every hole we play. On any one hole I could get a birdie and he could bogey or worse; however, over the course of 18 holes, the fact that he is much better than I am will give him an increasing advantage.

In basketball, by slowing the game down the inferior team can decrease the number of possessions, giving them a better chance of pulling off an upset. This idea is so entrenched that it has become a common belief that only lesser teams play slow and therefore slow-playing teams cannot win the championship. Kenny Smith played for Dean Smith at the University of North Carolina. Coach Smith might be famous for the four corners delay game, but most of his teams played fast. He was a strong believer in the fast break, and frankly usually had the better team so wanted to speed up the game.

I understand the slower game of UVA and Texas Tech not being Kenny Smith's cup of tea, but as he sat there arguing that no team can win a championship playing the way that both teams in the championship game play I was wondering what in the world he was thinking? One of these teams had to win. They were the only two teams left, and by the way, they were the only two teams left because they beat everyone they played in the tournament. I don't know if this is the future of college basketball, but I do know this: the old idea that slow teams cannot win championships was just proven false.

College basketball is not the only place where old ideas refuse to die. The financial market are full of old ideas that simply refuse to go away. For example, we simply must have a bear market because one is supposed to happen every five years. Over the history of the stock market we typically get a bear market once every five years. The idea here today is that a bear market must be looming because we have not had one since the 2008 financial crisis.

Before I debunk this idea I must freely admit that I use the five-year average all of the time. Many of you already know this because we have had that conversation. How long should we give a manager to know if she is doing her job? At least five years, because that is the average length of a full market cycle, with the cycle being bear market, recovery, bull market, and then another bear market.

Five years is, however, an average, much like the typical southern summer thunderstorm lasts 20 minutes. Anyone who has lived in the Southeastern United States knows this. However, this does not mean one can simply set his watch for 20 minutes when the storm begins and then safely walk outside. It is not that simple.

This market does not have to go down simply because it has been so many years since it has happened. For one thing, the very idea that the market has not experienced a significant downturn since 2008 is misleading. European stocks suffered their setback in 2011. Most stocks in the S&P 500 suffered in 2016 as only the FANG stocks kept the market above water.

The downturn that occurred in the fourth quarter of 2018 was technically a bear market, which by definition is a market down more than 20 percent. Some are already dismissing it, however, because it lasted such a short time. Granted the only real issue was this very idea that a bear market must happen simply because it hasn't.

Similarly there is an old idea that the economy as a whole must go into recession because a recession is supposed to happen roughly every five years. The market cycle mirrors the economic cycle, although the market is usually ahead of the actual economy. Again, the idea is that there is a cycle where business does well, they expand, then they over-build and the economy slows down to adjust. After the recession there is a recovery and we do it again. The last recession in this country ended officially in 2009. We are overdue based on the idea that this average time span must hold.

Again, the problem here is that real life is just not that simple. In our current circumstance there is a question of when the last recession actually ended. Several years after the technical end of the recession, surveys showed that most people still thought we were in a recession. This is because the "recovery" was the most anemic recovery we had experienced, at least since the Great Depression. The rate of growth was half our normal average, let alone the normal recovery boost. So yes, the recession was over, but it did not feel like it.

Which matters more: the academic definition of a recession being two consecutive quarters of negative growth and the end being a return to positive growth, or what real people feel in their pocketbooks? If most Americans thought we were still in a recession, then I'm of the opinion that we were in a recession. After all, economics is mostly psychological. This does not mean it isn't real, but it does mean that what actually happens is hugely influenced by what we thought would happen.

For example, if people become convinced that a certain bank is on the verge of collapse, then it will almost certainly happen. It matters not that the bank was perfectly sound when this belief took hold. People believed the bank was not safe and therefore started withdrawing all of their assets from the bank. Enough people withdraw their assets and all of a sudden the bank is actually in trouble – the self-fulfilling prophecy. So, I'm willing to go along with the view that we have not been out of the recession nearly as long as the experts say.

However, even if they are correct, it is clear the economy has not grown in total nearly as much as it usually does in a full cycle. If we are growing half as quickly, does it not seem logical that the cycle would take twice as long?

Of course even if that were not the case, these timelines are just averages. We do not go into a recession simply because it is time; we go into a recession because businesses and individuals have expanded too rapidly and need to correct that by temporarily ceasing growth or even shrinking it. To use an example many would

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REVIEW *of* ECONOMY

The 4th quarter 2019 GDP growth came in at 2.2 percent which meant that we grew 3 percent over 2018 as a whole. The first quarter of the year is estimated to be a little slower, but this is the best sustained growth we have seen in the U.S. in a very long time.

The official unemployment rate is 3.8 percent in March. This is the longest sustained under 4 percent rate since the 1960s. Wages are growing at 3.2 percent which means real wage growth.

Inflation is 1.9 percent based on the latest consumer price index report. That remains steady from last quarter. Put all together this is simply the best economy we have seen in my professional career. +

REVIEW *of* MARKET

Markets rebound. For the quarter the S&P 500 finished up 13.65 percent and small company stocks represented by the Russell 2000 index were up 14.58 percent. Growth once again out-paced value.

Bonds rallied as well. The Barclays U.S. Aggregate Bond index ended up 2.94 percent. High yield bonds rose 7.26 percent.

International stocks were also positive. The EAFE index finished up 10.13 percent while the MSCI Emerging Markets index ended the quarter up 9.97 percent. +

MARKET *forecast*

Eventually markets must reflect reality. The selloff in the 4th quarter made no sense and it has basically been undone. Where do we go from here? We are cautiously optimistic.

Small company stocks should do better as should value stocks. Emerging markets also still look attractive. That bodes well. International stocks may carry more risk as the economies are not as strong in Europe and developed Asia.

Bonds are doing their job and reducing volatility by remaining stable in the downturn. Yields have dropped once again and are likely to go back up as stocks rally. +

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understand, a recession is like a new homeowner being "house-poor."

Most homeowners have been there. We fell in love and bought the house which was, in reality, just out of our price range. Now we have this great house and no money. So the annual vacation gets cut. We fire the lawn service and reintroduce ourselves to the lawn mower. We make excuses for not going out to dinner with friends. Time passes, raises eventually come, or maybe we can refinance and things improve.

So, have we bought too much house? There really are no signs of this being the case. The key I always use is the employment situation. Our unemployment rate is at 3.8 percent and has been below 4 percent for longer than any period in our country since the 1960s. Not only is unemployment low, but wages are growing faster than the rate of inflation. More importantly, they are growing faster on the lower end of the scale. This does not make for an economy which is about to go in reverse.

Another old idea is that the Fed raising interest rates will slow the economy. The truth about interest rates, like so many of these ideas, is more complicated. The Fed raising rates early in an economic expansion is usually a good thing; it means the economy is growing again. The economy and the stock market both tend to grow as interest rates rise. It is when rates peak that the economy and the market start to head in the opposite direction. So now our old ideas are related: what one thinks about the Fed's raising rates is directly related to how close she thinks we are to the end of the cycle and another recession. Late last year all we heard was that we are late in the cycle. If that is true, then the Fed raising rates is bad. But, is it true? One would not know it now. We seem to be still chugging along.

Ultimately all these ideas persist because of the fatal flaw of economics as a science. In the hard sciences the scientific method requires a control – this group gets the experimental treatment while this other group gets a placebo. The treatment works or it does not. There is no control group in economics. The truth is that we don't know how much Fed policy influences the real world. Many believe, myself included, that the actions of our Fed in the immediate aftermath of the financial crisis saved us from a far worse outcome. However, there is no way to actually know that. We cannot set up an alternative universe in which the Fed did nothing. All we can do is look at history and attempt to learn as much as possible from it. The problem with that is every time it is a little different: the Fed raised rates and the market dropped in the 4th quarter of 2018; the Fed softened their talk and the market rebounded to begin 2019.

At the same time the trade negotiations with China looked bleak in the Fall of 2018 and much better in the early days of 2019. Was the market responding to the Fed or to trade talks? This is the problem with these old economic ideas – they are impossible to prove and just as impossible to disprove.

What is an investor to do? Investing is much like basketball in the sense that there may be differing styles but some fundamentals are constant. Some teams play fast and some play slow. Some investors seek rapid growth and some seek steady income. All great teams play defense. All great investors are risk-averse. All great teams have an identity and they stick to it. North Carolina plays fast, Virginia plays slow, both have now won championships in the last few years. They are who they are. All great investors have a process and they stick to that process through booms and busts. All understand that it doesn't really matter what others say or think; an idea, old or new, is only good if it works.

Warm Regards,

Chuck Osborne

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