The Conservative Strategist

APRIL 2019

A QUARTERLY INVESTMENT NEWSLETTER PUBLISHED EXCLUSIVELY FOR CLIENTS OF SEASONAL STRATEGY

The Fed's worried about the economy. Investors don't seem to be.

From its September 28 close at 2914, the S&P plunged more than 19% during Q4, hitting a low of 2351 on December 24. Since then, it's been nearly straight-up, with the S&P closing as high as 2855 on March 21. This comeback is as surprising as the event that largely triggered it: The Fed's about-face on monetary policy.

The Fed had been tightening monetary policy since 2017, steadily raising short-term rates from near-zero levels. In late December, 2018, the Fed started hinting that it would moderate its plans to raise interest rates throughout 2019. By January, Fed Chairman Powell announced that tightening would go on hold *if necessary.* And in mid-March, that necessity was invoked, as the Fed put on hold all interest rate increases for the remainder of 2019. In just a few months, the Fed has flipped from hawkish to dovish.

Investors celebrate. Should they?

Equity investors have celebrated the move, but have they sufficiently absorbed its implications? Clearly, the Fed is worried about economic growth stalling. The European and Chinese economies are struggling. Our housing market is showing signs of advanced wear, with prices sagging in both high-end and low-end markets. But most troublingly, debt is rising across the economy at a time in the economic cycle when it should be moderating.

World's top bond manager, on the Fed's move

"What the heck is that ***one hike in 2020*** *thing about? It seems almost desperate. The Fed has gone from* ***we got this*** *to* ***we'll get back to you.*** *Not reassuring."*

Jeffrey Gundlach, CNBC, March 21, 2019, reacting to the Fed's statement that not only would it not raise interest rates in 2019, but that it did not see more than one rate increase in 2020.

Gundlach's view is that the Fed's about-face on interest rates will lose its credibility, and damage investor confidence.

We're seeing record or near-record debt levels in all of these sectors:

- *Consumers (student loans, auto loans, credit cards)*
- *Investors (margin)*
- *Corporations (BBB sector, the lowest investment grade, has ballooned)*
- *Government (unprecedented trillion-dollar annual deficits projected)*

Growth and deficits have not moved upward together except for the briefest periods. *Fortune* magazine calls this *America's Disastrous New Normal,* threatening to choke off future recoveries.

If the recovery is still healthy, why in December did defaults on all the above types of consumer loans rise for the first time since January 2017?

(Continued on page 4)

The Markets March 29, 2019	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	2834.40	13.62%	13.62%
International Stocks (Vanguard Index)	16.67	10.22%	10.22%
Emerging Markets Stocks (Vanguard Index)	26.88	11.30%	11.30%
Real Estate Stocks (Vanguard REIT Index)	28.86	17.25%	17.25%
Bonds (30 year US Treasury/Vanguard Index)	2.81%	4.36%	4.36%
Dollar (US Dollar Index)	97.28	1.15%	1.15%
Gold (London Afternoon Fix)	$1295.15	1.26%	1.26%
Money Market Funds (IBC Index/7-day yield)	2.46%	+0.04%	+0.04%*

*change in yield

Portfolio Planning

Profit margins look toppy
(as if you need another reason to worry)

It's been a bull market in corporate profit margins for quite some time. I think there are three reasons for that, and they are all waning or reversing.

"In my opinion, you have to be wildly optimistic to believe that corporate profits as a percent of GDP can, for any sustained period, hold much above 6%. One thing keeping the percentage down will be competition, which is alive and well. In addition, there's a public-policy point: If corporate investors, in aggregate, are going to eat an ever-growing portion of the American economic pie, some other group will have to settle for a smaller portion. That would justifiably raise political problems—and in my view a major reslicing of the pie just isn't going to happen." — Warren Buffett, *Fortune* magazine, November 22, 1999

Low interest rates

A 35-year secular decline in interest rates has made debt less costly for corporations, and set a consistent tailwind behind corporate profit growth. With rates not far from historic lows, that tailwind is fading. (Bear in mind that since we're talking about profit *margins,* it's the direction of rates, not their level, that matters most.)

Corporate taxes

Corporate taxes as a percentage of GDP have been declining for 50 years, and Trump's recent tax plan may well represent the final milking of that cash cow. The repatriation of offshore accounts may also contribute to a firming of overall tax receipts going forward.

Labor costs — and social climate

Through a combination of offshoring, globalization, and now the Trump administration's loosening of regulation, labor's share of corporate profits has been declining for years, and recently reached an all-time low. There is growing evidence that the public's patience with this is terminal. We see that in the new minimum wage laws in multiple states, in the backlash against near-record inequality and the 1%, and in the Blue Wave in Congress. It is long past time for employees to get a bigger slice of the corporate pie — and that means a smaller slice for shareholders.

Tech giants' productivity gains

In the past couple of decades, a few giant tech companies have staked out huge swaths of territory relatively unimpeded, contributing mightily to their profit margins. It has been winner-take-all in big tech. But now, the giants are increasingly horning in on each other's territory. Witness Google's challenge to Apple in the lucrative smartphone market. Witness Amazon's encroachment on Netflix, and Apple's recent announcement to start a Netflix-like service. And there are growing calls to break up Big Tech, and social dissatisfaction with privacy encroachments by FaceBook, Apple, Amazon, and Google. None of this helps the profit margin outlook in this key sector.

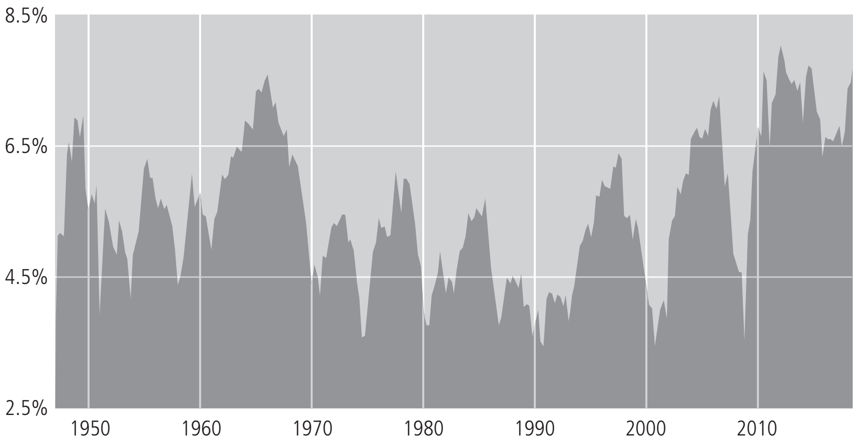
Cyclical and meaningful margins

Note the cyclical nature of the chart on this page. For more than 60 years, corporate profits as a percentage of our gross output has bounced between the high 3s and the low 7s. As Buffett noted 20 years ago, they had never remained above 6% for long for the entire 20th century. But for the past eight years, they've remained high due to a kind of perfect confluence of the above trends. In addition to the normal gravity of the business cycle (and this cycle is of near record age), the waning of the above trends may make it rougher for corporate earnings growth in coming years.

Note, too, how corporate profit margins tend to plunge in or around '0' years (1970, 1980, 1990, 2000, 2010). This does not bode well for 2020, which is also likely to see a groundswell of political rhetoric and Congressional investigation against corporate power. ■

Profit margins high — and vulnerable

Corporate profits as a percent of GDP, 1947-2019

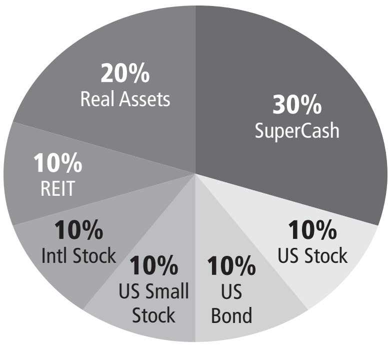


Source: The Felder Report

SuperDiversified Portfolios (SDPs)

SDPs reflect risk-on Q1

SDP1 ***Conservative***

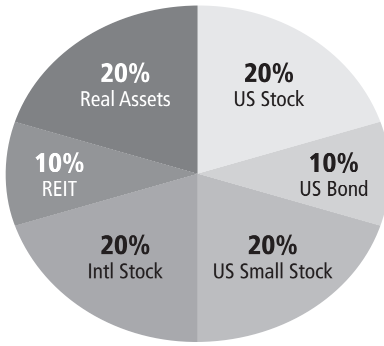


1st Quarter ***8.59%***

Last 12 Months ***3.37%***

Risk assets bounced back across-the-board in Q1, sparking the top quarter for the SDPs since the giant gains of the second and third quarters of 2009, coming out of the epic volatility of the financial crisis.

SDP2 ***Moderate***



1st Quarter ***11.99%***

Last 12 Months ***2.93%***

Even in those record 2009 quarters, at least one asset class declined each quarter. In Q2 2009 it was Bonds. In Q3 2009 it was Real Assets. But this past quarter, all asset classes rebounded sharply.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Real assets rebound looks broad and solid

Asset Class	Mutual Fund	Performance 1st Quarter '19	Performance Last 12 Months
SuperCash	PIMCO Instl Low Duration	1.18%	1.93%
	Merger	2.07%	7.28%
	Calamos Market Neutral	2.80%	3.08%
US Stock	Vanguard Index Trust 500	13.62%	9.35%
US Bond	Vanguard Long-Treasury	4.36%	6.21%
US Small Stock	Vanguard Small-Cap Index	16.15%	5.45%
Intl Stock	Vanguard Intl Index	10.22%	-5.25%
REIT	Vanguard REIT Index	17.25%	19.86%
Real Assets	PIMCO Commodity Real Return	9.14%	-5.97%

Best
Worst

Along with the rebound in financial assets in Q1, real assets also rallied strongly. The rally was across all major sectors of real assets — from raw commodities to energy infrastructure to global renewables to gold stocks to timberlands.

This seems like a contradiction to the thesis of a global slowdown. If so many economies are so weak, the price of commodities and commodity-related businesses should not be rallying so strongly. But in fact, real assets tend to do well late in the economic cycle.

Mr. Yield Curve on the inversion

Roughly as rare as a Mercury transit (Mercury crossing in front of the Sun, 13 to 14 times per century), the yield curve inverted on March 22. Why should we care? Because it's a reliable signal of a coming recession, according to the man who has been analyzing the yield curve for 30 years, Professor Campbell Harvey at Duke's Fuqua School of Business.

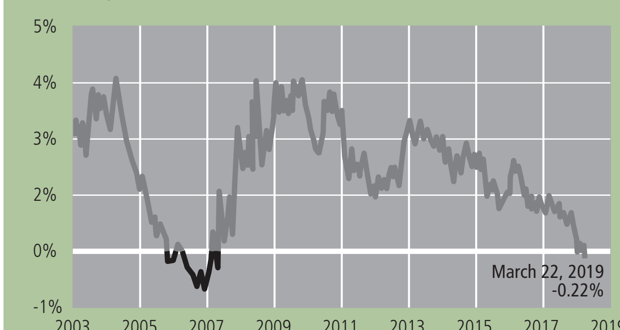
Usually, longer-term rates are higher than short-term rates, so lenders get compensated by borrowers for taking inflation risk. But once per decade or so, often when the supply of credit starts to outswamp demand and lenders anticipate an economic downturn, the rate on the three-month US Treasury Bill approaches then exceeds the rate on the ten-year US Treasury Note. You have an inversion.

Harvey's 1986 University of Chicago dissertation maintained that yield curve inversions are invariably followed by recessions 12 to 18 months later. He's been proven right in all three subsequent inversions.

One caveat: An official inversion signal occurs only when yields are inverted for three full months. It's only been a week as of this writing.

Yes, we have an inversion (almost)

Treasury yields, three-month bill *vs.* ten-year note
January 2003 to March 2019



The last time the yield curve inverted, late 2006 into mid-2007, a bear market and sharp recession soon followed.

Source: Ryan ALM

The Conservative Strategist is researched, edited, and published quarterly by Robert J. Gavrich of Seasonal Strategy, an investment adviser licensed with, and subject to examination by, the California Department of Business Oversight. All contents contained herein are derived from data believed to be reliable, but accuracy cannot be guaranteed. Bear in mind that past performance does not guarantee future results. The officers of Seasonal Strategy may from time to time hold positions in securities mentioned in this newsletter. The information and opinions herein are subject to change without notice. Reproduction in whole or in part without the express written consent of Seasonal Strategy is prohibited. Form ADV-II available upon request.

Robert J. Gavrich
CA-Licensed Investment Adviser
President, Seasonal Strategy
1517 Fountain Street • Alameda, CA 94501

Phone 415.956.1721
Fax 415.956.1722
Email bob@seasonalstrategy.com
seasonalstrategy.com

Banks turning savers into suckers

A pox on the big banks. Their profligate lending contributed to the 2007-2009 financial crisis. And they have profited from its aftermath.

A little history

The Federal Reserve responded to the financial crisis by steadily lowering short-term interest rates until in late 2015 / early 2016, they neared the vanishing point. A slew of short-term rates fell in line, including bank savings account rates.

By 2017, the Fed began to raise short-term rates in response to the economy's strength, and has been doing so ever since, until its pause in Q1. Most short-term rates have followed higher. Three-month Treasury Bill rates, for instance, have risen from a low of 0.01% in late 2015 to 2.41% recently.

Slacker banks

And bank savings account rates? They haven't budged from their lows, and now average 0.10% according to *bankrate.com*. Big banks like Wells Fargo, BofA, and Chase pay a mere 0.05%, 0.02%, even 0.01% on some accounts.

This borders on theft. But you don't have to be a victim. With the rise of online banking, with competition among money market funds, and with the proliferation of online websites that list best rates (like *bankrate.com),* there's no need to get near zero on your savings.

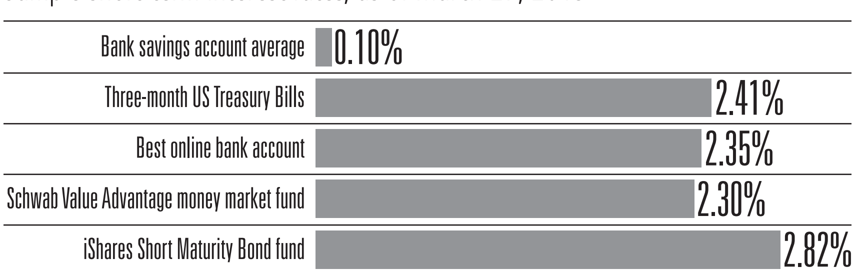
A simple process

Here's a simple process to get the most on your short-term money. First, analyze your spending. Determine how much you need in day-to-day liquidity (Level 1), how much cash for short-term needs (a month or so, Level 2), and how much extra cash you want on hand (a 6-12 month timeframe, level 3). Second, keep no more than the minimum in your bank checking account to avoid monthly fees. Third, find a competitive online bank account or money market fund. Plenty pay more than 2% today. Fourth, link your newfound account to your checking account. Fifth, authorize a recurring monthly transfer from your new account to your checking account, to cover level 1 and 2 needs. Sixth, for Level 3 cash, search for a solid ultrashort bond fund that pays a little more than money market funds, with minimal risk.

With only a little up-front hassle, you could be earning hundreds or even thousands per year more on your savings, instead of supporting the the big banks. ■

Don't settle for pennies on your savings

Sample short-term interest rates, as of March 27, 2019



Fed's worried

(Continued from page 1)

That's the kind of datapoint that makes the Fed take its foot off the brake and hover it again over the accelerator.

Did the economy just fail its stress test?

The Fed's 2017-initiated Quantitative Tightening (QT) program can be viewed as one giant stress test of the economy. Tighten until the economy cries *Uncle* was the unspoken mandate.

After roughly 200 basis points (2 percentage points) of tightening, the data the Fed collects is indicating that risks to growth are rising rapidly, as are internal credit-related stresses. It didn't take much for the economy to cry *Uncle,* and that's disappointing. It means that the Fed has not succeeded in raising interest rates enough that lowering them will be a sufficiently powerful weapon in fighting the next recession.

Yet all investors see is that interest rates are not going up any further for the remainder of 2019. It's as if markets have mistaken the defibrillator for the long-term cure.

Instead, markets should be concerned for two reasons:

a) The economic recovery, entering a record 11th year, is clearly more fragile than previously thought, and

b) The Fed's reversal paints a picture of economic leadership that is somewhat unsure of its own guidance. ■