SYMONS® CAPITAL MANAGEMENT

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THE BIG PICTURE

In some ways a lot changed in the third quarter, and in some ways nothing changed. What clearly changed is popular perceptions in the market. The market began shifting from pro-growth to pro-safety. Why? There are multiple possibilities. It's pretty clear that the Fed meetings in July and September, and subsequent chatter, had a lot to do with it, along with the China trade war. On the Fed side, people were disappointed with the slow action the Fed is taking in dropping rates, which additionally puts into question market assumptions about the timing of future rate cuts. On the trade war side, hopes for a quick resolution were dashed time and again.

So, while market perceptions started to change, what stayed the same? Economic data. Most macroeconomic and corporate data changed only modestly. We should note that U.S. economic data did improve a bit in September, as it usually does every September, probably due to the end of the U.S. government fiscal year. It seems that every September all the departments spend all their money so they can demand more next year. But September global economic data, including the U.S., showed global manufacturing weakness around the world.

Over the past decade and more, one of the biggest changes in financial markets dynamics has been the dramatic increase in government and central bank interventions to save investors and economies from any pain. It most obviously started around 1990 in Japan when their stock market had a severe drop. Japan was faced with a no-growth economy, and the government and the central bank became the first entrants in the parade of massive growth of sovereign debt and central bank interventions depressing interest rates and purchasing financial assets. Since then, for almost 30 years Japan's economy and stock market have been on a trip to nowhere. The cost of government interventions has been far in excess of any subsequent growth in their economy. In Japan's stock market, equity prices and P/Es have never recovered to pre-1990 levels. Neither monetary interventions nor government fiscal spending has been able to create sustainable, organic economic growth in Japan. And overnight on September 30 Japan scared the global financial markets by taking actions to try to steepen their yield curve. Bond buyers fled, as they suddenly saw the risk to Japan's bond prices, corporate profitability and overall economy should rates rise to any material extent.

What does the Japanese experience mean for Europe and the U.S.? Like Japan, Europe recently announced what can fairly be labeled "Perpetual Quantitative Easing" — constant central bank interventions in financial markets. The principal result for Europe has been, at best, anemic GDP growth along with massive debt growth. Bond yields have fallen to the lowest in recorded history, with much sovereign debt, and even some corporate debt, offering negative yields. Negative yields make no sense whatsoever. Zero and negative interest rates ultimately destroy banks, insurance companies, pension plans and savers. Negative rates can't go on forever, but here we are. Something will break, but it is hard to say what or when.

In the U.S., similar to Japan and Europe, the money added to the system by the Fed through Quantitative Easing purchases (which ended in the U.S. in 2015), and by Congress through TARP and other bailouts, has propped up asset prices, but not so much the real economy. Growth in debt has far exceeded GDP growth. Where does this all end? Not unlike 2000 and 2008, if investor sentiment changes from optimism to fear, the continuing additions to liquidity, generated by more debt and potentially by more QE asset purchases, is not at all guaranteed to flow into either propping up financial assets or consumer purchases. Once people sense an economic downturn, cash becomes a more attractive asset than stocks, bonds, mortgages or consumer discretionary consumption.

Perhaps an early-warning sign of that eventuality appeared in the U.S. in mid-September in the bank "repo" market. Repo stands for "repurchase agreement," which is a way to maintain liquidity in the banking system. A repo essentially involves a bank with excess liquidity making a short-term collateralized loan to a bank that needs liquidity. Starting around September 17, rates in the repo market jumped from around 2.2% to as high as 10%. Banks with liquidity just didn't want to lend to other banks, and no one is sure why. So the Fed had to step in and be the lender to maintain liquidity. Banks appear to be turning more cautious about counterparty risk in the banking system.

Overall, the experience of central bank interventions since 1990 suggests that they are not a panacea for the lack of organic economic growth. Actually, central bank interventions seem to create their own, if different, risks.

THE ECONOMY AND INVESTMENT MARKETS

While most economic data changed only modestly in the third quarter, we continue to see material growth in the underlying debt required to keep supporting that economic data. When commentators talk about growth, they rarely talk about debt growing faster than any "growth" number, such as GDP. Is there a risk of debt burdens impacting economic data? Eventually yes. Consumer, corporate and country debt burdens are problematic, and at some point it is likely they will become a real problem — a real burden on economic growth. But it is hard to say when that happens.

What else has been going on? Q4 of 2018 saw a 19% market downturn, but Fed action stopped that in its tracks around the end of last year. We've been looking for a slowdown since the second half of 2018, as economic and fundamental corporate data then looked set to slow. Corporate growth has clearly slowed, as it was hard to improve on the tax cut fueled growth we'd had. Economic growth has taken a bit longer to slow, but recent revisions show the numbers are weaker than originally reported.

What do we see now? Mostly we're looking for opportunities one stock at a time rather than any sustained market advance. What are those opportunities? We think the macro and fundamental outlook will continue to deteriorate, at least for a while. Thus, we generally want to be defensive in nature. We view the recent September bounce as just a pause in a more probable downturn, as people look to the Fed and government to provide relief, rather than to any organic, sustainable economic growth. The thing is, we don't see how sustained economic growth can happen in any meaningful way right now.

The Fed cut rates in late July and the market went down because expectations of more intervention were so high. The September rate cut also had no positive effect. We don't see how investor expectations of more Fed support can be met in the short term, at least not without first seeing a meaningful deterioration in the market.

So what do we do next? We are willing to sell hope-based rallies driven by the next market expectation of Fed stimulus, a trade deal, fiscal stimulus, or some other investor-saving event. Hope dies hard. Investing on hope can be a dangerous game to play, but investors are so conditioned to government protection of markets that there can be attractive opportunities to sell a holding here or there.

At the same time, we are looking for sensible opportunities to reinvest into the slowing growth environment. We just don't want to get too greedy. Mostly, we expect good opportunities will present themselves one at a time, and we want to take advantage of them. The basic idea, though, is to sell hope and not get hurt by market gyrations. At the same time, we want to take advantage of the opportunities that are presented. With an expensive market, that is not always easy to do. If an opportunity isn't ripe yet, cash can be a preferable asset to hold.

EQUITY STRATEGIES AND PORTFOLIO MANAGEMENT

One change we would note from earlier in 2019 is that the health care sector is starting to look more interesting. That's a traditionally defensive sector, but to our mind government meddling in the space over the past decade has really muddied the waters. At this point, though, we think the market has taken a decent first stab at pricing in concerns, particularly pharmaceuticals' legal issues. We still have to keep an eye on how the wind is blowing in the political space as the 2020 elections approach, but at this point we're willing to take a closer look in the health care area.

That brings up the question: if we're buying a bit there, are we selling elsewhere? The answer is that it is a stock-by-stock process. The whole market looks expensive to us (which doesn't mean it has to go down immediately), but the defensive areas still look cheaper than the growth areas. As we said earlier in this Letter, there's a lot of "hopium" being ingested in growth, with one obvious area being semiconductor stocks. The data continue to deteriorate there, but some of the companies keep saying things will get better, and many investors continue to buy that.

That leads us to possible clouds on the horizon. Of course there are constant worries — trade wars, saber-rattling in the Middle East, Brexit, and so on, but in our judgment the one cloud that's going to be pretty unavoidable is October and forward data. Primarily we're talking about corporate earnings, but really we think it flows through to economic data as well. As indicated above, there have been a fair number of companies that have sounded pretty hopeful notes, and many investors have followed along. Historically, we've seen a fair number of market drops in October, and we think some of them were due to the fact that, when the fourth quarter arrives, eyes start to focus on the next year. From what we see, the likely data for 2020 looks poor, and we think companies are going to have to acknowledge that, at least to some extent, beginning in October. We saw a pretty bad fourth quarter last year. We expect a similar one this year.

Nevertheless, we always keep looking for opportunities, not just in health care but across the entire market. For instance, the long-term outlook for energy is pretty terrible, but so are assumptions, with XLE (energy sector ETF) trading not too far from 10-year lows. Could there be some opportunities there? To be clear, it's hard to imagine there won't be a fair number of energy companies that don't survive the next downturn, but there are also some well-managed companies that are being thrown out along with the trash.

The last portfolio management consideration we'd mention is inflation. Inflation has been fairly steady for a while, and we're towards the lower bound of the recent range. What makes that interesting is that so many people are convinced that deflation is coming and the dollar has soared. Trying to predict inflation is tougher than predicting the economy, but given that everyone is on the same (deflation) side of the boat, the reward for successfully picking the other side is high if you get it right. That means looking at things like foreign markets and energy as potentially interesting ideas, particularly as they're generally more beaten down.

At any rate, to us the general market direction remains clear. The economy is slowing down, and we don't see how that is at all likely to change anytime soon. Our base case right now is that we expect to see a further rotation from growth to safety. But the timing is always tough. Perhaps a safer probability is that we will see higher volatility. The market is largely being held up by hope of more Fed action or a trade deal. Hope is a much more fragile support for asset prices than organic economic growth.

CONCLUSION

Being cautious and patient is where the real opportunity resides for equity investors. Eventually valuations become more attractive, dividend yields increase, and the risk/reward dynamics of equity ownership become more favorable. We can hardly wait. In the meantime, we focus on protecting capital and thereby increasing purchasing power. This is why risk management is so important.

Most investors' basic long-term goals are to build durable (rather than temporary) wealth and so achieve financial security. That is why Warren Buffett's Rule #1 is "Don't lose money," and why we say that intelligent risk management matters — a lot. No one can say when risks go from being problematic to a real problem, but risk can happen fast and we believe that warning signs are becoming more evident.

Symons Capital is constantly realigning portfolios to respond to changing risks and opportunities in the market. Such a disciplined approach to investing is something that passive portfolios, target-date portfolios, and fixed allocation portfolios never do. Risks and opportunities are constantly changing, and Symons Capital seeks to change with them. We seek to provide risk management that reflects changing market conditions.

We never know for sure what will happen, or when. But in our judgment more could go wrong than right. If we are prepared, as we seek to be, such a market-turn event would become a long-term investment opportunity, not something to be feared.

Yours sincerely,

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