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THE BIG PICTURE

2019 was a remarkable year for financial markets. The S&P 500 Index was up more than 30%. At the same time, Wall Street earnings estimates were down about 5% from a year ago — which is called an earnings recession. Why the disparity?

Do we have a China trade deal that matters? A Phase One deal was announced in December, but the full terms were not disclosed. There is supposed to be a signing on January 15. The whole thing seems pretty hand-wavy and people weren't impressed. The stock market didn't move, bonds rose a bit, and agricultural prices decreased a bit. Not what one would expect out of a real trade deal. We think it is fair to call it a trade truce. While they say they'll keep talking, they can't seem to reach a serious agreement on anything. Still, trade deal optimism is one Wall Street argument for why the market is fine.

Do we have Fed liquidity interventions that matter? Perhaps for stock prices, if not for the real economy. Problems in the bank repo (repurchase) market have been in the news since mid-September. This market is where banks that have excess reserves make overnight loans to banks that are short of their required reserves. Banks started refusing to lend to each other in mid-September and so repo interest rates soared. The Fed jumped in to lend to banks with insufficient reserves in order to keep repo interest rates down and stop a repo market crisis, but the crisis continued through the fourth quarter. People initially were talking about the Fed adding repo market support of $50 billion of liquidity, but instead it looks like they're willing to add $500 billion to keep the interbank lending market functioning. This is unprecedented. Repo rates hardly moved on the Fed announcement of continued repo market support. You would think $500 billion is enough liquidity, but the market reaction makes us wonder. Which leaves unanswered the question of what exactly is causing the repo market stress. Nevertheless, the Fed did manage to quell concerns enough to get past the end-of-year funding turn from 2019 to 2020.

More broadly, the turnaround in Fed monetary policy from a year ago is stunning. In 2018 the Fed raised interest rates and indicated it would continue to do so in 2019. It also indicated that it would continue Quantitative Tightening (QT) in 2019 — reducing the size of its balance sheet by selling assets. Both actions were supposed to "normalize" monetary policy, by allowing the market more of a say in determining interest rates and asset prices. That didn't last for long. What the Fed actually did in 2019 was to lower interest rates three times and to inject hundreds of billions of Quantitative Easing (QE) liquidity into the financial system. Why the change in policy? The U.S. economy didn't alter its slow-growth pace. Rather, we believe the Fed reversed course due to stress in the financial markets, starting with the almost 20% stock market drop in late 2018. The Fed is worried about the functioning of the financial system, about the markets becoming illiquid, which problem was caused by the Fed itself by allowing the system to become addicted to constant central bank liquidity injections. Overall, the Fed and other central banks seem to be faced with a market fragility problem of their own making.

Why did the stock market have such a remarkable 2019? We would suggest that the basic reason was the constant addition of market liquidity by central banks adding to the money supply. The central banks buy up risk-free assets like U.S. Treasury bonds, and investors use that cash to buy the riskier assets like stocks and junk bonds. Can this continue? For a while, yes, but not forever.

This is why Symons Capital's Intelligent Risk Management (IRM) investment process has lead us to tilt toward higher quality and what we believe are safer investment assets. In addition, as liquidity concerns gradually increase, cash becomes a more valuable asset. Cash both reduces downside risk and allows us to be a more nimble investor when attractive investment opportunities become available. As the macroeconomic and fundamental investment factors evolve, we steadily reorient our portfolios.

Bottom line — based partially on trade deal hopes but primarily on the Fed's highly accommodative monetary policies of dropping rates and adding cash to financial markets, in 2019 the market took the ball and ran with it. We, on the other hand, have stayed conservative. It's the stance we think is appropriate given the concerns we see on the horizon.

THE ECONOMY AND INVESTMENT MARKETS

The global economy is close to stall-speed, and the U.S. economy continues to slow down, but inch forward. With all the central banks' liquidity support of markets it is hard to see a stock market downturn and easy to imagine a sideways stock market. With the current historically high asset valuations it is also difficult to imagine 2020 showing asset price gains anything like what happened in 2019.

The concerns we see directly affect the sustainability of the bullish narratives of 2019, so let's go through them. First is the supposed trade deal. The idea of a real, thorough, final Phase Two deal that involves all the sticking points seems incredibly unlikely. We see the highest probability being that it will take a long time, if ever, before we see a significant trade deal. Could we see tariff increases? It seems like a bit of a nuclear option, and tariff threats start looking like paper tigers if we keep ignoring the dates. Trump regularly tells us they're getting close to a big deal, but we've been hearing that for a very long time.

The trade dispute involves much more than tariffs. The unresolved difficult parts of a trade deal involve a range of serious national security concerns. They include actions by China concerning theft of intellectual property (patents, etc.), forced transfer of technology if a company wants to do business in China, and joint venture requirements — where foreign enterprises have to have Chinese partners in order to do business there. These are more than purely economic/tariff issues, and so are more difficult to resolve. These issues have been building for a long time, and are unlikely to be resolved quickly.

We think the more important concern is the financial stress we see in the system, first in the repo market and more recently with QE4, where the Fed has said it plans to purchase T-bills at the rate of $60 billion a month through April 2020. The size and speed of the liquidity injections has been dramatic. At the pace of expansion and the timetable given, it looks like the Fed balance sheet will hit a new all-time high in 2020, a far cry from the late-2018 path of Quantitative Tightening and balance sheet reduction. Of course, the Fed can change its plans again.

Why are these Fed interventions necessary? We are told we have a healthy economy, but financial markets are showing stress. On the repo market problems, the Bank for International Settlement (BIS) came out with a paper on what happened. They say that the Fed was facing multiple potential LTCM situations (a hedge fund that failed in 1998 and that then Fed Chair Alan Greenspan decided to bail out) from "tight" conditions in the repo market. There are several

hedge funds that are using the repo market for leverage funding and they were under stress. Apparently you can never put that increased money supply liquidity back in the bottle. At this point, with all the money added over the past decade, and only one short-lived attempt at QT to cut back all the QE asset purchases by the Fed, we wonder whether the Fed can ever put any of its QE back without undue stress to the system.

The current financial markets seem to be very reliant on Fed promises of whatever liquidity is necessary to "stabilize" interest rates and so asset prices. It is even more concerning that the Fed seems to be promising liquidity, and so asset price support, to non-banks such as hedge funds. A liquid market is one where an asset can be sold immediately at a price close to its most recent price. Why should the Fed be promising that to investors in assets like junk bonds, where the market is by definition riskier?

It seems incredible that largely unregulated hedge funds with an insatiable appetite for leverage are holding financial markets hostage, but that seems to be at least part of the liquidity problem. The question is, what happens next? Will the Fed continue to let the hedge funds get away with this? Are they that afraid of a financial market crisis if hedge funds have to sell some assets to shrink their balance sheets and reduce their leverage? How would a forced deleveraging of hedge funds affect the risk-ladder of assets?

Perhaps the simplest way to look at this is that in the middle of the last market meltdown, in early September of 2008, shortly before Lehman declared bankruptcy, the repo market saw big stress. Having the issue resurfacing in 2019-2020 isn't good. We're comfortable watching and waiting before getting more aggressive with our portfolios. We believe there are times to take risk, but this certainly doesn't seem like one of them. Back in 2007 we concluded the market party was starting to get pretty crazy and decided to scale back. We are taking the same basic approach here.

INVESTMENT STRATEGIES AND PORTFOLIO MANAGEMENT

We see plenty of possible problems, but investors still took abundant money from the Fed and ran with the ball. When QE4 started in the 4th quarter of 2019, it looked like the best guess was that the money was headed towards Treasuries. But after a slow start, the QE money started getting into more speculative investments, and we had a stock market melt up. Ultimately, stocks soared in the fourth quarter and bonds went down a bit (interest rates up a bit).

What do we do going forward? That's a tougher question than a lot of people seem to think. Looking at sentiment surveys, people have moved out of bonds and into cyclically positive stocks like tech and banks. That is surprising to us. There seems to be a kneejerk tendency to think that QE leads to higher stock prices and a strong economy. We think that's historically too simplistic. What has often happened is that the economy had been doing poorly, and QE came in just when the economy was set to improve anyway. There also have been times when QE came in and a slowdown continued. Domestically, we've seen stocks hang in during those times, but rotate to safer names. Internationally, the reaction to QE has been more negative, with a move more wholeheartedly to 'safe' assets like government bonds.

Thus, given that QE4 isn't targeted at anything specific, and the broadly varied history of what's happened with central bank easing over time and place, it's easy for us to imagine that we get a big rotation into safety at some point. It's worth noting that few investors seem to be positioned for something like that. Along those lines it's also interesting to see the similarities between now and 2000. The market had offensively valued tech names benefitting from Fed largess. We had calls of a new paradigm, where the old rules didn't matter anymore. At the same time, we were pondering a slowdown in the economy. In 2000, the end result was a huge rotation out of growth and into value. We'd expect something that rhymes with that, though the economy is weaker this time around, so we'd expect a rush into safety (such as low volatility) more than value (such as low price-to-book and low growth).

Dealing with market tops can be difficult. Symons Capital saw the potential problems of 2000 and 2008 coming before they really had an impact. Thus we missed some of the gains in 1999 and 2007. We've become similarly cautious here, and we are willing to deal with the pain of missing out a bit in order to protect capital. There are obvious economic problems and expensive markets, and we don't want to get hit by them. After the fact, nobody cared about the last part of the moves we missed in 2000 or 2007, because they remember really well what came after the market turned. We believe we're quite possibly looking at a similar scenario here. But it hasn't happened yet and no one can predict the timing of any such event.

One final concern we have discussed in earlier Quarterly Letters is the ever growing debt burdens faced by countries, corporations and consumers. If something can't go on forever, it won't. We believe that current global debt burdens cannot be repaid in their entirety because debt is growing about twice as fast as the global (and U.S.) economy. But, of course, no one knows what will trigger a debt crisis. The most obvious trigger is interest rate increases, and that may be why central banks have been suppressing interest rates for most of the past decade.

CONCLUSION

Today, we see both a sideways market principally due to Fed liquidity injections and a range of possible risks to consider — high debt burdens, high stock valuations, weakening macroeconomic data, and continuing financial markets instability that has resulted in extensive central bank market interventions. What to do? We have built our research and portfolio management work on the belief that most investors' core goal is to gain and maintain financial security. We seek that goal through Intelligent Risk Management (IRM). IRM is about finding the best risk/reward opportunities. Our IRM approach involves both macroeconomic research and fundamental stock analysis. IRM involves both seeking to limit downside risk and to find upside opportunities. There are times when it makes sense to risk money to capture opportunities. But we only want to risk money when the perceived reward makes sense.

We can't predict the future, but we can gauge probabilities by examining what has happened in the past in similar circumstances, while also including present day differences (such as central bank market interventions) to identify possible future paths. We look at macroeconomics, company fundamentals, investor sentiment, market technicals, monetary and fiscal policy, inflation, and other factors that may impact the financial markets. The reason we analyze so much data, rather than just relying on factors like momentum, is that the core of our work is risk management. Making intelligent decisions includes weighing probabilities — having a good decision-making process is critical. Having a process that acknowledges uncertainties about the future reduces the potential impact of future risks. As we work toward making portfolio decisions, dealing with uncertainty means that we are never certain that we have the "right" answer, and so we are always looking for new and additional information to best identify the most likely probabilities among all the possibilities. In our opinion, the IRM process is important to preserving capital in the short-term and building financial security in the long-term. We believe it has served our clients well over the past decades.

Yours sincerely,

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