ICR® 4th Quarter Newsletter – January 2020

Unlike in 2018, the markets ended the year strong, with the S&P 500 index gaining 8.5% in the fourth quarter. For the year, stocks posted their biggest annual gain since 2013. Technology led the way in both the fourth quarter and the year, while real estate was the only sector to post a negative return for the quarter.

Global monetary easing as well as reduced tensions in the U.S.-China trade conflict served as tailwinds for world markets. Foreign stocks moved up in the fourth quarter, with the MSCI EAFE developed markets index posting a 7.8% gain. Emerging markets, which had been lagging the U.S., outperformed for the quarter with a gain of 11.4%.

Somewhat paradoxically, through the third quarter, earnings per share (EPS) growth had actually decreased by almost 4% for the year. Depending on fourth quarter results, which are coming in as we write this, 2019 could be only the second year since the financial crisis with negative EPS growth for the S&P 500. It would be most unusual to have the stock market up 30% in the context of a four-quarter earnings recession. Of course, investors are forward-looking and the strong rally in 2019 would seem to indicate optimism for future earnings growth in the face of weaker current financial reports.

The yield curve, which had inverted at the beginning of March, finally normalized in early December when the yield on the five-year Treasury bond rose above that of the three-month Treasury bill. As we noted in previous newsletters, that inversion has historically been a reliable sign of an upcoming recession. The fact that the curve has now un-inverted is fostering hope that recession has been put off until 2021 or perhaps 2022. However, it is fairly typical for the curve to renormalize before the actual start of a recession. Time will tell.

The Unseen Consequences of Cheap Money

"There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen."
— **Claude-Frédéric Bastiat** (1801 – 1850)

Bastiat was a prominent French economist, writer, and brilliant advocate of an unrestricted free market. His essay, "What is Seen and What is Unseen," introduced the concepts of opportunity cost and unseen or unintended consequences.

While there is no denying the erudition of modern central bankers, we're not sure Bastiat would consider them "good economists." That's because of the unintended consequences of crisis era policies that are still with us and have been expanding.

When the 2008 crisis hit, the Federal Reserve initiated a suite of monetary policies, including quantitative easing (QE), which provided easy access to loanable funds. The *intended* consequences of these policies are obvious – increased aggregate demand, economic recovery, and the bull market in almost everything. Ten-plus years later, it is the *unintended* consequences of these ongoing and expanding policies that are causing concern.

We are currently enjoying what, by most accounts, is a very good economy. Unemployment is at 50-year lows. The stock market is at all-time highs. Housing prices have recovered, and consumers are confident. These are all signs of a solid economy, and this is exactly what central bankers intended as the consequence of their credit expansion. However, they never intended the artificial expansion of easy

credit to become permanent policy. That's because economic growth that is dependent on rising debt is unsustainable. And yet, unsustainable monetary policy continues for the simple reason that ending it would bring consequences that no one can accept. Recall the fourth quarter of 2018 when the Fed was attempting to "normalize" interest rates and slowly reduce their balance sheet. The market revolted, as it had in 2013 with the mere suggestion of tapering asset purchases by the Fed – "taper tantrum." Policies implemented as a response to the crisis now can't be exited without provoking the next crisis.

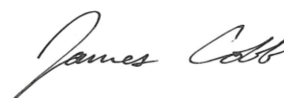
In the United States we have a massive credit bubble sitting on corporate balance sheets. Companies have taken advantage of the artificially low interest rates, and they've borrowed heavily to fund share buybacks and acquisitions. This financial engineering drives up EPS and stock prices by reducing outstanding shares without increasing earnings. This indebtedness has led to a deterioration in the quality of corporate bonds. Despite the rally in risk assets in 2019, the number of defaults - while still low - rose by approximately 50%, according to data compiled by J.P. Morgan.

Ultimately, markets will need to reprice for this rising default risk with higher interest rates on corporate bonds. However, that day of reckoning is being held off by the flood of central bank liquidity and international investors fleeing negative yields overseas. Once again, unintended consequences of monetary policies are becoming problematic.

This is all classic late-cycle or end-of-cycle stuff. Another economist, Hyman Minsky, stated that market stability is inherently destabilizing. In other words, long periods of relative stability in risk assets causes investors to keep upping the risk during a long period of calm. Investors are lulled into unwittingly increasing risk at a time they should be de-risking and upgrading their portfolios.

In keeping with Bastiat's and Minsky's admonitions about market stability and the realities of market forces, we are mindful of the consequences of the last decade's credit binge. We believe patience will lead to attractive opportunities for disciplined investors who don't chase returns by upping risk. We're working to make sense of what's happening in the economy, so we can create a cogent investment strategy that will meet your financial goals. Thank you for your confidence and support and we look forward to discussing any questions or concerns you may have.

Sincerely,



James A. Heine   James L. Cobb

Market Report (as of 12/31/19)

Index	**2019 (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	28.9	13.0	9.4
Dow Jones Industrial Average	22.3	13.0	9.9
U.S. Aggregate Bond Index	8.7	4.0	3.0
MSCI EAFE (Foreign Index)	18.4	6.6	2.8

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