MARKET REVIEW AND ECONOMIC OUTLOOK

"A form of fraud in which belief in the success of a nonexistent enterprise is fostered by the payment of quick returns to the first investors from money invested by later investors." – Definition of a Ponzi Scheme, or a description of the current rage in cryptocurrencies.

The U.S. equity markets closed out 2017 with a bang, with both small cap and large cap U.S. stock indices hitting new all-time highs in the 4th quarter. The Russell 1000 large cap index rose 6.59% for the quarter and 21.69% for the year, while the Russell 2000 small cap index gained 3.34% and 14.65% respectively. As has been the theme for the past year, growth stocks led the way once again in the fourth quarter with the Russell 1000 Growth index returning 7.86% while the Russell 1000 Value index returned 5.33%. For the year, the Russell 1000 Growth outperformed the Russell 1000 Value by a whopping 16.55%. As we have expanded on in recent newsletters, Bowling's process utilizes a value foundation which has worked well over the long haul but puts us temporarily out of favor.

While the stock market's current fascination with growth stocks has hurt our performance on a relative basis, history indicates that these types of things tend to be short-lived. In the last quarter century, there have only been two time periods during which the outperformance of growth stocks versus value stocks eclipsed what we saw in 2017. The first was during the tech bubble of the late 1990's (when people were really infatuated with internet stocks) and the second was in the 2009 Financial Crisis (when people were really scared of the financial sector which is largely populated with value stocks). Following these events, value stocks outperformed growth stocks by an average of 32% over the subsequent 5 years.

As the holidays fade and investors begin looking toward the New Year, we occasionally get asked about our stock market outlook for the coming year. However, long-time clients (and readers of this newsletter) know that we have none. This isn't due to a lack of diligence or concern about what 2018 will bring (it sure would be nice to know the future), but rather an acknowledgement of the futility in doing so. We feel very strongly that the best course of action for investors is to develop an asset allocation that meets your long-term needs and that you are comfortable with. Adjust it if your life circumstances dictate a change, but otherwise leave it alone. Trying to make changes based on short-term forecasts is simply a losing game over the long run.

To illustrate this, one needs to look back no further than 2017. The average Wall Street analyst estimate this time last year called for a 5.5% rise in the S&P 500 for 2017, which was actually the most bearish forecast since 2005. Of the 16 Wall Street firms tracked by Bespoke Investment Group, the highest forecast called for only a 10.1% rise in the index. So of course, the S&P 500 then goes on to rise nearly 22% in 2017, once again rendering the Wall Street forecasts completely useless. Since 2000, the average Wall Street consensus has missed the actual number by an average of 13%, and called for double digit stock market gains in 2008 (which ended up being one of the worst bear markets in history). When it comes to forecasting things like corporate earnings and U.S. Gross Domestic Product (GDP) growth, analyst estimates can be very useful and fairly accurate. However, translating those types of things into short-term stock market performance is of no value whatsoever. It's honestly mind-boggling that firms even continue to publish annual estimates of stock market returns.

Tax Reform

One thing that was missed by all of these analysts this time last year, but certainly hasn't been overlooked by the market, is the tax reform bill signed in the 4th quarter of 2017. In case you missed it, the tax bill includes a significant reduction in the corporate tax rate from 35% to 21%. While the impact on individuals can be debated, the significant corporate tax rate cuts will be a boon to businesses of all types and has been a positive catalyst for their stocks. As the market soared higher in 2017, many questioned whether the stock market had gotten ahead of itself. But as the dust clears on the tax reform bill, analysts are now scrambling to raise their corporate earnings forecasts for the next several years. At any given time, the stock market is attempting to predict where the economy is going, and it tends to get there several months before the prognosticators figure it out.

Prior to the tax bill, the economy was already on solid footing with the unemployment rate at a 17 year low of 4.1%. The Institute of Supply Management announced in early January that 2017 was the strongest year for manufacturing since 2004. Before the tax bill was even announced corporate earnings had begun to accelerate. As of mid-December, consensus S&P 500 earnings forecasts called for a 9.6% rise in 2017 and 11.8% growth in 2018. Now estimates are coming in that are calling for an additional 7% earnings boost in 2018, which would put overall earnings growth in the high teens for the year. According to data compiled by Yardeni Research and Bloomberg, consensus earnings estimates are calling for 13% annualized growth over the next 5 years. Based on an analysis by Bespoke Investment Group, the percentage of upward revisions to 2018 earnings estimates are the highest in at least 10 years, surpassing the upward revisions seen as the economy emerged from the Financial Crisis.

The tax bill also includes a one-time exemption to repatriate foreign cash at a discounted rate of 15.5%. Under the old rules, many companies with international subsidiaries were not subjected to U.S. taxes until foreign earnings were "repatriated", or brought back to the U.S. To avoid being subject to a relatively high tax rate, many companies elected to leave these earnings overseas. Goldman Sachs estimates that the S&P 500 alone has approximately $920 billion of untaxed cash overseas. The tax bill will almost certainly result in massive amounts of cash being brought back to the U.S., which will likely have a positive impact on the U.S. economy. The last time the U.S. had a so-called "tax holiday" was in late 2004 as part of the American Jobs Creation Act. At the time, U.S. companies were allowed to repatriate overseas cash at a tax rate of 5.25% which resulted in $362 billion being brought back from overseas. Roughly 80% of the repatriated cash went towards company stock buybacks.

It's likely that this time around much of the cash repatriated by U.S. corporations will once again be used for financial engineering. To take advantage of low interest rates (and avoid the taxes of bringing back cash to the U.S.), corporate debt issuance has accelerated over the last 5 years. According to a Bank of America survey of 302 U.S. companies, 65% indicated that they will use part of the repatriated cash to pay down debt while 46% will increase stock buybacks. 42% said it will be used to fund acquisitions of other companies while 29% indicated they will increase dividends. All of these activities are generally good for stocks, which is another reason why the stock market has rallied so ferociously as of late.

There are many things that go into the pricing of stocks, including company earnings and dividends. However, one thing that is often overlooked is the basic supply and demand relationship for U.S. stocks. Since December of 1996, the number of U.S. publicly-listed companies on stock exchanges is down an astounding 46%, which means that there are fewer publicly-traded investment opportunities for individuals and institutions (such as pension managers) to invest in. On top of that, amongst the companies that are left we have seen an unprecedented drop in the number of shares these companies have outstanding due to share repurchases.

Over the past 7 years, the number of shares outstanding amongst S&P 500 companies is down approximately 7%. Within the technology sector, which is now about 22% of the S&P 500, the number of shares outstanding is down a whopping 17.5% over the last 10 years. Within the Consumer Staples and Consumer Discretionary sectors, the decline is 18% and 15% over that same time period. Within Healthcare and Industrials, the number of shares outstanding is down more than 10% from the peak. With fewer companies having fewer shares outstanding, the long-term supply and demand dynamics in the U.S. stock market are decidedly bullish. It's highly likely that this trend will continue for the foreseeable future.

After years of steady but sub-par growth, the world economy appears to be revving up. In addition to the employment and manufacturing numbers in the U.S., in December the International Monetary Fund raised its world growth forecast (GDP) for the second time in a year and now calls for 2018 growth of 3.7%. Goldman Sachs is even more bullish with its 4% growth estimate in 2018. Either of these numbers would be the strongest growth in 7 years.

Following the passing of the tax reform bill, the Bloomberg Commodity Index rallied for a record 14 days in a row. In early January, crude oil moved to a 3-year high of $70 dollars/barrel. Walmart, signaling the tightness in the labor market, announced that they are using some of the proceeds from the tax reform bill to raise the minimum wage for workers from $9/hour to $11/hour. The Bloomberg Consumer Comfort Index, a measure of confidence in the economy, rose to a 17-year high in early January. It's very likely that we are now entering a phase of the economy that we haven't seen in over a decade, where the headlines shift from a concern about not enough growth to concern about too much growth. Readers should be prepared to see more headlines about inflation and interest rates heading higher. Unfortunately, none of these headlines will be predictive of stock market performance.

Bitcoin Mania

One of the big stories of 2017 has been the dramatic rise of the digital currency Bitcoin. It's hard to turn on any type of financial media without hearing or reading about it. For those of you wise enough to completely ignore the financial media, Bitcoin was developed by an unnamed coder (using the alias Satoshi Nakamoto) in 2009 with the objective of providing a completely anonymous international payment system. Unlike the U.S. dollar which is backed by the Federal Reserve, the Bitcoin ecosystem is not backed by any central authority nor is there any physical currency. Rather, it is dependent on a tacit agreement among users that a string of code on a computer somewhere out in cyberspace is worth something. New Bitcoins are "mined" by computers that solve complex mathematical problems and verify Bitcoin transactions. It's estimated that about 70% of the Bitcoin mining process is occurring in China, even though that country has outlawed Bitcoin exchanges. If this doesn't sound crazy enough to you, please read on!

Despite the fact that Bowling does not have authority to purchase currencies or futures contracts (including Bitcoin) in any of our strategies, the Bitcoin rage provides a fascinating case study in behavioral finance that is useful to all investors. We will give the caveat that we have no forecast on where the price of Bitcoin is going because the entire relationship between Bitcoins and the U.S. dollar is entirely arbitrary to begin with. However, from a behavioral standpoint we are seeing some things that historically have not worked out well for investors.

One of the things that is a bit concerning is that we have begun to see financial publications (and websites and television shows) refer to Bitcoin as an "investment" when it is in fact a currency. No one would ever refer to U.S. dollars or Japanese yen as an "investment" because currencies are designed to be a store of value, not an appreciating asset. If you are actually using Bitcoin as a currency to conduct transactions (as opposed to speculation), you are much more interested in the stability of the currency than you are the absolute value versus another currency (such as the U.S. dollar). In other words, you wouldn't really care whether a Bitcoin is worth a penny or a million U.S. dollars, as long as everyone agreed on what the relationship is and you could count on the purchasing power being relatively stable. If the value of a currency is relatively stable, then it does not make for a good investment (which is why you don't see people trying to get rich by stuffing U.S. dollars under their mattress). If it's not stable, then it doesn't make for a useful currency. Either way, it's hard to see where this is going.

This positioning in the media that Bitcoin is an "investment" appears to us to be irresponsible, but unfortunately the media is always complicit in asset bubbles. In the late 90's investors were bombarded with articles and television shows about how to get rich in internet stocks. In the mid 2000's, the media sold investors on real estate being a great investment when it is in fact a depreciating asset. In 2008 you had commentators going onto their radio shows and touting gold as a great investment. These people don't care if you make or lose money, they just want you to tune in.

Another thing that should raise some concern amongst investors is that we now appear to have large numbers of people purchasing Bitcoins who never intend to use them for transactions. It's our anecdotal evidence that many of these people tend to be unsophisticated investors who have never bought or sold currencies before. This is very similar to what we saw 10 years ago in the housing bubble that formed in certain areas of the country. You ended up with people who had never been involved in the real estate industry who decided that houses were a get-rich-quick scheme and started flipping houses to each other (rather than purchasing them to live in). In 2007-8 we saw a flood of people who had never been involved in precious metals markets suddenly believe they were experts and bought gold, silver, and copper that they were never going to actually use for anything. The same thing happened with Dutch Tulips in the 1600's and Beanie Babies in the 1990's. When people with no particular need (or expertise) in a particular asset class start buying it with the idea they are going to get rich, it rarely turns out well. In fact, we can't think of a single instance.

One last thing we see that raises some eyebrows from a behavioral standpoint is the minimization of the risks involved with purchasing Bitcoins and other cryptocurrencies. At the present time the only real advantage to using Bitcoin (rather than something like U.S. dollars) is the fact that it is supposedly anonymous. This would be very useful if you were dealing in illicit activities such as drugs, terrorism, or money laundering, but not so useful (or even desired) if you are mostly making mortgage payments, shopping on Amazon, or dining at a local eatery.

The long-term success of Bitcoin is dependent on governments around the world allowing the Bitcoin ecosystem to remain relatively anonymous, but what's going to happen if they decide that this presents a security risk? In fact, on December 28th South Korea banned anonymous trading of digital currencies (including Bitcoin), and then in early January announced it was working on a bill to ban the exchanges outright. China has also banned Bitcoin exchanges and is now in the process of limiting the amount of electricity being supplied to Bitcoin mining farms (believe it or not, the worldwide electricity required to support Bitcoin mining has now exceeded that of over 140 countries, including Argentina).

After only 802 people claimed Bitcoin capital gains on their 2015 tax returns, in early December the IRS won a ruling against Coinbase (the largest U.S. Bitcoin exchange) which required the firm to hand over records of 9 million Bitcoin transactions. The IRS has classified cryptocurrencies as property, not currency, and thus realized gains must be reported to the IRS so they can get their cut. It has also been reported that the IRS has hired a firm to help identify the owners of digital "wallets" that hold Bitcoin. So if you are actually trying to use Bitcoin (or another cryptocurrency) for legitimate purchases, you now have to track your exchanges to/from U.S. dollars and report any gains to the IRS. This is neither convenient nor anonymous.

Unlike the traditional monetary system in the U.S., Bitcoin transactions are designed to be absolute and can't be traced. As was chronicled on a recent episode of the Big Bang Theory, if you lose the computer that holds your Bitcoin wallet, your access to your Bitcoins is gone forever. Ditto if your computer crashes and the Bitcoin data is not backed up. If your Bitcoin wallet is out on a server in cyberspace (on an exchange like Coinbase) and the exchange gets hacked, your Bitcoins are gone forever.

As if all of that isn't enough, there have been some head scratching developments in recent weeks that make it hard to believe that investors are acting rationally with Bitcoin and other cryptocurrencies. In October, a struggling beverage manufacturer by the name of Long Island Iced Tea Corporation received a notice from the NASDAQ that it would be de-listed (removed from the exchange) unless the market value of its shares rose above $35 million for 10 consecutive days. If that weren't enough, in a November filing with the SEC, the company admitted that its financial reporting had "material weakness", which is typically a warning sign for investors. With no legitimate business catalyst to turn things around, the company instead decided to ride Bitcoin mania to save itself. In December the company changed its name to Long Blockchain Corporation (Blockchain is the technology behind Bitcoin). By the end of the day the company had seen its stock price rise by 275%, and by January it had met the NASDAQs requirement and saved itself from delisting. In October, a struggling, money-bleeding biotech firm called Bioptic changed its name to Riot Blockchain and saw its stock rise over 600% by the end of the year. On January 2, a struggling burger-chain franchisee named Chanticleer launched a block-chain based customer loyalty program and saw its stock rise 41% in one day. As we were writing this letter, Kodak (which had seen its stock drop from $36/share to $3/share since 2013) launched KodakCoin, a "photo-centric cryptocurrency" that will "create a new economy for photography." The stock then jumped 300% in a little over 24 hours, despite the fact that there is probably no one outside of the company who knows what the term "photo-centric cryptocurrency" even means. There is nothing rational about any of this behavior and it is eerily similar to what occurred with internet stocks in the late 1990s. It should be telling that all of these companies are struggling and had seen their stock price drop below $5/share before their big announcements.

In 2013, a digital currency called Dogecoin (named after an internet meme of a dog) was launched as a self-described joke by its creator. As of last week, the cumulative value of Dogecoins had reached a value of $2 Billion, despite the fact that there is an unlimited supply of them! The creator of the currency is warning users that a bust bigger than the internet stock bubble is coming but as of yet it has not deterred speculators. We here at Bowling thought we had seen everything at this point but we were clearly wrong. It doesn't seem possible that all of this can end well, so we will stick to things that have tangible cash flows associated with them (like boring stocks and bonds).

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