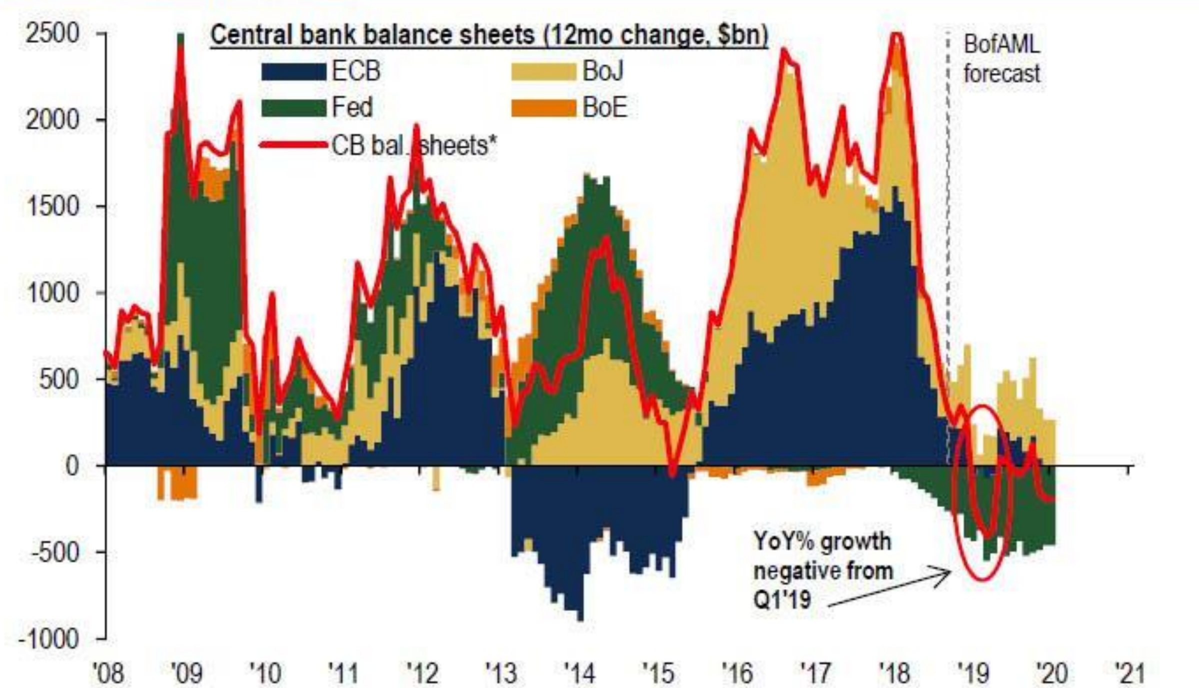
It doesn't matter, until it matters

We have been talking about the Fed draining liquidity from the economy for a few quarters. It had not impacted the market, until this quarter. It hit with a vengeance. At its low, the S&P 500 was down 20% from its high, technically the start of a bear market. Will it continue? Will the Fed reverse course and stop draining?

Chart 28: Central bank liquidity ($bn)



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg; * assumes BoJ purchases continue at the current reduced pace vs stated level

DEBT

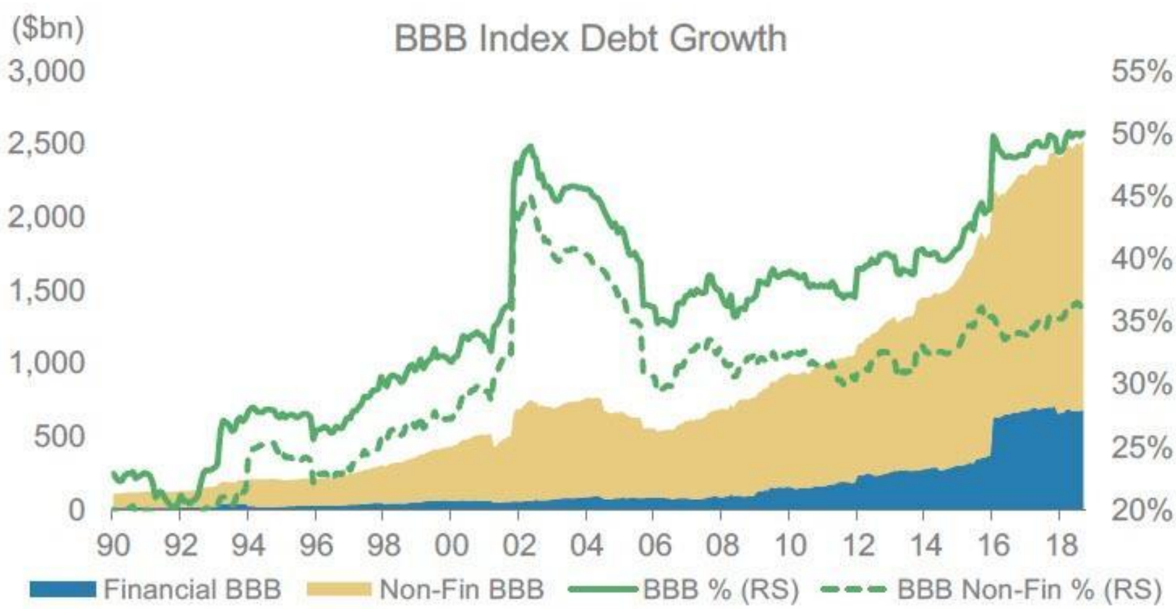
Markets price at the margin. If you are trying to price a $400 million debt deal and you have buyers for only $380 million, you have to increase the yield until you get to $400 million. It's the last marginal $20 million that prices the deal.

When the Fed was adding liquidity during its Quantitative Easing ("QE") programs, there was extra capital, at the margin, for debt and equity. Yields fell and stock prices went up. That has now flipped. The Fed is draining liquidity at the margin in its Quantitative Tightening ("QT") program. The reverse should now happen with yields rising and stock prices falling.

Ok, that is the easier conceptual piece of the impact of QT. There are also structural problems created by the Fed's largesse under QE. With near 0% interest rates, companies found it advantageous to issue debt and buy back stock. This raised leverage ratios, but investors did not care at 0% interest rates. The number of stock shares went down, EPS and stock prices went up. It was win-win. What was not to like?

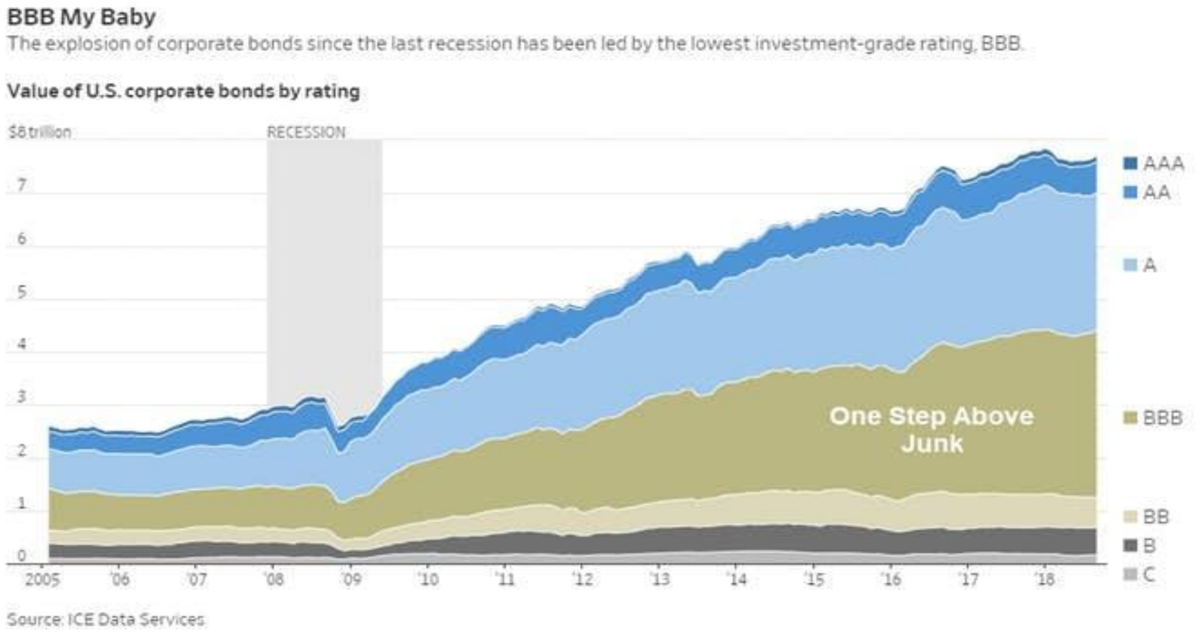
Much like a 20 year old with a credit card, it is easy to get into debt, but harder to get out. Investors tend to solely look at the Income Statement. Only in more difficult times do investors look at the Balance Sheet. Those times may be upon us. As investors focus on leverage, the spread between the corporate yield and the "risk-free" rate (USTs) expands. Also, as yields increase, the ability of the company to pay decreases and ratings get cut.
The growth in corporate debt since 2009 has been led by the BBB category, closely followed by the A category.

Exhibit 3: IG BBBs now total $2.5tn; 50% of IG index



Source: Morgan Stanley Research, FTSE Fixed Income LLC

BBB debt grew from around $1 trillion in 2008 to nearly $2.5 trillion a decade later in 2018. The percentage of BBB debt in the Investment Grade ("IG") Index rose from around 35% to nearly 50% now. Single A debt grew significantly as well. Overall corporate debt grew from around $3 trillion to around $7.5 trillion.

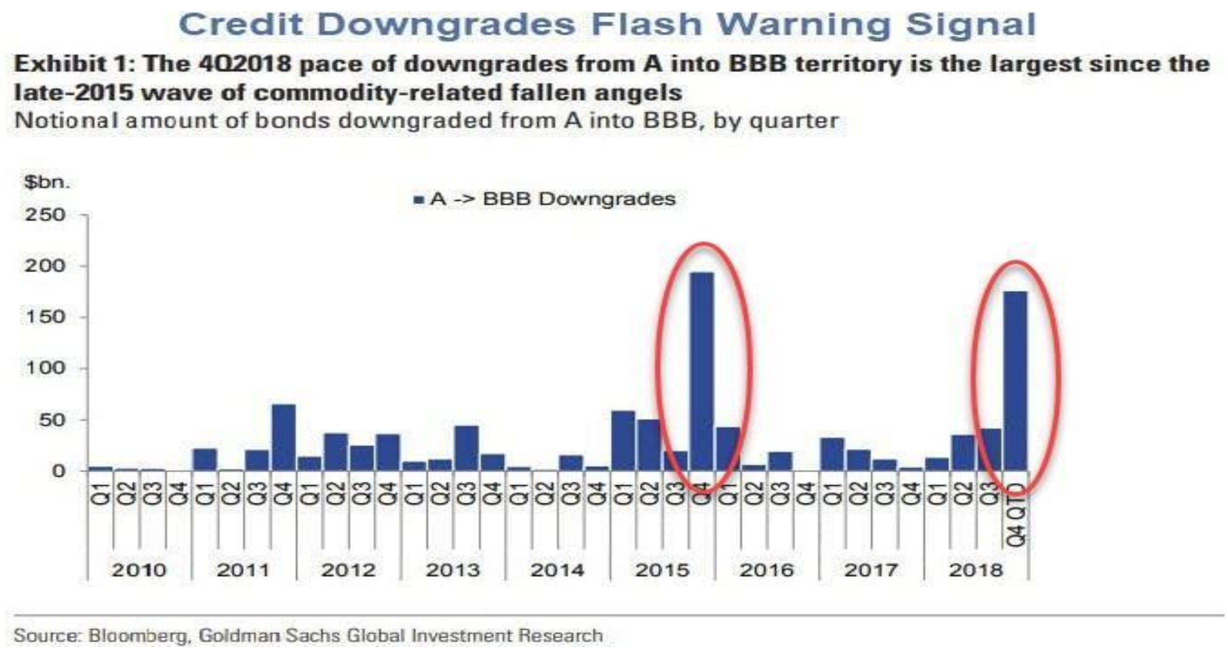


The size of the debt matters because it makes the entire debt market more fragile. If cash flow continues to grow steadily, interest and principal gets paid and all is fine. However, if cash flows should become more volatile and uncertain, the impact to ratings and yields will be more severe and volatile. This volatility translates into the equity market because equity is paid after debt and earnings are computed after subtracting the interest. At the margin this has large impacts.

The overall debt rating make up of the IG index matters because the lower the overall credit rating of the IG index, the riskier and therefore the more volatile the overall index will be. There is less room for unforeseen problems. This impacts the equity markets because there is a risk premium for owning equities. As risk goes up for debt, it goes up even more for equities.

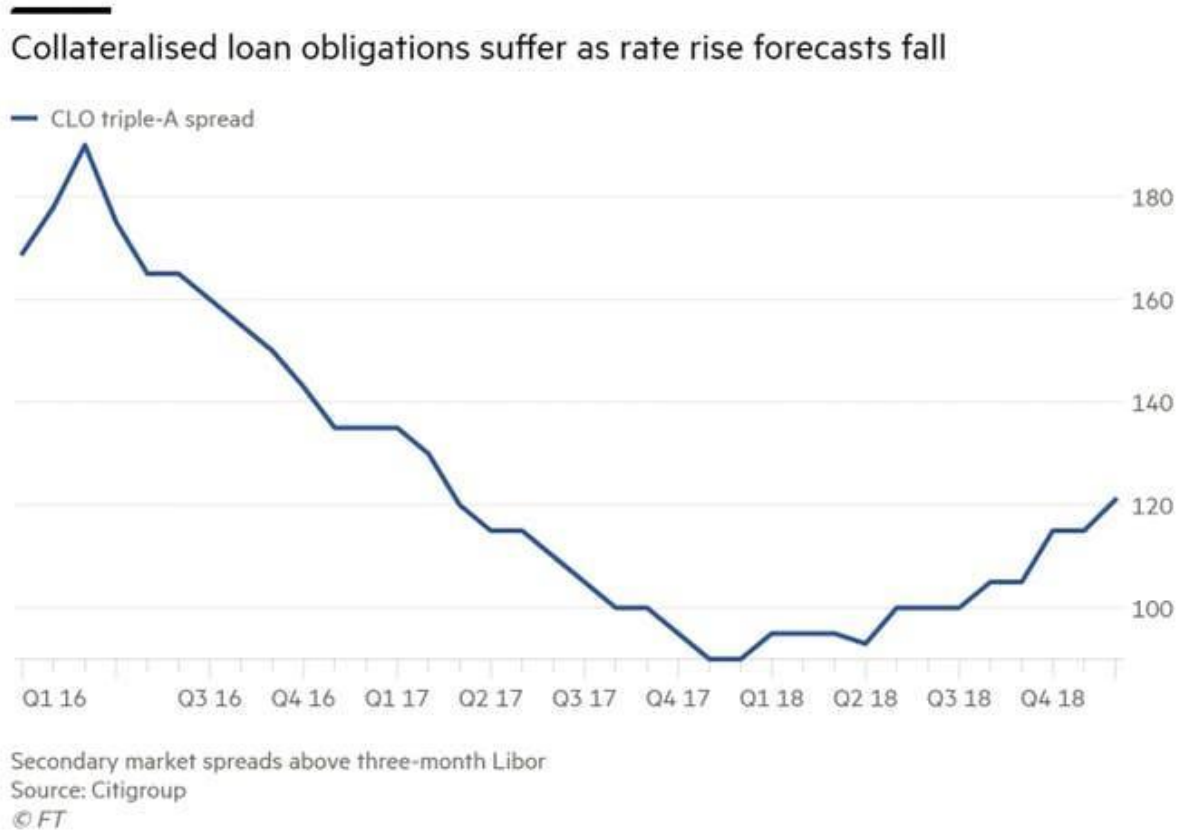
In the past decade while these debts were being built up, the market had the wind at its back. The Fed was pumping liquidity, yields were going down, equities were going up. When the Fed reversed, investors looked to the stock market to see if they should care. As long as the market went up, they were content whistling past the graveyard. That has now changed.

Another problem is what happens if global growth slows and debt gets downgraded. As long as downgrades are few and small, there isn't much impact. But if these downgrades are large, they get noticed. Recently GE and PG&E have seen pressure on their ratings. Others have seen outright downgrades. Q4 2018 has seen a spike in downgrades from A to BBB. This has focused attention on the problem and added to the market volatility in past quarter.



The largest volatility happens in the riskier debt levels. The Leveraged Loan Index ran into trouble in the quarter. Some large banks could not sell their deals and had to keep the loans. To get the deals, the banks had to offer great terms and little in the ways debt covenants. These deals were easy to originate and sell when the wind was at their back. Now, not so much. When this happens, credit conditions tighten. The vast majority of companies plan on rolling over the debt. 50% of the debt matures over the next 5 years.

CLOs are packages of loans that are structured into tranches. Prior to 2008, many of these loans were mortgages. Now most of these loans are corporate loans. Spreads are starting to widen on these products. It is still early, but if this continues it adds to the fragility of the debt markets and equity markets.



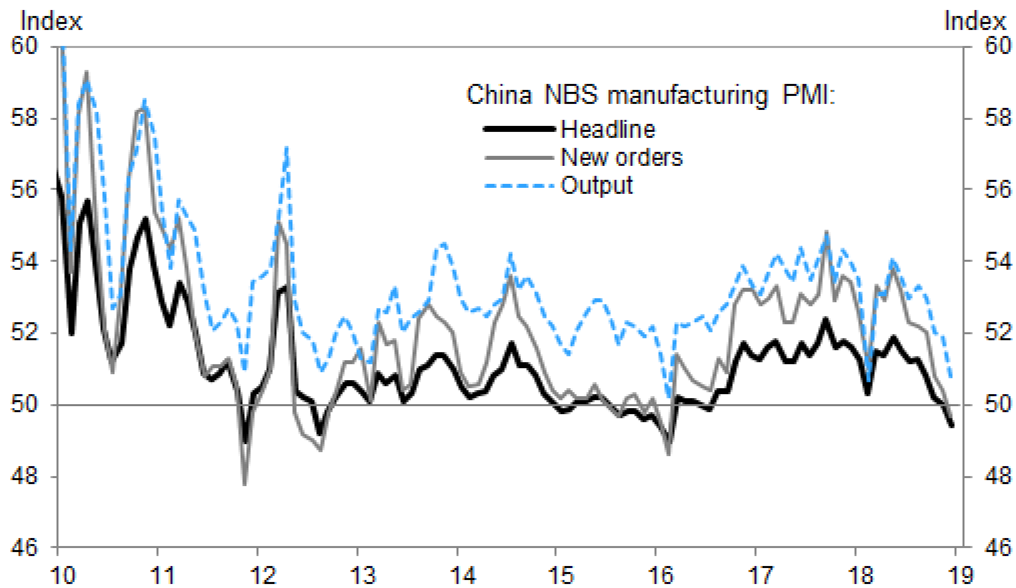
Investors act like these transitions happen in a smooth, orderly way. In reality, they tend to happen in violent, volatile ways. Investors move money to safer alternatives, wait for a near-term bottom, then move out the risk curve until the next violent move. For the past decade the markets were a one-way trade up. We think that has now changed. If global GDP growth continues to slow, the volatility will continue.

CHINA

We follow China because it has been the leader in global GDP growth this past decade. When it slows, so does global GDP. The larger companies in the US are global companies and are greatly impacted by the larger economies in the world. Apple and many other large stocks saw most of their growth in China. Recently, Apple preannounced and took their numbers down due to China. Apple's CEO, Tim Cook, blamed the miss on China and said that China had been slowing since last summer. China's cell phone market is much more competitive than the US, so Apple's comments may be more Apple and tech specific, but investors will be watching China intently.

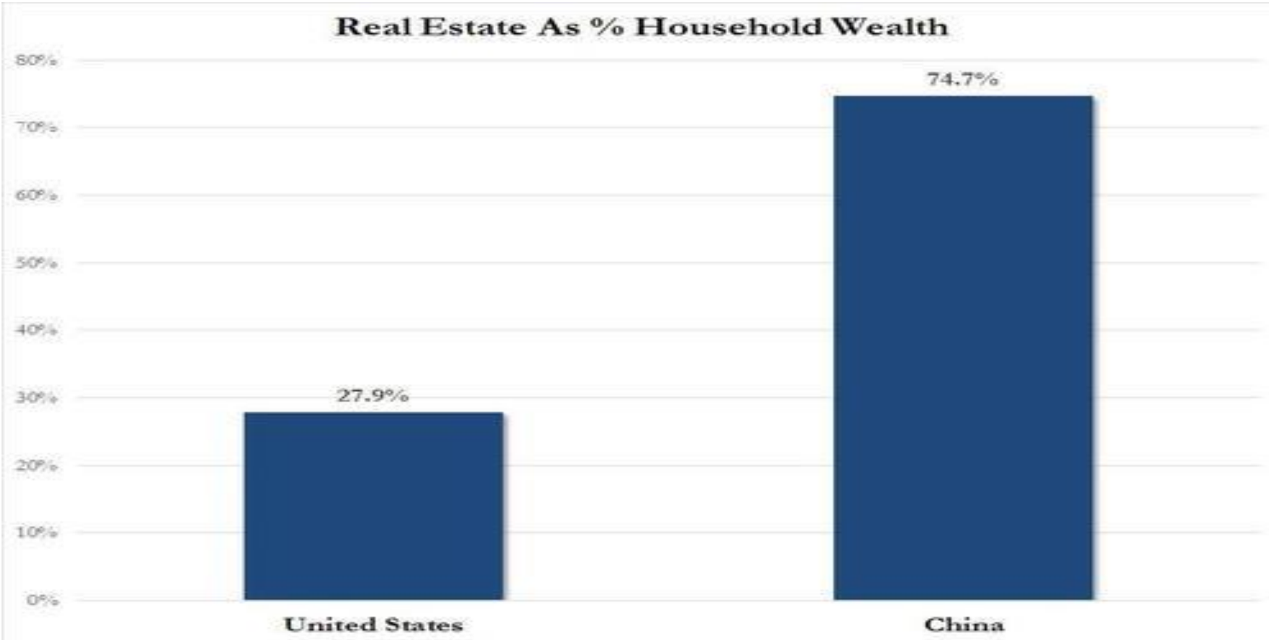
China's Caixin composite PMI recently dropped below 50 which indicates contraction. This backs up Tim Cook's comments. China has been impacted by US tariffs and threats of more tariffs. The recently negotiated new "NAFTA" agreement requires more North American content for Canada and Mexico to receive lower tariffs when exporting into the US. This impacts China the most as they were the largest beneficiary of the old lower content requirements. The China NBS manufacturing PMI also dipped below 50.

Source: ZeroHedge

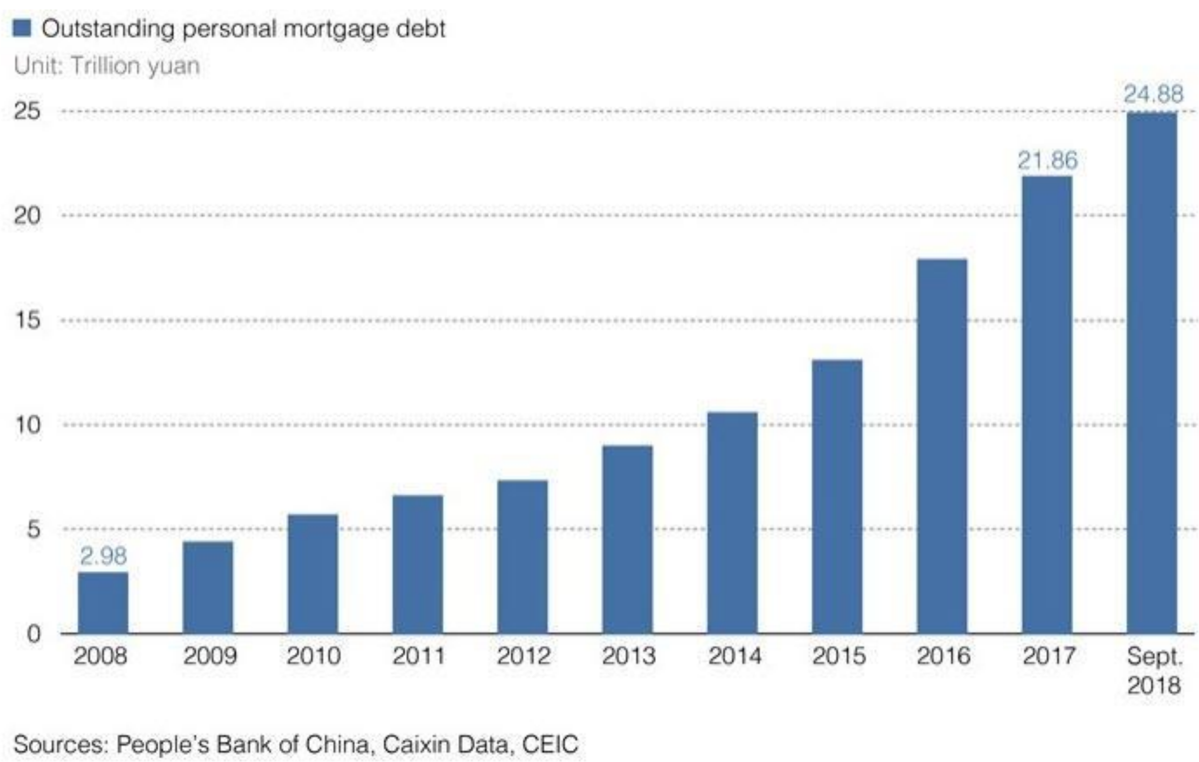


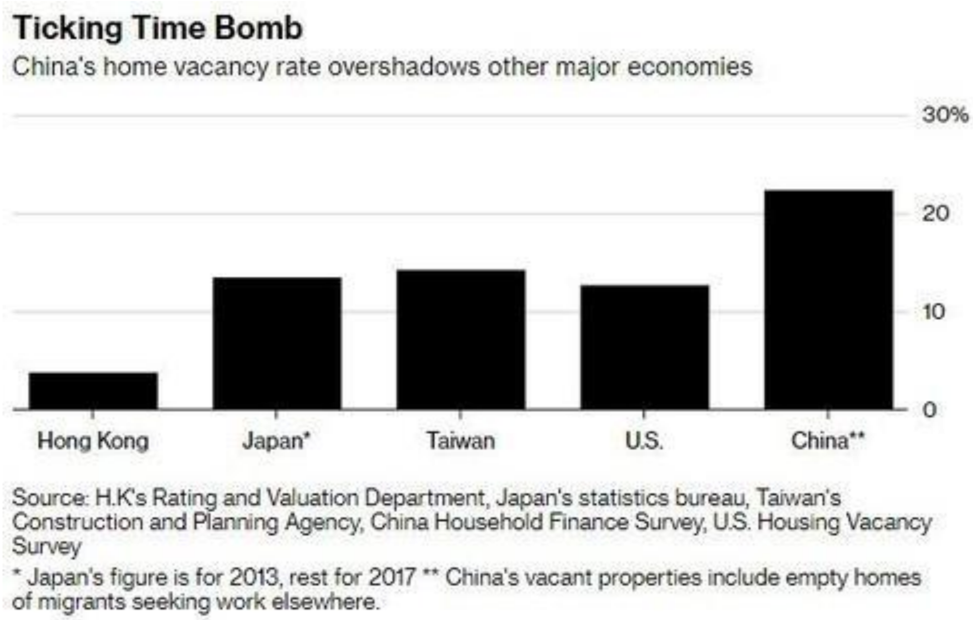
Source: ZeroHedge

One of China's largest engines of growth has been its housing sector. This sector has been driven by home price appreciation. Many wealthy Chinese buys new homes as investments and do not move in so they can resell later as a new home. Mortgage debt and home vacancy has ballooned over the past decade. It is estimated that there are 50 million empty apartments in China. Last year, the Wall Street Journal noted that more than 200 cities across China have been buying excess apartments from property developers and moving in families from condemned city blocks and nearby villages. This program has been going on for over 3 years and is set to expire in 2020.



We were amazed at the comments of Mr. Tian, the chairman of China's large state mortgage bank, CCB, speaking at Peking University's Guanghua school of management. Tian said that "there's no money to be made if you buy a flat nowadays. If you insist on buying a home, aren't you trapped at the high price level?" This is an alarming statement given the high prices and vacancy rates. It gives pause to China's large growth engine that is based on price appreciation.

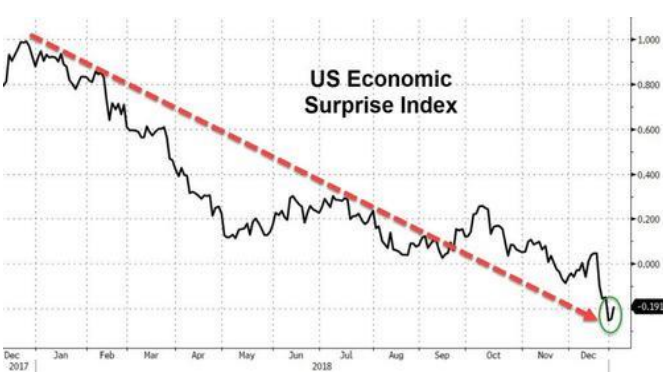


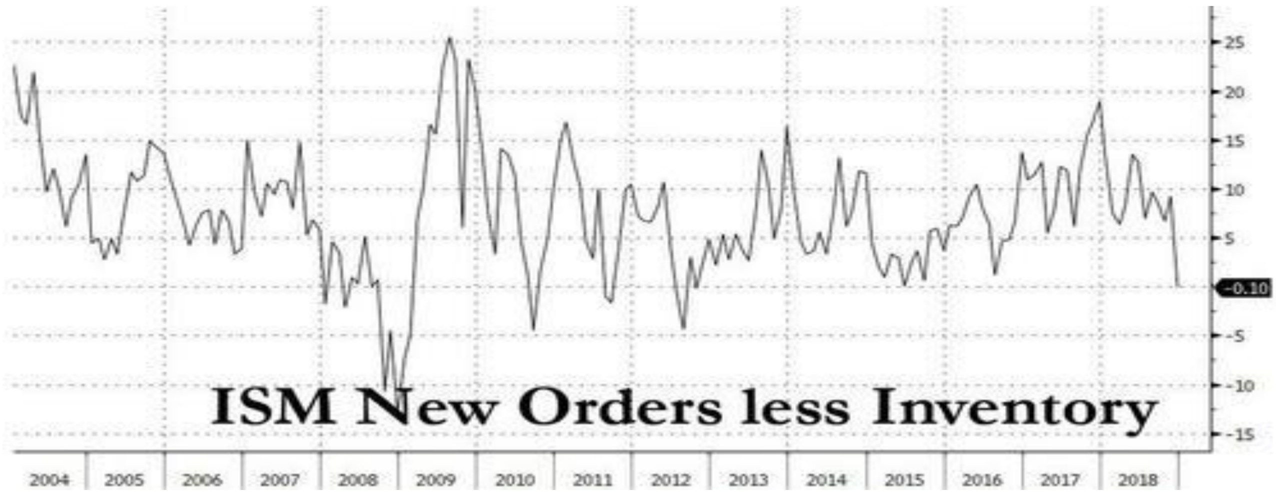


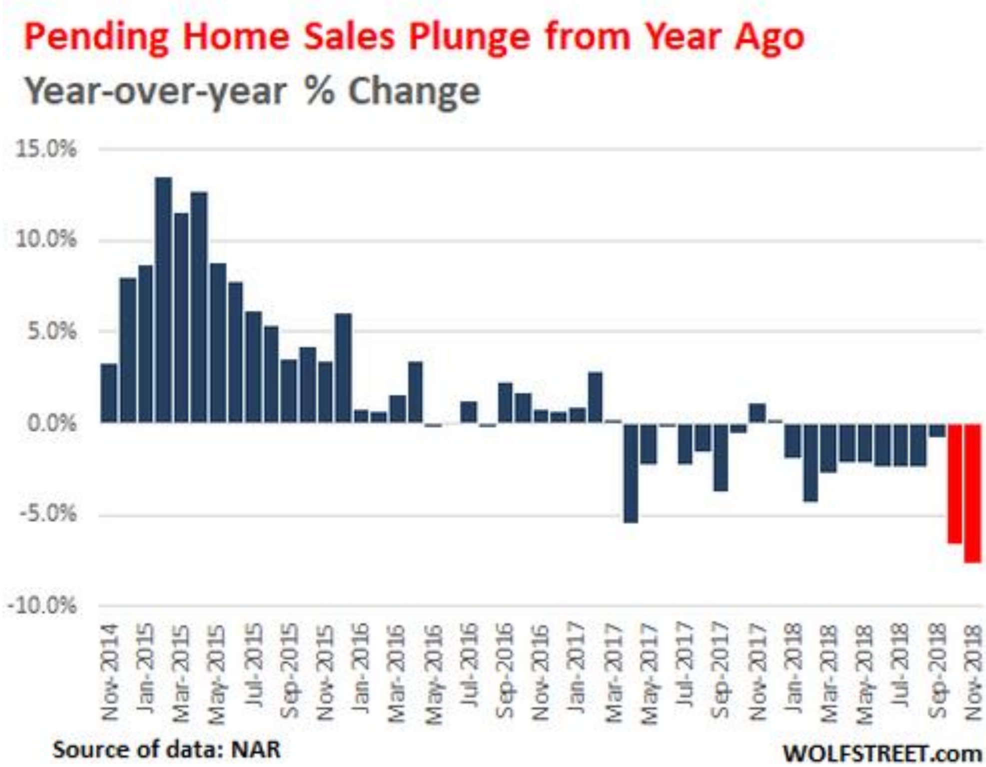
US growth

The US has been growing nicely and the unemployment rate is very low. As always, the question is, will this continue. Morgan Stanley's chief US equity strategist, Mike Wilson, sees a "massive" deceleration in economic growth in 2019. Not a recession but a deceleration. Wilson expects Q4 18 GDP growth of 3.1% slowing to 1.7% by Q4 19 as tax cuts wear off and interest rates rise.

We would note that some of the recent GDP growth was due to inventory build ahead of possible tariff increases. This has the effect of pulling demand forward and softening future demand. We would also note that the recent US Manufacturing ISM new orders less inventory just went negative, which suggests slowing ahead. Citi's Economic Surprise Index has been slowing all of 2018. This also suggests deceleration. Pending home sales are also dropping showing trouble in that sector. Finally, Morgan Stanley's auto analyst, Adam Jonas, expects global auto sales to be down 0.3% year over year in 2019. Ford, which reported a 8.8% drop yoy in December sales, announced that they would not be reporting monthly sales anymore, but will only report quarterly sales. This is generally not good news.







Wilson also predicts an earnings recession in 2019, which he defines as two quarters of negative year-over-year growth. We note that earnings comparisons get more difficult this year as we anniversary last year's tax-cuts.

Europe

Many European economies (notably Germany) actually contracted in Q3. This is interesting as interest rates in many of these same countries are still negative. Japan experienced the same. European auto sales fell 8.1% yoy in November, so the contraction may be continuing. The point being that negative interest rates are not the panacea that many investors think.

VALUATION

The Leuthold Group noted in Q3 that median stock P/Es for NYSE listed stocks had surpassed the prior peaks found in 1929, 2000 and 2007. The price-to-sales ratio for S&P 500 was higher than the 2000's prior peak. The median P/S ratio was twice as great as 2000's peak. While 2000's overvaluation was concentrated in larger stocks, today it's everywhere.

We believe 2019 will be an interesting year. With high valuations and slowing global growth recent volatility could continue. Expect reactions from the Fed which could lead to more roller coaster markets.

LOOKING FORWARD

We try to produce the best risk-adjusted returns available. As risks have increased, we have increased our protection. If risks subside or are priced in, we will gladly reduce our protection. But until the market more fully reflects these risks, we will remain cautious.

Best regards,

Thomas H. Forester

CIO and Portfolio Manager

For more complete information on the Forester Funds, including charges and expenses, obtain a prospectus by calling 1-800-388-0365 or visiting www.ForesterValue.com. The prospectus should be read carefully before investing.

The foregoing does not constitute an offer or recommendation of any securities for sale. Past performance is not indicative of future results. The views expressed herein are those of Thomas Forester and are not intended as investment advice.

Copyright © 2019. All rights reserved.