May 2019

From the front page of this weekend's WSJ:

Broad Market Turmoil Caps Difficult Month for Stocks

BY CORRIE DRIEBUSCH AND NATHAN ALLEN

Rising trade tensions sent stocks and bond yields around the world skidding Friday, capping a tough month for markets that caused the Dow industrials to notch their longest losing streak in nearly eight years.

Major U.S. stock indexes lost more than 1% on Friday and closed the month of May down more than 6.5%, their worst monthly performance since December.

The Dow Jones Industrial Average slid 354.84 points, or 1.4%, to 24815.04, capping its sixth consecutive week of losses, the longest weekly losing streak since June 2011. The S& P 500 fell 36.80 points, or 1.3%, to 2752.06 while the Nasdaq Composite lost 114.57 points, or 1.5%, to 7453.15. All three indexes remain up for the year, though gains have shrunk, with the Dow industrials now only up 6.4% in 2019.

Investor unease also rippled across the bond market. The yield on 10-year U.S. Treasurys fell sharply to 2.139%, marking its largest one-month yield decline since 2015. As concerns about economic growth build, yields have dropped to their lowest level since September 2017.

At the heart of May's stock and bond-yield drop: The fear that the U.S. economy's nearly decade long expansion--which in July will become the longest on record--may be nearing an end. While few analysts anticipate an imminent recession, many worry that economic growth could stumble as companies rein in spending and higher tariffs around the world hurt sales.

Gold, a haven investors tend to put money in when they're worried about the economy, rose to $1,305.80 a troy ounce, up 1.8% in May, its biggest monthly gain since January. Yields on German 10year bunds fell to negative 0.201%, an all-time low.

Investors fled riskier assets after President Trump threatened to impose escalating tariffs on Mexico, a move investors fear could hurt corporate earnings, increase prices for U.S. consumers and crimp economic growth. The Mexican peso fell 2.5% against the dollar, while the Japanese yen, typically perceived as safer, gained.

Mr. Trump said late Thursday that the U.S. would impose escalating tariffs on its southern neighbor starting June 10, unless the country takes action to deter the flow of Central American migrants passing through its borders. The levies could hit 25% by October if Mexico fails to satisfy the White House's demands.

"This will impact consumer spending. This will impact corporate earnings. This is utilizing a trade policy tool to enforce policy outside of trade, and that sets a concerning precedent and leaves investors wondering how else tariffs could possibly be used," said Kristina Hooper, chief global market strategist at Invesco. "Markets were already freaking out over existing tariffs. We've just thrown gas on the fire."

It is the latest in mounting trade tensions. Through Friday, the administration has imposed 25% tariffs on roughly $250 billion of Chinese imports. It has threatened to add even more goods to its tariff lists.

After a choppy end to 2018, U.S. stocks had climbed to fresh records this year on optimism that a trade deal between the U.S. and China would be struck.

Then, in early May, those hopes quickly faded after Mr. Trump threatened to raise tariffs quickly on Chinese imports.

The higher tariffs have hurt stocks in recent weeks, from retailers hit with higher costs on imported goods, to manufacturers that import steel and aluminum from China to technology companies facing weaker sales in a coveted market. Energy companies also tumbled in May, as concerns about trade policy and slowdown in the Chinese economy drove the price of oil down 16% to its lowest level since February.

Bank shares are getting a double hit. Falling interest rates narrow the gap between what banks charge borrowers and what they pay depositors, so lower yields are pressuring shares of big banks. Furthermore, bank performance tends to be a reflection of the economy, as banks do well when companies and consumers are spending freely and taking out big loans. Higher tariffs threaten to curb that spending. The KBW Nasdaq Bank Index shed 1.7% Friday, putting its monthly loss at 10%.

Shares of auto makers and their suppliers, which are highly exposed to trade fluctuations, also fell more Friday. General Motors and Ford drops put their monthly declines at 14% and 8.9%, respectively.

Both companies have extensive manufacturing footprints in Mexico and rely on a network of suppliers that transport raw materials and semi-finished products across the border. They also import parts from China. ...

U.S. markets weren't alone in their May declines. The Stoxx Europe 600 lost 5.7% during the month, its biggest drop since January 2016. The Hang Seng fell more than 9% in May, while the Shanghai Composite lost 5.8%, marking both of their biggest one-month drops since October. ...

From Friday's Global Investment Strategy:

Despite the darkening clouds hanging over the trade war, we still expect a detente to be reached that prevents a further escalation of the conflict. Both sides would suffer from an extended trade war. For China, it is no longer just about losing access to the vast U.S. market. It is also about losing access to vital technology. The blacklisting of Huawei deprives China of critical components needed to realize its dream of becoming a world leader in AI and robotics.

The trade war will not harm the U.S. as much as it will China, but it has still raised prices for American consumers, while lowering the prices of key agricultural exports such as soybeans. It has also hurt the stock market, which Trump seems to view as a barometer for his own success as president.

If a trade detente is eventually reached, market attention will shift back to the outlook for global growth. We expect the combination of aggressive Chinese fiscal/credit stimulus and the palliative effects of falling global bond yields over the past seven months to lift growth in the back half of the year.

That afternoon we received the following from BCA Research:

SPECIAL ALERT

Lowering The Price Target On Our Short S&P 500 Trade Due To The Escalation Of The Trade War

We remain structurally overweight global equities, but hedged our long exposure on May 10th following what we regarded as an overly complacent reaction by investors to President Trump's decision to further raise tariffs on Chinese imports. Last night's announcement that the U.S. will increase tariffs on Mexican imports represents a further escalation of the trade war. About two-thirds of U.S.-Mexican cross-border trade is between the same companies. Higher tariffs and increased operating inefficiencies will eat into the profits of U.S.-listed firms. Accordingly, we are reducing the profit target on our short S&P 500 trade from 2711 to 2650.

The drop in interest rates has caused REITs to outperform:

In REITs, Bricks And Mortar Wins

May 7, 2019

Brad Thomas

... Berkshire Hathaway also has investments in Store Capital (STOR) (as do 2 HCM clients), as well as Seritage Growth Properties (SRG) - two traditional real estate investment trusts that operate off of actual real estate instead of online carts and mouse clicks.

Source: Yahoo Finance

I'm especially aware of this considering how, in September 2016, I wrote an article titled, "I Wonder If Ben Graham Would Have Invested in Store Capital." And then in May 2017, I upgraded the net lease REIT to a Strong Buy.

Then, less than 60 days later, on June 26, Berkshire Hathaway invested $377 million in Store to become a 9.8% owner (at the time). Shares have since grown by over 50%. ...

Reading the Tea Leaves

Since most other mall REITs have already reported, we know - yet again - that our theory still holds true… Despite Amazon being Amazon, the best retail real estate operators are doing just fine. It's just that the gap between the strong and the weak in this space is clear.

And it's only growing more clear as time goes on.

Heading into this reporting cycle, we were curious to see how some of these operators - everyone from the premium mall space to the Class-C landlords - were going to speak about the rampant amount of store closures that have shaken out already this year.

It's been reported that more than 6,000 store closures have been announced by U.S. retailers so far in 2019, which is more than all of 2018. Though, instead of the department stores and big-box players going dark, as was the case with Sears and Toys 'R' Us, this year we've seen more in-line tenants like Charlotte Russe and Payless Shoesource biting the bullet.

So really then… How are mall owners faring? ...

Finally, **Pennsylvania Real Estate Investment Trust** (PEI) (which is held by 5 of our clients) boosted the mall REIT subsector Friday afternoon with some solid announcements. As the company explained on its earnings calls, it generated Q1-19 FFO per share of $0.26.

That compares with $0.28 per share in the year-ago quarter, but its core mall total occupancy was 94.7%, up 100 basis points from Q1-18. And same-store net operating income, or NOI, rose 2.2%. It also affirmed full-year adjusted FFO guidance of $1.20 to $1.34 per share.

On its latest earnings call, PREIT CEO Joe Coradino said, "The quality of the portfolio has driven our ability to come in at the top end of our peer group with same-store NOI results and to maintain our full-year guidance."

PREIT's densification efforts will likely generate around $150 million to $300 million as it monetizes land for multi-family development.

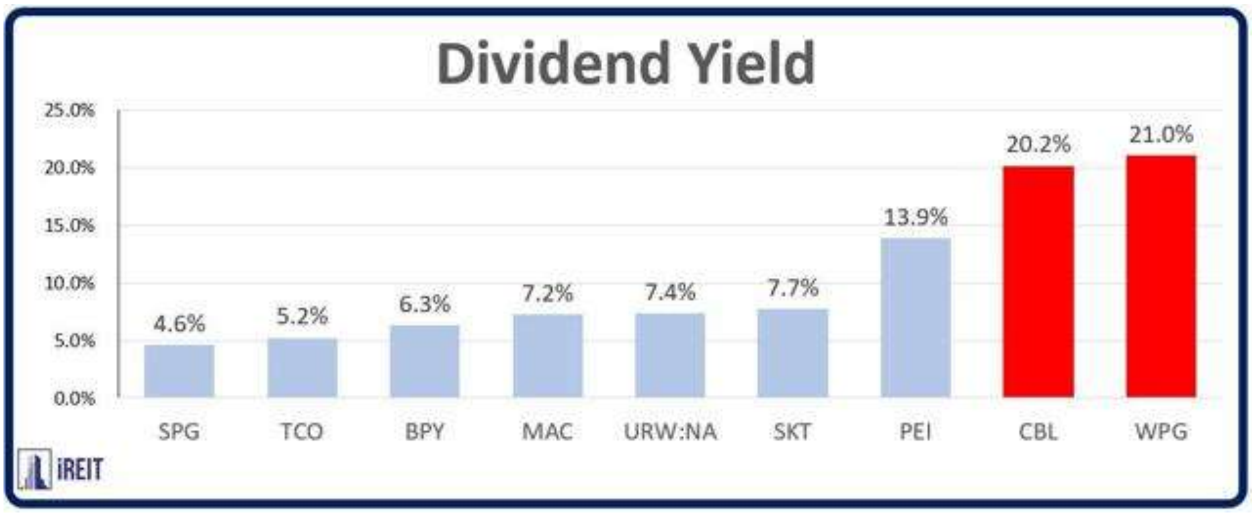
During the same earnings call, Coradino also noted how the company already has "several institutional investors engaged," something it sees as "a top priority." So no wonder PEI surged Friday afternoon… up 15.6% for the week, as shown below.

A Few Quotes and Some Data

… a few of Klarman's famous quotes alongside some helpful mall REIT data I've put together. (BPY is held by1 client)

He's a very smart man, as evidenced by statements such as:

"The single greatest edge an investor can have is a long-term orientation."



And this one…

"Value investing is risk aversion."

Ticker	16-17 FFO/Share Growth	17-18 FFO/Share Growth2	18-19 FFO/Share Growth	19-20 FFO/Share Growth	20-21 FFO/Share Growth	5 Year Average
URW:NA	9.29%	3.60%	32.36%	-6.27%	-7.33%	6.33%
BPY	5.88%	2.78%	8.99%	4.34%	0.00%	5.50%
SPG	6.86%	8.21%	2.61%	3.26%	3.99%	4.99%
TCO	-2.89%	3.51%	-3.68%	5.04%	7.35%	1.87%
SKT	-10.17%	16.98%	-9.23%	-1.38%	2.25%	-0.31%
MAC	-6.13%	-2.61%	-4.72%	3.24%	3.27%	-1.39%
PEI	-16.40%	-2.53%	-17.92%	5.78%	8.15%	-4.59%
WPG	-8.43%	-7.36%	-20.73%	-4.59%	-3.59%	-8.94%
CBL	-13.69%	-16.83%	-17.51%	-4.98%	-2.36%	-11.07%

iREIT

And this one…

"Ultimately, nothing should be more important to investors than the ability to sleep soundly at night."

Ticker	5 Year Trailing FFO	P/FFO	Difference
BPY	0.0	13.0	na
SPG	17.7	14.4	-19%
WPG	5.2	4.0	-23%
TCO	19.8	14.0	-29%
MAC	17.8	11.8	-34%
SKT	14.7	8.2	-44%
PEI	10.1	4.8	-52%
URW:NA	19.7	9.0	-54%
CBL	4.5	0.9	-81%

iREIT

And this one too…

Most investors are primarily oriented toward return - how much they can make - and pay little attention to risk: how much they can lose."

Finally, as you can imagine, this Seth Klarman quote is one of my favorites:

Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night." ...

Follow-ups

In the following 3 minute video Morningstar's Ben Johnson, director of global ETF research, speaks with Holly Framsted, who's the head of factor ETFs for BlackRock iShares. While titled "Will Value Investing Come Back?", she emphasizes the importance of Factor diversification: https://www.morningstar.com/videos/929034/will-value-investing-come-back.html

We have previously warned about the importance of avoiding IPOs, so when a segment of CNBC's Squawk Alley on May 25th showed the IPO ETF was up over 30% YTD, we decided to take a closer look. We have added the S&P 500 (orange line) to Morningstar's chart:

From the NYT:

Economists often don’t know what they’re talking about

By **Robert J. Samuelson** May 12

The most intriguing and indisputable thing we have learned about economists in recent decades is that they don’t know nearly as much as they thought they knew. We see evidence of this all the time. Just recently, the Bureau of Labor Statistics reported that the economy had created 263,000 payroll jobs in April. This was almost 40 percent more than the 190,000 that economists had predicted.

Something new and different seems to be happening in labor markets, as the growth in jobs has continued to be unexpectedly strong. But just what it is, how long it will last and whether it might soon be reversed are mysteries to most of us, including most economists.

It's part of the larger problem. As an economic journalist for roughly half a century, I have slowly and somewhat reluctantly come to the conclusion that many economists (and this applies across the political spectrum) often don't know what they're talking about — a shortcoming that is sometimes acknowledged and sometimes isn't.

Before I appear unbearably arrogant, let me state the obvious. Most economists I've dealt with over the years are extremely smart and well-informed. They're a lot smarter than I am. I've learned much from them; it has been one of the rewards of the job. Most are also public-spirited and generous with their time. With a few exceptions, they generally elevate the level of public discussion.

Still, the record is what it is, and it's not pretty. Time after time, economists have failed to foresee major economic trends. In recent years, global interest rates have plunged to historically low levels. (A 10-yearTreasury bond fetches 2.5 percent.) Given the importance of interest rates in economic decisions — they affect everything from housing to the stock market — this is a big deal. But most economists did not anticipate the declines and still can't fully explain them.

Going back a bit further, economists did not predict double-digit inflation (monthly peaks of 12 percent in 1974 and 1975 and 15 percent in 1980). Its emergence frightened and demoralized millions of Americans. Indeed, policies Democratic economists advocated in the 1960s kindled the inflation. Now, ironically, inflation has unexpectedly remained low (generally less than 2 percent annually), and many economists have been baffled by that, too.

Productivity is another disappointment. As you probably know, productivity is just another term for efficiency. It means doing more with less. Higher productivity is the ultimate engine of higher living standards. It is crucial to economic success.

Over the past five decades, I cannot remember one instance when economists have correctly forecast a major shift in productivity growth, whether up or down. Not in the late 1960s and early 1970s when productivity growth slowed. Nor in the 1990s when productivity accelerated. And not now, when there has been a pronounced slowdown. (From 2010 to 2017, productivity growth has averaged 0.5 percent annually, compared with a post-World War II average of 2 percent.)

The Trump administration's economists believe they will reverse these trends. Their corporate tax cuts will stimulate investment and productivity gains, the thinking goes. Maybe, but I'm skeptical. My view is that the ignorance gap is huge — that is, the difference between what economists (and by extension the rest of us) know and what we need to know.

Of course, the most conspicuous example of this ignorance gap is the 2008-2009 financial crisis and the Great Recession. "Why did nobody notice it?" Queen Elizabeth famously asked. The answer is actually fairly easy.

Economists and others are conditioned by their own experiences, and a widespread financial panic in a rich society was not among those experiences. It hadn't happened in their lifetimes and couldn't happen. We had solved that problem through sensible government regulation and sophisticated financial management.

So it seemed. In reality, the belief that we had outlawed a financial panic rationalized more risk-taking behavior, which ultimately led to a financial panic.

The larger cause of the ignorance gap is the very complexity and obscurity of a $20 trillion economy (the United States) or an $85 trillion economy (the world). To say it is changing in detailed and often-unanticipated ways is simply to affirm that mere mortals, including economists, have never been very good at predicting the future.

What I think can be held against economists — not all, but many — is that they exaggerate what they know and how much they can influence the economy. The aim is usually to gain and retain political relevance and power. But the result is often disappointment, as government performance falls short of promises. A little more humility might be in order.

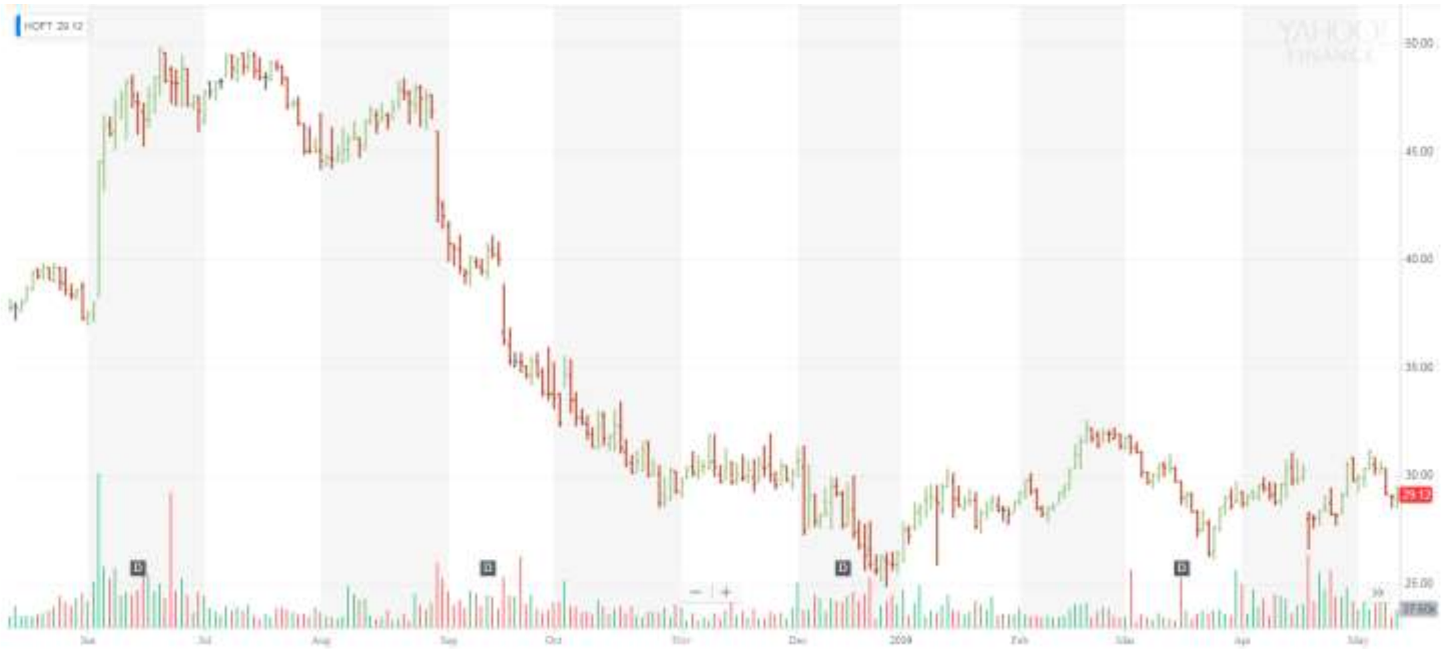
Positions

ELY - This IVA System pick, which manufactures golf clubs, was purchased for 5 clients on 5/28 @ 15.26:

Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
05/23/2019	1	Fleischer Russell		5,000
05/20/2019	2	Brewer Oliver G, Lynch Bria		16,575

HOFT - This IVA System pick, a furniture company, was purchased for 4 clients on 5/20 @ 28.33, and 1 on 5/28 @ 27.52:



Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
04/25/2019	1	Toms Paul		1,000
04/24/2019	2	Beeler W Christopher, Huckf		4,000
04/23/2019	1	Toms Paul		1,000
04/22/2019	1	Williamson Henry G		8,000

USAK - This IVA System pick was purchased for 5 clients on 5/9&10 @ 13.96:

Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
05/06/2019	1	Chambers M		1,360
05/02/2019	1	Glaser Thomas		2,900
05/01/2019	6	Bates Jason, Greene Alexan		28,425

From InsiderInsights' May 6th issue:

USA Truck (USAK) @ $14.32

We last left shares of USA Truck at the end of November 2017, cashing in a 119% gain in USAK in 41 weeks. Insiders were proven prescient when they signaled value in their beatendown shares by buying them Significantly earlier in 2017, and the stock gained steadily as this trucker's turnaround gained traction.

We ended up leaving a bit too soon, and USAK kept rising for several months after we took our hefty profits. But momentum left the this and other transportation stocks last year, and USAK has now fallen below where we sold them 18 months ago.

Several of the same predictive insiders that made us money back in 2017 are again signaling value in USAK now, and we're betting that the stock can provide another profitable ride. Six USA Truck insiders bought their stock on May 1st, after the company released Q1 results. Three in the cluster increase their holdings substantially with their latest buys. Four in the bunch have excellent track records with their past purchases.

USA Truck offers truckload services as a medium-to-long-haul common carrier; and dedicated freight services. It transports full dry van trailer loads of freight from origin to destination throughout the U.S., Canada, and Mexico. The company also provides freight brokerage and rail intermodal services.

USA Truck's Q1 results represented the company's 7th consecutive quarterly profit since its turnaround kicked in. Adjusted EPS of 24 cents was a notable improvement from last year's 14 cent profit, and 3 cents more than expected. Total revenues increased a solid 7.2%, to $134 million.

Yet USAK sold off on the quarter, and the stock still looks to be in a steady technical downtrend. In his Q1 press release, CEO (and insider buyer) James Reed acknowledged that his industry was currently in the midst of a "complex environment with dropping spot rates that put pressure on our logistics business, a continued challenging driver market, increasing fuel prices, relative seasonally soft first quarter demand, and another unusually difficult weather season."

These very real industry concerns are obviously weighing on USAK's price right now, despite the company's perfectly decent Q1 results. And investors are understandably concerned that these headwinds could yet cause a quarterly miss for the firm later this year.

The four analysts following USAK did tick down expectations leading into the Q1 event. But the average EPS estimate for 2018 still calls for 30% bottom-line growth, to $2.04, with another 20% growth expected in 2020, to $2.48. All rate the stock a Buy or better, with price targets ranging from $22 to $30.

We're betting that industry headwinds are already priced into USAK. After halving in price from last year's highs, the stock is trading for 6 times expected EPS, and less than 7.5 times trailing earnings. Even in the unsexy trucking industry, USAK's valuation seems overly depressed.