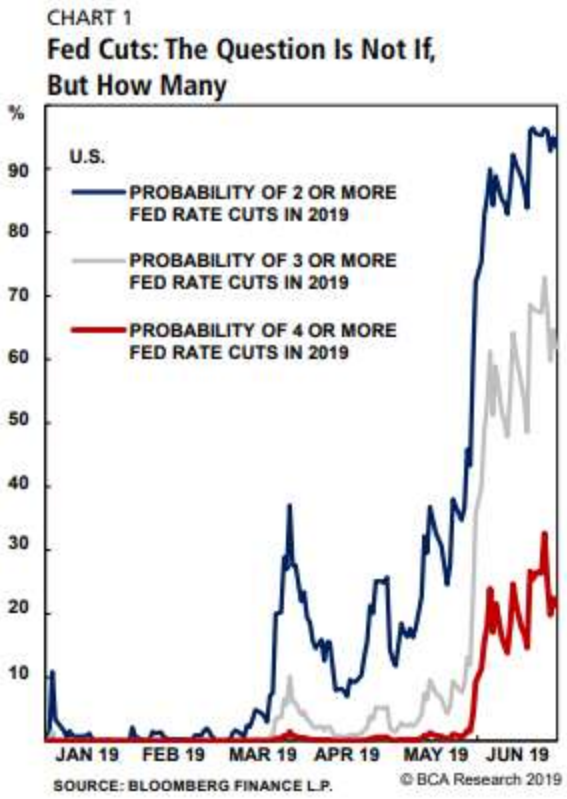
June 2019

On June 20th, the S&P 500 reached an all-time high, the only major US index to do so. While stocks pulled back toward the end of the month, it still ended the month up 5.5%.

From Friday's BCA Global Investment Strategy Quarterly Report:

A Not So Recessionary Environment

If one had been told at the start of the year that investors would be expecting the fed funds rate to fall to 1.5% by mid-2020 – with a 93% chance that the Fed would cut rates at least twice and a 62% chance it will cut rates three times in 2019 – one would probably have assumed that the U.S. had teetered into recession and that the stock market would be down on the year (Chart 1).



Instead, the S&P 500 is near an all-time high, while credit spreads have narrowed by 145 bps since the start of the year. Outside the manufacturing sector, the economy continues to grow at an above-trend pace and the unemployment rate is below most estimates of full employment.

According to the Atlanta Fed, real final domestic demand is set to increase by 2.8% in Q2, up from 1.6% in Q1. Real personal consumption expenditures are tracking to rise at a 3.7% annualized pace.

So why is the Fed telegraphing rate cuts when real interest rates are barely above zero? A few reasons stand out:

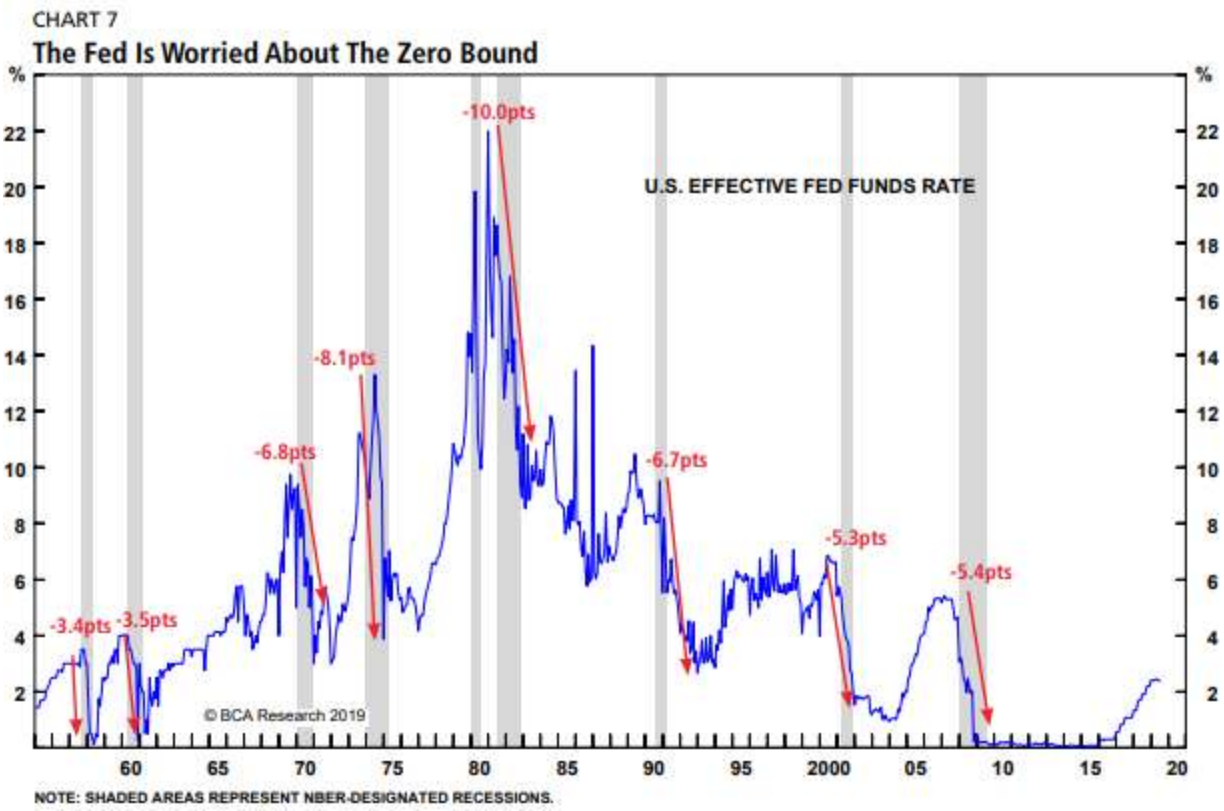
- Global growth has slowed.
- The trade war has heated up again following President Trump's decision to further increase tariffs on Chinese goods.
- Inflation expectations have fallen in the U.S. as well as around the world.

A Fundamental Asymmetry

Given that inflation expectations are quite low and there is considerable uncertainty over the level of the neutral rate, it does make some sense for policymakers to err on the side of being too dovish rather than too hawkish. This is because there is an asymmetry in monetary policy in the current environment.

If the neutral rate turns out to be higher than expected and inflation starts to accelerate, central banks can always raise rates. In contrast, if the neutral rate turns out to be very low, the decision to hike rates could plunge the economy into a downward spiral.

Historically, the Fed has cut rates by over five percentage points during recessions (Chart 7). At the present rate of inflation, the zero-lower bound on interest rates would be quickly reached, at which point monetary policy would become largely impotent.



The asymmetry described above argues in favor of letting the economy run hot in order to allow inflation to rise. A higher inflation rate going into a recession would let a central bank push real rates deeper into negative territory before the zero bound is reached.

In addition, a higher inflation rate would facilitate wage adjustments in response to economic shocks. Firms typically try to reduce costs when demand for their products and services declines, but employers are often wary of cutting nominal wages. Even though it is not fully rational, workers get more upset when they are told that their wages will fall by 2% when inflation is 1% than when they are told their wages will rise by 1% when inflation is 3%.

More controversially, a modestly higher inflation rate could improve financial stability. In a low-inflation, low-nominal-rate environment, risky borrowers are likely to be able to roll over loans for an extended period of time. This could lead to the proliferation of bad debt….

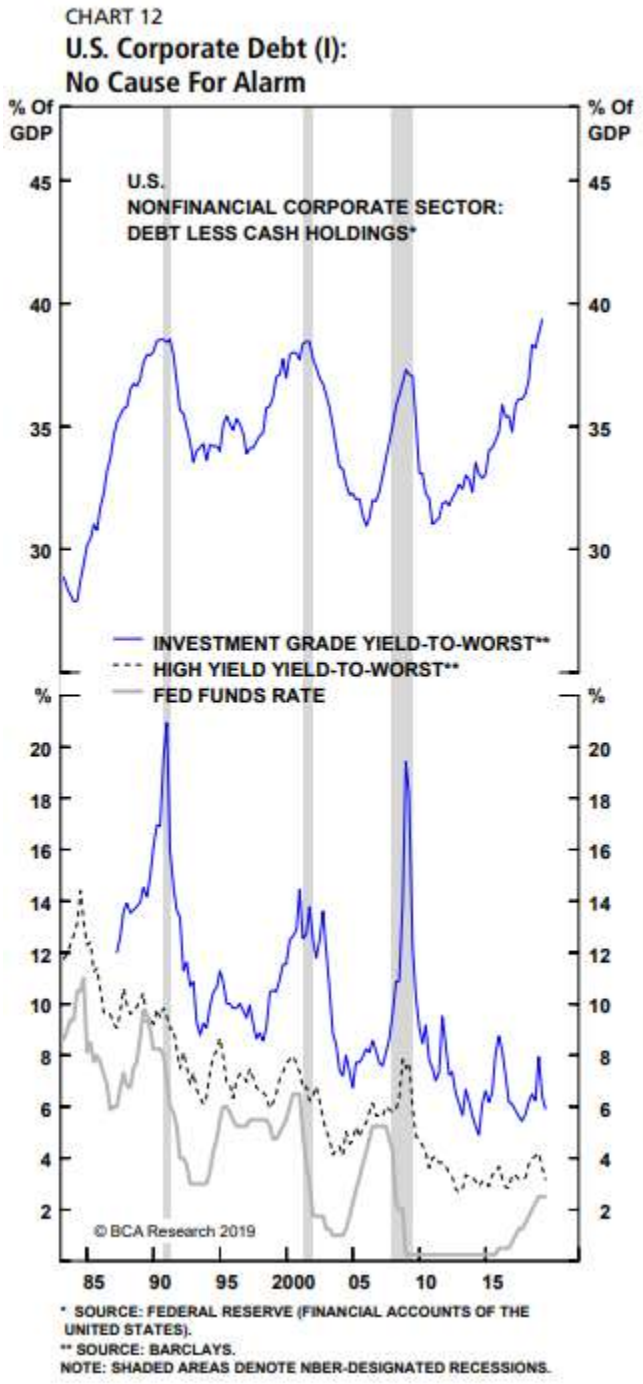
U.S. Imbalances Are Modest

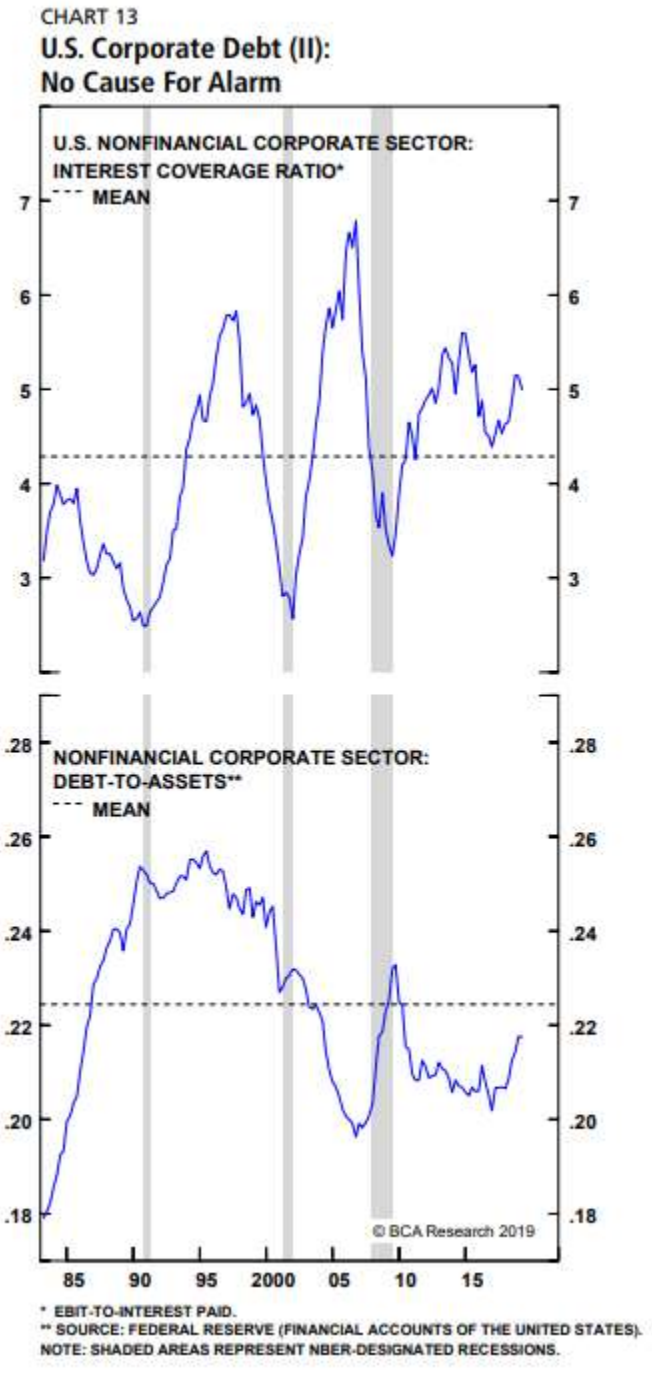
Recessions usually occur when rising rates expose some serious imbalances in the economy. In the U.S. at least, the imbalances are fairly modest. ... housing is on solid ground, which means that mortgage rates would need to rise substantially before the sector crumbles. Equities are pricey, but far from bubble territory. Moreover, unlike in the late 1990s, the run-up in stock prices over the past five years has not led to a massive capex overhang.

Corporate debt is the weakest link in the financial system, but we should keep things in perspective. Even after the recent run-up, net corporate debt is only modestly higher than it was in the late 1980s, a period where the fed funds rate averaged nearly 10% (Chart 12).

Thanks to low interest rates and rapid asset accumulation, the economy-wide interest coverage ratio is above its long-term average, while the ratio of debt-to-assets is below its long-term average (Chart 13). The corporate

sector financial balance – the difference between what businesses earn and spend – is still in surplus. Every recession during the past 50 years has begun when the corporate sector financial balance was in deficit (Chart 14).



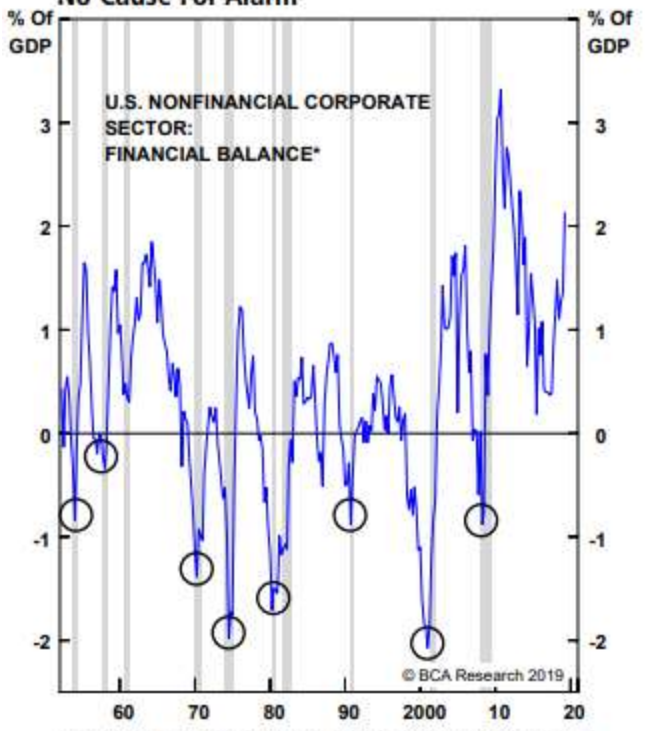


The Dollar, The Neutral Rate, and Global Growth

In a globalized economy, capital flows can equalize, at least partially, neutral rates across countries. If any one central bank tries to raise rates – while others are standing pat or even cutting rates – the currency of the economy where rates are rising will shoot up, causing net exports to shrink and growth to slow.

CHART 14

U.S. Corporate Debt (III): No Cause For Alarm



* FINANCIAL BALANCE IS CALCULATED AS GROSS SAVINGS LESS NET CAPITAL TRANSFERS PAID LESS CAPITAL EXPENDITURES (EXCLUDING INVENTORY CHANGE).
Q4 2017 DATA POINT EXCLUDED DUE TO THE IMPACT OF THE TAX ON FOREIGN EARNINGS RETAINED ABROAD (2017 TAX CUTS AND JOBS ACT) ON CAPITAL TRANSFERS.
SOURCE: FEDERAL RESERVE (FINANCIAL ACCOUNTS OF THE UNITED STATES).
NOTE: SHADED AREAS REPRESENT NBER-DESIGNATED RECESSIONS.

CHART 15

The Dollar Is A Countercyclical Currency

* SOURCE: FEDERAL RESERVE.
** SOURCE: MARKIT/ J.P. MORGAN.

In the case of the U.S. dollar, there is an additional issue to worry about, which is that there is about $12 trillion in overseas dollar-denominated debt. A stronger greenback would make it difficult for external borrowers to service their debts, leading to increased bankruptcies and defaults. Since financial and economic imbalances are arguably larger outside the U.S., a rising dollar would probably pose more of a problem for the rest of the world than for the United States. Although this is a serious risk, it is unlikely to materialize over the next 12-to-18 months, given our assumption that the dollar will weaken over this period.

The U.S. dollar trades as a countercyclical currency, which is another way of saying that it tends to weaken whenever global growth strengthens (Chart 15). While the U.S. benefits from faster global growth, the rest of the world benefits even more. This stems from the fact that the U.S. has a smaller manufacturing base and a larger service sector than most other economies, which makes the U.S. a "low beta" economy. Hence, stronger global growth tends to cause capital to flow from the U.S. to the rest of the world, putting downward pressure on the greenback.

Right now, China is stimulating its economy. The stimulus is a reaction to both slowing domestic growth, as well as worries about the potential repercussions of a trade war. It also reflects the fact that Chinese credit growth had sunk to a level only modestly above nominal GDP growth late last year. With the ratio of credit-to-GDP no longer rising quickly, the authorities had the luxury of suspending the deleveraging campaign.

The combination of Chinese stimulus, the lagged effects from lower bond yields, and a turn in the global manufacturing cycle should all lift global growth in the back half of this year. This should cause the dollar to weaken.

Trade War Worries

Needless to say, this rosy outlook is predicated on the assumption that the trade war does not get out of hand. Our baseline envisions a "muddle through" scenario, where some sort of deal is hatched that allows the U.S. to bring down existing tariffs over time in exchange for a binding agreement by the Chinese to improve market access for U.S. companies and better secure intellectual property rights.

The specifics of the deal are less important than there being a deal – any deal – that avoids a major escalation. Ultimately, the distinction between a "small" trade war and a "moderate" trade war is a function of how high tariffs end up being. Tariffs are taxes, and while no one likes to pay taxes, they are a familiar part of the global capitalist system.

What is less familiar, and much more dangerous to global finance, are nontariff barriers that effectively bar countries from accessing critical inputs and technologies. Most global trade is in the form of intermediate goods. If a company cannot access the global supply chain, there is a good chance it may not be able to function at all. The current travails of Huawei is a perfect example of this.

A full-blown trade war would create a lot of stranded capital. The stock market represents a claim on the existing capital stock, not the capital stock that would emerge after a trade war has been fought. Stocks would plunge in this scenario, with the U.S. and most other economies succumbing to a recession. Enough voters would blame Donald Trump that he would lose the election. While such an outcome cannot be entirely dismissed, it is precisely its severity that makes it highly unlikely.

Inflation: Waiting For Godot?

Global monetary policy is highly accommodative at present, and will only become more so if the Fed and some other central banks cut rates. Provided that the trade war does not boil over, global growth should accelerate, putting downward pressure on the U.S. dollar. A weaker dollar will further ease global financial conditions. In such a setting, global growth is likely to remain above trend, leading to a further erosion of labor market slack.

Among the major economies, the U.S. is the closest to exhausting all remaining spare capacity. The unemployment rate has fallen to 3.6%, the lowest level since 1969. The number of people outside the labor force who want a job as a share of the working-age population is below the level last seen in 2000. The quits and job opening rates remain near record highs.

Given the erosion in slack, why has inflation not taken off? … It is only once the unemployment rate falls well below NAIRU that inflation starts to kick in. In the 1960s, it was not before the unemployment rate fell two percentage points below NAIRU that inflation broke out.

Wage growth has picked up. However, productivity growth has risen as well. As a result, unit labor costs – the ratio of wages-to-productivity – have actually decelerated over the past 18 months. Unit labor cost inflation tends to lead core inflation by up to one year.

As the unemployment rate continues to drop, wage growth is likely to begin outstripping productivity gains. A wage-price spiral could develop. This is not a major risk for the next 12 months, but could become an issue thereafter.

Could structural forces related to globalization, automation, demographics, and waning union power prevent inflation from rising even if labor markets tighten significantly further? We think that is unlikely.

Alt-Right Or Ctrl-Left, The Result Is Usually Inflation

In a speech to the Council on Foreign Relations this week, Jay Powell noted that "The Fed is insulated from short-term political pressures – what is often referred to as our 'independence'."

The operative words in his remarks were "short-term". Powell knows full well that the Fed's independence is not cast in stone. Even if Trump cannot legally fire or demote him, the President can choose who to nominate to the Fed's Board of Governors. Early on in his tenure, Trump showed little interest in the workings of the Federal Reserve. He even went so far as to nominate Marvin Goodfriend – definitely no good friend of easy money – to the Fed board.

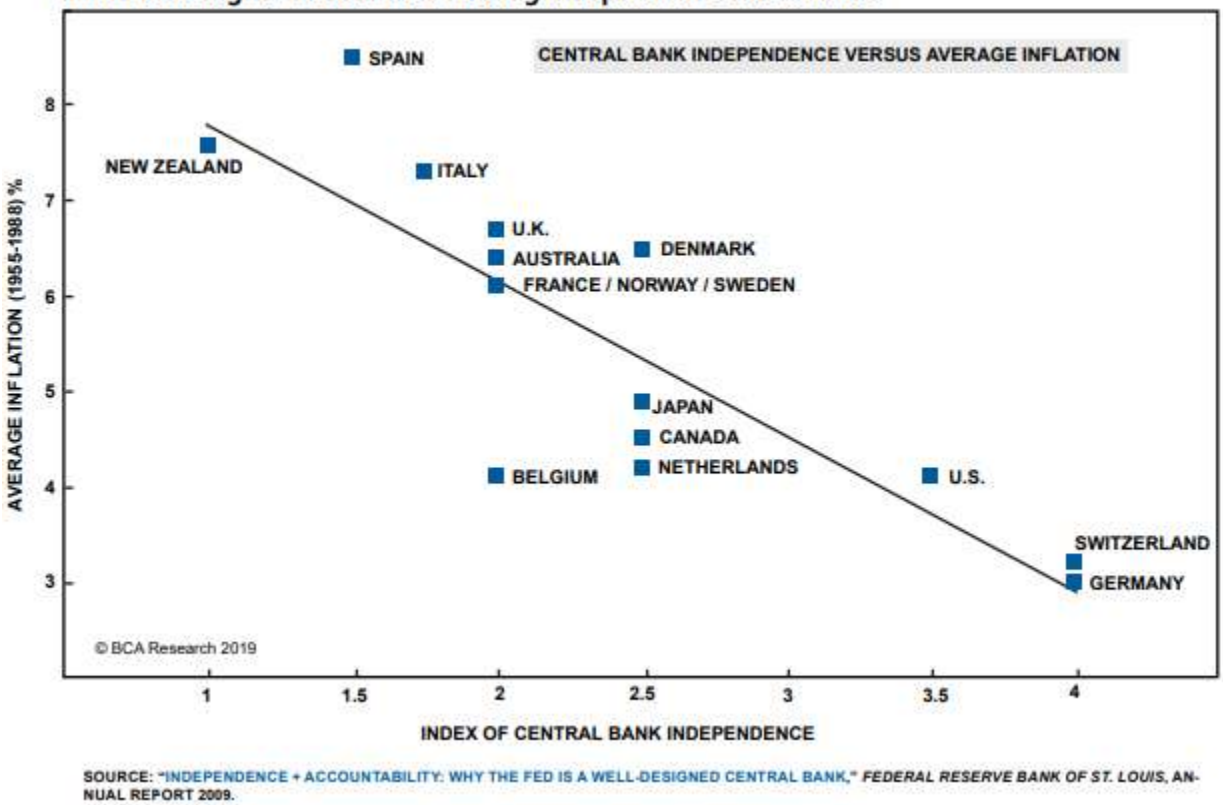
Trump's last two candidates, Stephen Moore and Herman Cain, were both political flunkies, happy to ditch their previous commitments to hard money in favor of Trump's desire to see lower interest rates. Neither made it as far as the Senate confirmation process.

Recent media reports have suggested that Trump will nominate Judy Shelton, a previously unknown economist whose main claim to fame is the promulgation of a bizarre theory about why the Fed should not pay interest on excess reserves (which, conveniently, would imply that overnight rates would need to fall to zero immediately)

It is not clear whether Trump's attempt to stack the Fed with lackeys will succeed. But one thing is clear: Countries with independent central banks tend to end up with lower inflation rates than countries where central banks are not independent (Chart 31).

CHART 31

Inflation Is Higher In Countries Lacking Independent Central Banks



SOURCE: "INDEPENDENCE + ACCOUNTABILITY: WHY THE FED IS A WELL-DESIGNED CENTRAL BANK," *FEDERAL RESERVE BANK OF ST. LOUIS*, ANNUAL REPORT 2009.

Whether it be Trump-style right-wing populism or left-wing populism (don't forget, MMT is a product of the left, not the right), the result is usually the same: higher inflation.

Equities

Stocks tend to peak about six months before the onset of a recession. In the 13-to-24 month period prior to the recession, returns tend to be substantially higher than during the rest of the expansion. We are approaching that party phase.

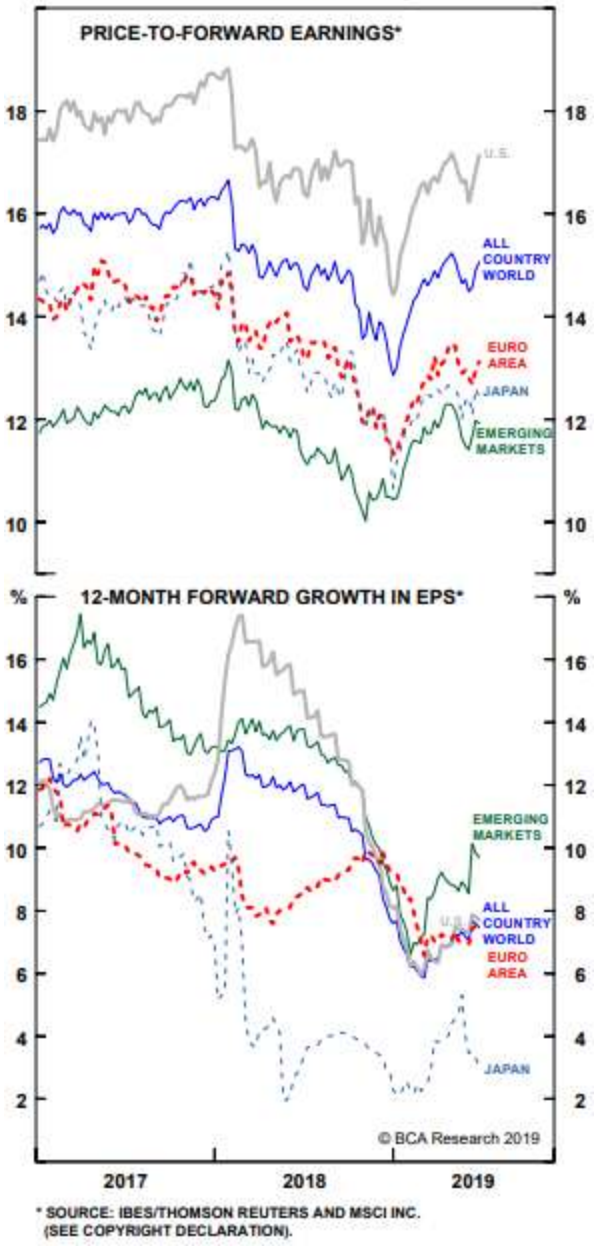
Global equities currently trade at 15-times forward earnings. Unlike last year, earning growth estimates are reasonably conservative (Chart 34).

Outside the U.S., stocks trade at a respectable 13-times forward earnings. Considering that bond yields are negative in real terms in most economies – and negative in nominal terms in Japan and many parts of Europe – this implies a sizable equity risk premium.

Currencies And Commodities

…Gold should do well in the first stage of the Fed cycle and at least part of the second stage. In the first stage, gold will benefit from a weaker dollar. In the initial part of the second stage, gold prices will continue to rise as inflation fears escalate. Gold will probably weaken temporarily once real interest rates reach restrictive territory and a recession becomes all but inevitable. We recommended buying gold on April 17, 2019. The trade is up 10.8% since then. Stick with it.

CHART 34
Global Stocks Are Not That Expensive



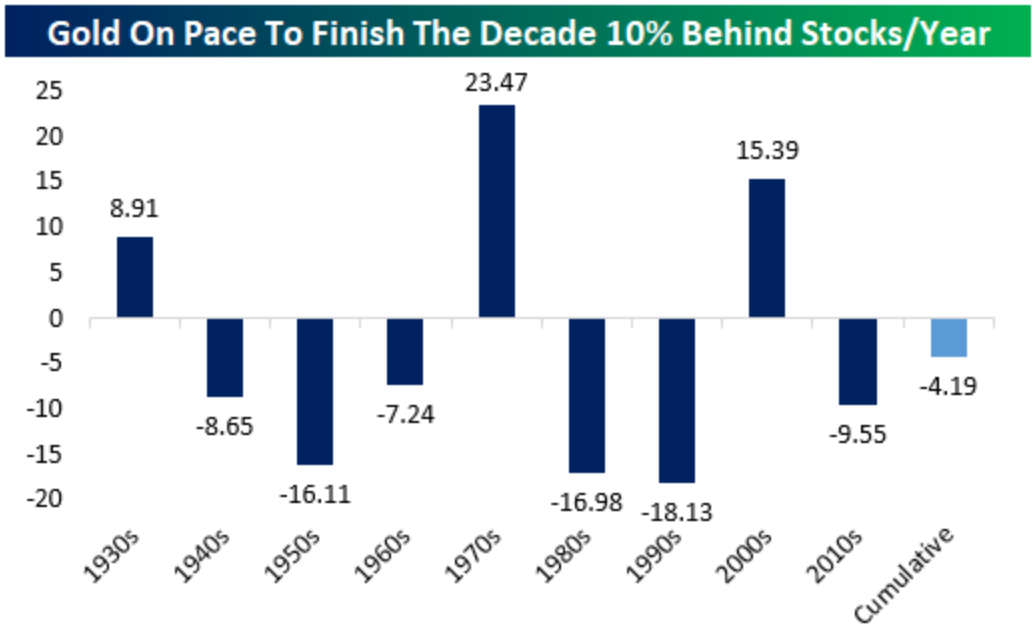
* SOURCE: IBES/THOMSON REUTERS AND MSCI INC. (SEE COPYRIGHT DECLARATION).

HCM does not recommend gold. From Bespoke:

Stocks Crush Rocks

Tue, Jun 18, 2019

The 2010s have been a rough decade for the yellow metal. As shown in the chart below, since 2009, gold is on pace to lose out to equity market total returns by almost 10%...per year. It's the sixth decade since the 1920s that the spot price of gold has lagged US equity market total return; over the course of the last 8 decades, the cumulative underperformance is more than 4%...and once again, that's per year! Given the costs of storing gold, which generally translate to an upward-sloping futures curve (contango), this analysis using spot prices is if anything *favorable* to gold! In other words, persistent and large asset allocation to gold leads to a substantial underperfomance versus stocks, even when putting your hands on the scale in favor of gold. That doesn't mean investors should never own gold, which can be a useful investment in terms of portfolio construction, but it does suggest that incremental units of gold exposure will reduce returns relative to equities over the long run.



Follow-ups

The Greatest Asset Bubble of All Time

June 18, 2019 by Nick Maggiulli

Which asset bubble was the greatest in history? Was it the flower that once sold for the price of a house? Or the magic internet money that went up 20x in a year? Or was it something else entirely?

This debate has raged on for far too long, so I decided to thoroughly analyze the data to answer this question once and for all. After doing some research (this article helped a lot) and a few Twitter polls, I have finalized the list of seven asset bubbles that should qualify as contenders for the greatest ever (In my Advanced Topics in Investments class, I cover all of these except for Japan. I also cover the Mississippi Bubble in France (1719-1720), which is not included here.):

- Tulip mania (1637)
- South Sea (1720)
- The Great Crash (1929)
- Japan (1989)
- DotCom (2000)
- U.S. Housing (2007)
- Bitcoin (2017)

If you have not heard of one of these bubbles and want a high-level summary, read this, otherwise, let's begin.

What Makes a "Great" Bubble?

Before we can select the greatest asset bubble of all time, we need to have some criteria over which *to judge* a bubble. Therefore, I propose that an asset bubble be evaluated on the following three measures:

- **Market Capitalization:** The size of the overall market for the asset class

- **Price:** The size of the price changes of the underlying asset class
- **Recovery Time:** The amount of time it took for the asset class to reach its prior highs (if ever)

Why do I propose these 3 values as a benchmark for comparison? Because they are useful for comparing bubbles to one another.

For example, let's say that there is an asset that goes up in price by 100x in a year to reach a total market capitalization of $10 million before collapsing and never recovering. While this asset bubble scored high on price movement and recovery time, it scored low on market capitalization relative to other bubbles, so would likely not be considered the greatest ever.

Of course this process is as much art as science, but I will be fair in my judgment of each bubble. **The one thing I can say with near certainty is that the greatest bubble in history will score highly on all three measures.** It will be a large market with extreme price changes that does not recover in a reasonable time frame.

With that being said, I am now going to go through each one of these criteria and narrow down the bubble list until we have a winner. ...

The Too Small Bubbles

- Tulip mania (1637)

If we had to choose the greatest bubble in history based on how speculative it was, the Tulip mania of 1637 takes the cake. No bubble in history has had an object of such low utility (a flower) sell for such a high price. The problem with the tulip bubble is that it wasn't that large. Despite its prominence in financial pop culture, most of the common knowledge surrounding tulip mania has been grossly exaggerated. As Anne Goldgar, the author of Tulipmania: Money, Honor, and Knowledge in the Dutch Age, states in this article:

Prices could be high, but mostly they weren't. Although it's true that the most expensive tulips of all cost around 5,000 guilders (the price of a well-appointed house), I was able to identify only 37 people who spent more than 300 guilders on bulbs, around the yearly wage of a master craftsman.

Jason Zweig also wrote an article on Tulip mania saying:

At its peak, the market for rare tulips seems to have been limited to a few hundred people in total, many of whom traded only once or twice.

Given this information, it appears that Tulip mania was more bark than bite and should not be considered the greatest bubble ever.

- South Sea (1720)

Despite suckering in the great Sir Isaac Newton with price increases of 10x in a year, the South Sea bubble wasn't really a bubble, but more of a scheme. If you read into the complexities of what it was trying to accomplish, it was more like an insane IPO than a traditionally traded asset class.

Regardless of this, my main issue with the South Sea bubble/scheme was that it wasn't particularly large and there was little evidence of widespread economic impact. As Edward Chancellor stated in Devil Take the Hindmost:

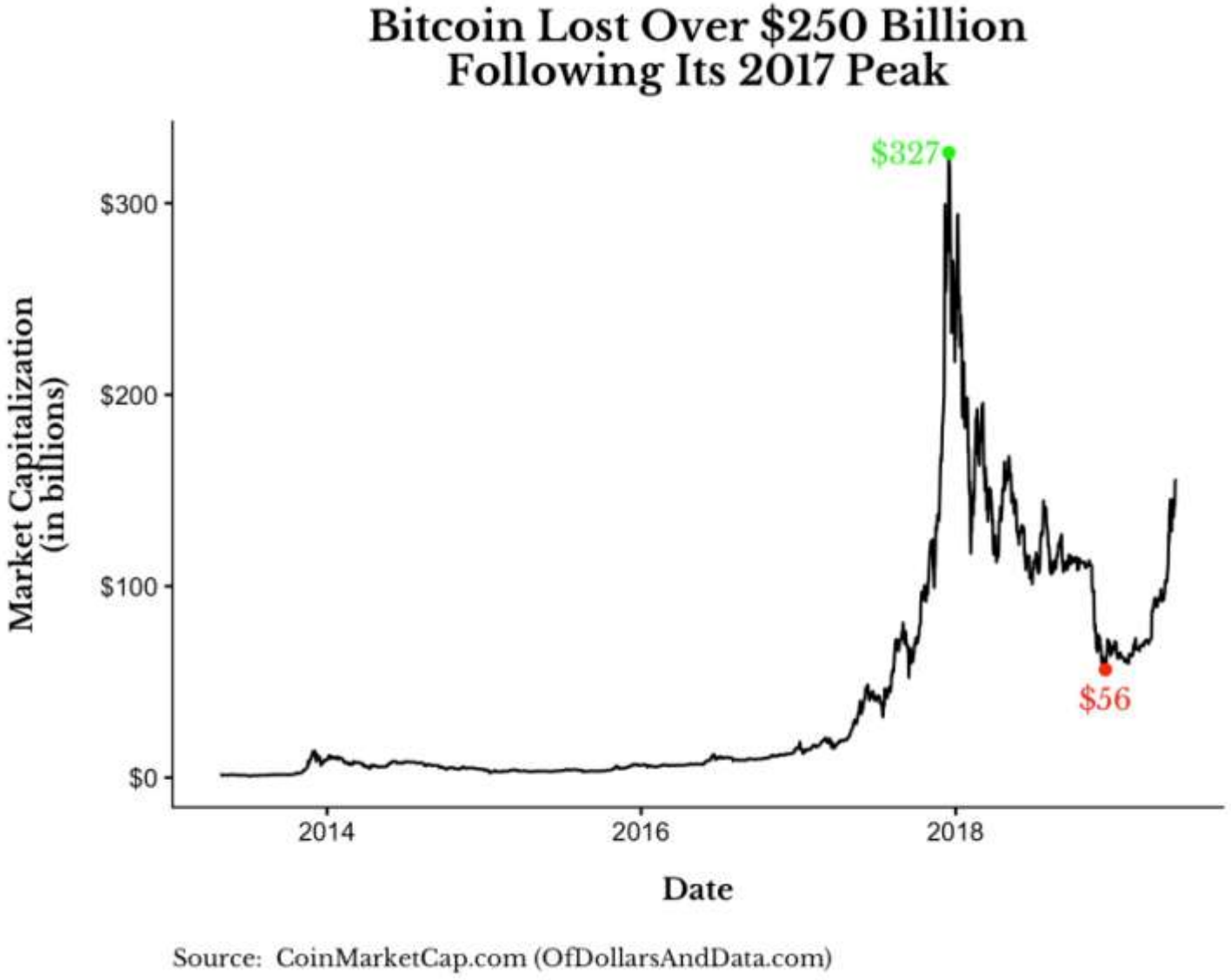
Although the South Sea stock fell to 15 percent of its peak (and the Bank of England and East India shares fell by near two-thirds),the number of mercantile bankruptcies in 1721 did not increase significantly from the previous year and the economy recovered quickly.

So though the bubble was a crazy one for a host of reasons, the negative effects were limited to South Sea shareholders. Thank you, next.

- Bitcoin (2017)

While Bitcoin went up 20x in 2017 and then lost 85% of its value in 2018, what happens to it in 2019 and beyond will ultimately determine how we interpret the 2017 "bubble."

That aside, my primary issue with calling Bitcoin the greatest bubble in history is that Bitcoin's market cap is too small. At its peak in December 2017, Bitcoin was only worth $327 billion:



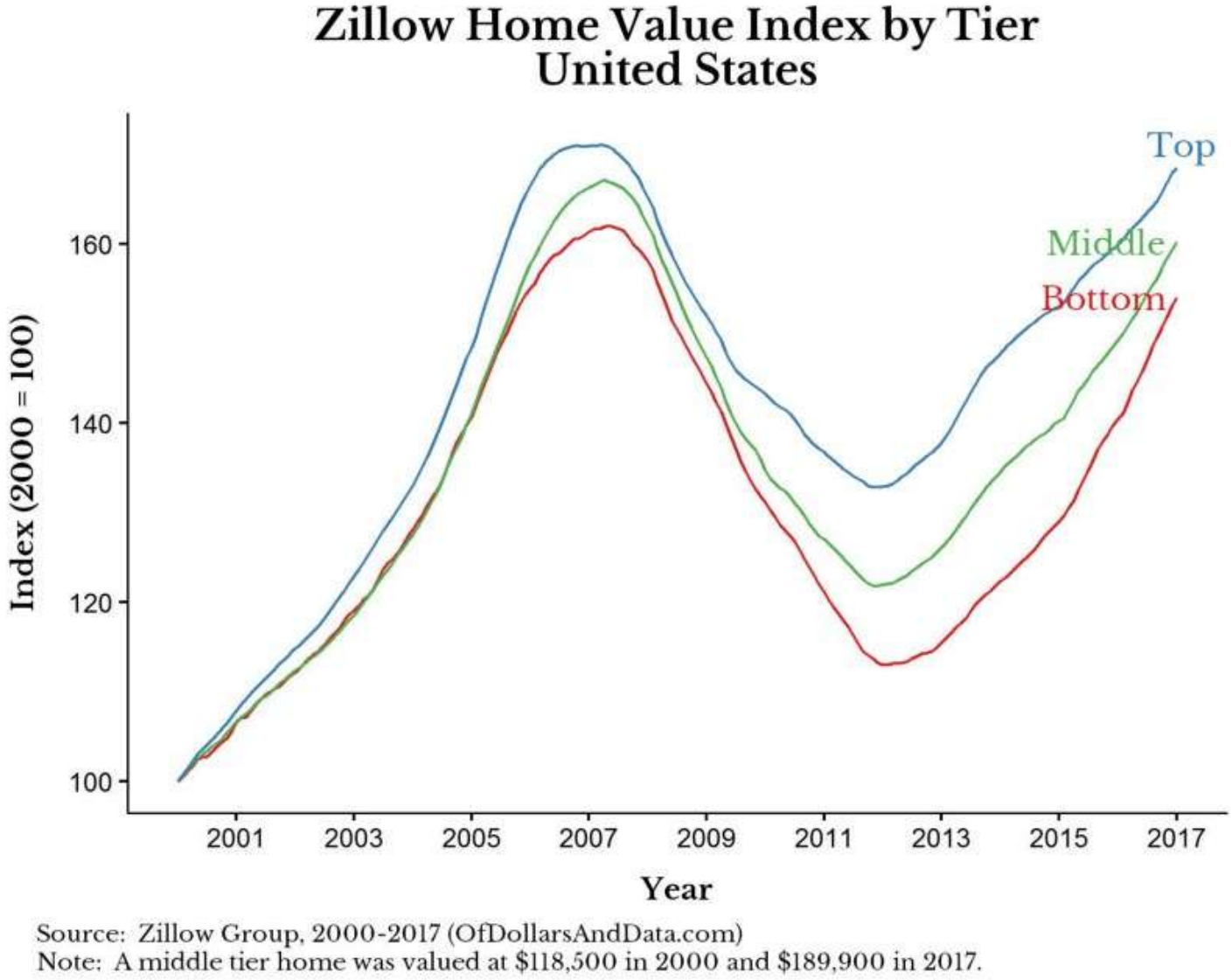
Compare this with U.S. stocks (~$30 trillion) and you will see that though Bitcoin gets 50% of the attention on Finance Twitter (FinTwit), it's too small to play in the bubble big leagues.

The "Stable" Price Bubble

- U.S. Housing (2007)

When it comes to BIG bubbles, the U.S. housing bubble of 2007 is the biggest on our list in terms of size. If you look at this visualization provided by Zillow, you will see that the U.S. residential housing market declined in value from $29.2 trillion at its peak to $22.7 trillion when it hit bottom in 2012. That is a decline of $6.5 trillion in the span of half a decade.

My issue with the U.S. housing bubble is that the price changes that went into the bubble were far too "stable" compared to the other bubbles on our list. This chart shows how the median U.S. house price increased ~70% from 2000 to 2007 or an annual gain of 7.9% a year:



Yes, a subset of U.S. real estate markets showed more extreme behavior than this, but the aggregate price changes (<2x) don't compare to the other bubbles on our list. Additionally, U.S. housing prices recovered within a decade of their old highs. So, while I cannot deny the U.S. housing bubble as being the biggest on our list, due to its lackluster showing in other criteria, it is not the greatest of all time.

The Quicker Recovery Bubbles

- The Great Crash (1929)

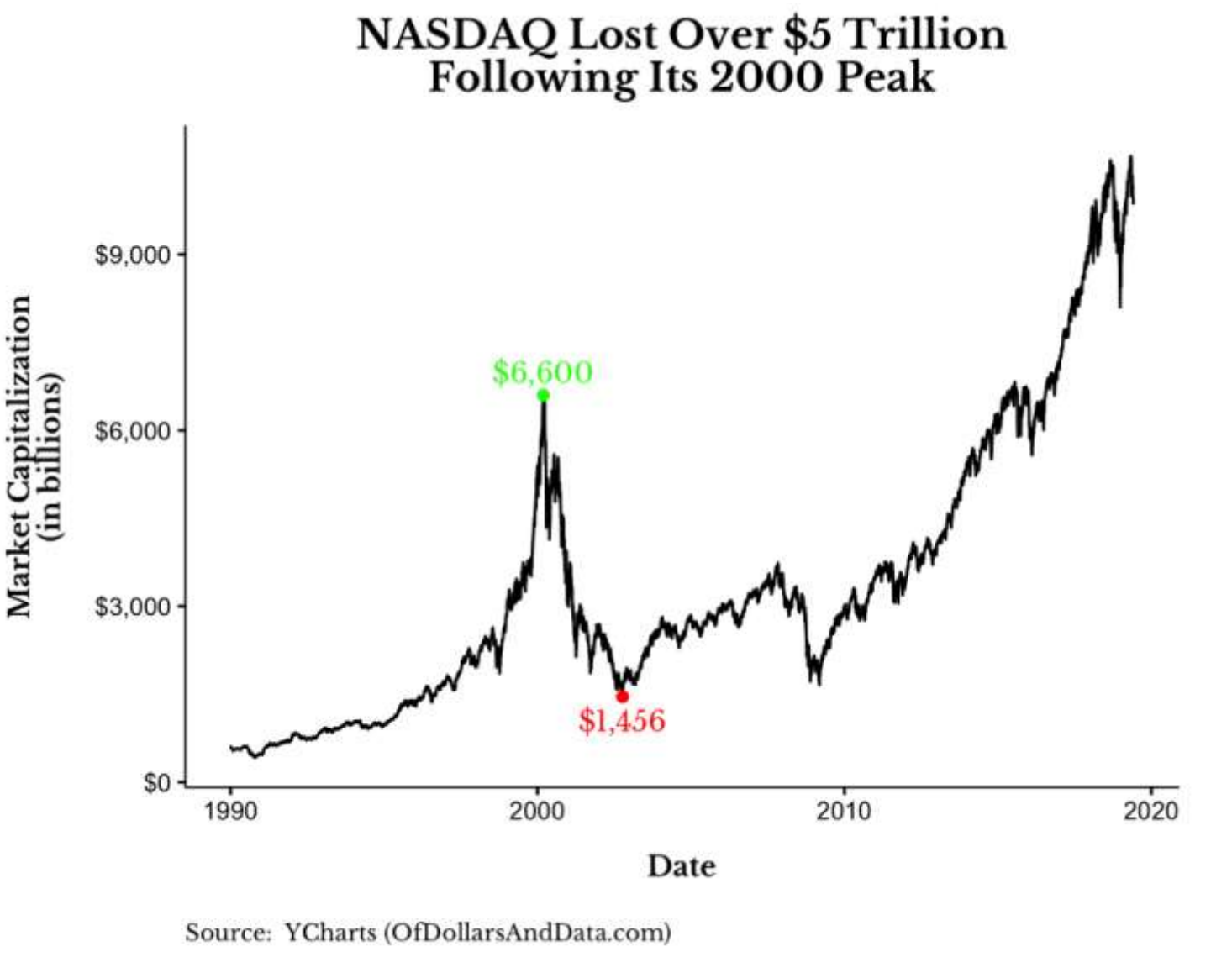
The Wall Street Crash of 1929 ("The Great Crash") had both a large change in market capitalization and an extreme run-up in prices in the decade prior. From 1920 to the peak in September 1929, U.S. stock prices increased 6.7x (adjusted for dividends and inflation). In addition, in August 1929 the NYSE estimated that the market value of the 846 listed companies was $90 billion (see Table 1 in this paper). If we adjust this figure for inflation that would represent less than $1.5 trillion today. So the 90% decline in stocks from 1929 to the summer of 1932 represents an aggregate loss of slightly over $1 trillion.

The only issue I take with the Great Crash is that it recovered back to its September 1929 high within seven years (adjusted for dividends and inflation). Yes, that seven years was difficult for the American people, but it wasn't necessarily the fault of the stock market crash, but of other systemic issues in the economy. As Morgan Housel recently noted about the Great Crash:
Only 2.5% of Americans owned stocks in 1929.

The huge majority of Americans watched in amazement as the market collapsed, and perhaps lost a sense of hope that they, too, might someday cash in on Wall Street. But that was all they lost: a dream. They did not lose any money because they had no money invested.

The real pain came nearly two years later, when the banks started to fail.
For these reasons, the Great Crash is a close contender, but not the greatest bubble in history.

- DotCom (2000)



After a 10x increase in prices starting in 1990, the NASDAQ peaked in March 2000 with a market capitalization of $6.6 trillion. The ensuing collapse wiped out $5.1 trillion in market value from the NASDAQ that it wouldn't gain back for 13 years:

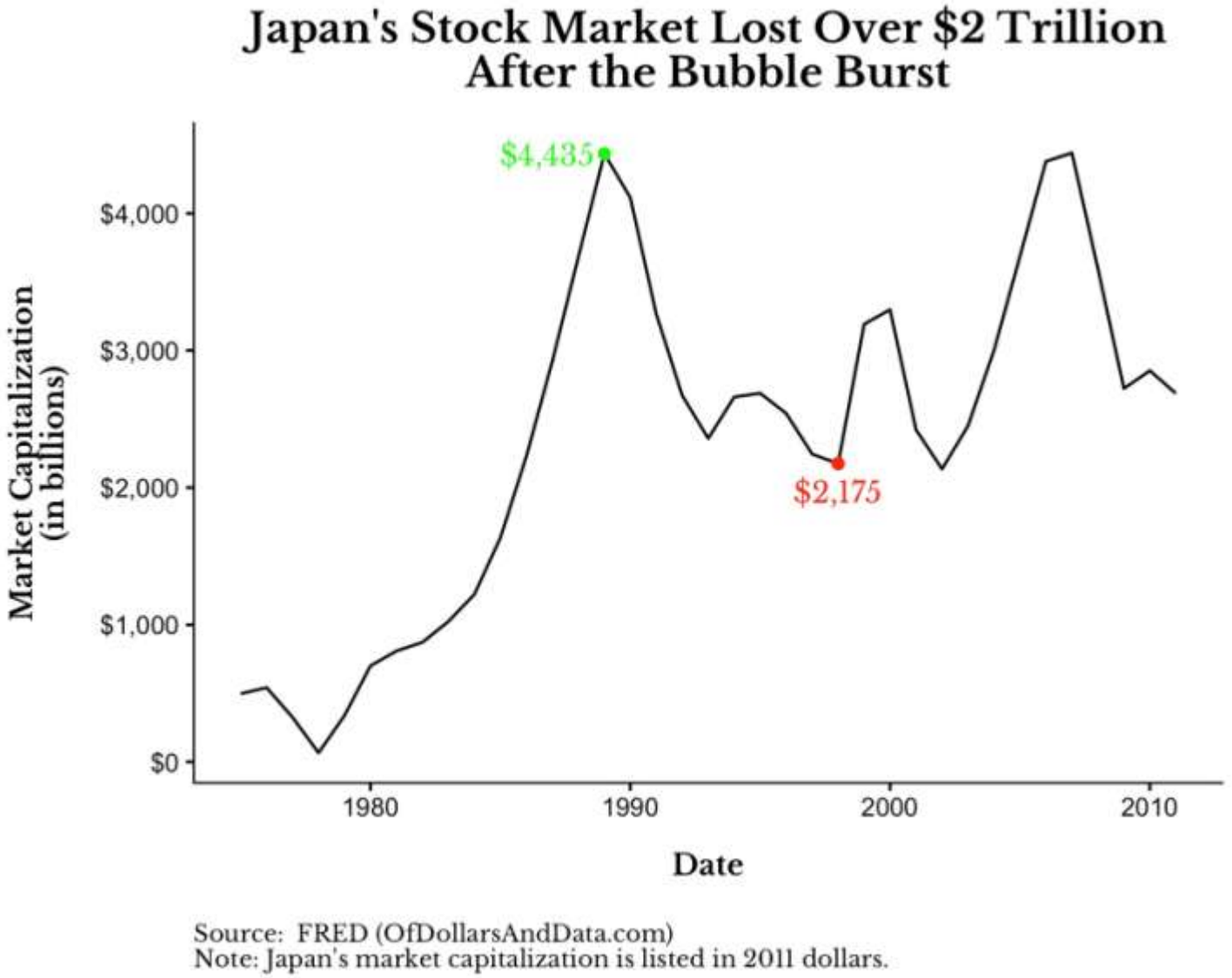
Though I originally thought that DotCom was the greatest asset bubble of all time, something Marc Andreessen said in his interview with Barry Ritholtz (see 17:32) changed my opinion:

The DotCom Crash hit in 2000 and all these ideas that were viewed as genius in 1998 were viewed as complete lunacy and idiocy in 2000. Pets.com being the classic example. So, it's actually really striking. All of those ideas are working today. I cannot think of a single idea that isn't working today. The kicker for the Pets.com story is that there is a company Chewy that just got bought for $3 billion.

My issue with calling the DotCom bubble the greatest is as Andreessen suggests: **The bubble wasn't wrong, it was just too early.**

The Greatest Bubble of All Time

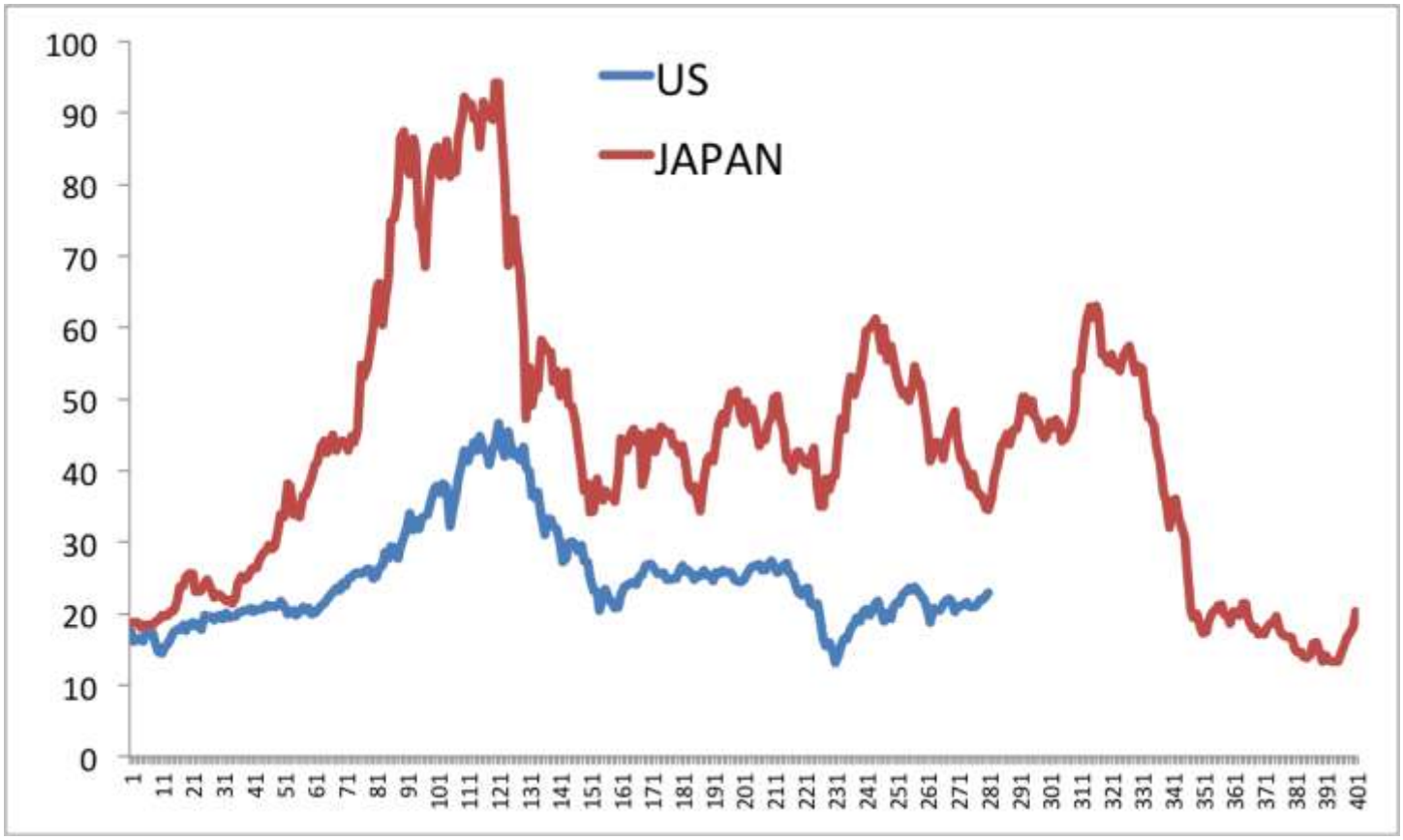
- Japan (1989)



Japan in the late 1980s was the grandaddy of them all. At the peak, the Japanese imperial palace was considered to be worth more than all the real estate in California and the Japanese stock market had grown 10x over the prior decade. **More importantly, in the 30 years since the peak, both Japanese stocks and residential real estate have yet to recover.**

To be precise, the Japanese stock market lost over $2 trillion and Japanese land values have declined by $8 trillion since the late 1980s/early 1990s:

In addition, Meb Faber put together an incredible chart illustrating just how extreme the Japanese bubble was compared to the DotCom bubble on valuation terms (i.e. 10-year P/E ratios):



If you still aren't convinced, consider reading this post by my colleague Ben Carlson where he makes the case for Japan as the greatest asset bubble ever in much more detail.

Summary

Japan is the winner for the greatest asset bubble of all time because of how well it scores on the three criteria (Market Cap, Price, and Recovery Time) relative to all other bubbles in market history. **To illustrate this, I have created a table below that summarizes how each of the seven bubbles fared on these three measures.**

I also added red boxes for each bubble to highlight what I consider the weak points in the discussion for greatest of all time (i.e. too small, little price movement, or decent recovery time). Japan is the only bubble in all green because of how well it scores on the three criteria:

Bubble	Market Cap Lost	Price Increase	Recovery Time
Tulip Mania (1637)	Considered small	10x-100x	Never
South Sea (1720)	Considered small	10x	100 years
The Great Crash (1929)	$1,350 billion	6x	7 years
Japan (1989)	$2,200 billion (excludes RE)	10x	TBD (going on 30 years)
DotCom (2000)	$5,000 billion	10x	15 years
U.S. Housing (2007)	$6,500 billion	<2x	10 years
Bitcoin (2017)	$270 billion	20x (in 1 year)	TBD (going on 1.5 years)

Note: The market capitalization lost in the Japanese bubble listed above *excludes* the $8 trillion of estimated losses in land/real estate ("RE") since the early 1990s. I did this to make the comparison with the other bubbles (i.e. one asset class only) more meaningful.

This table illustrates that though other bubbles are close contenders, Japan remains in a league of its own as the greatest asset bubble in history. ... (By comparison, at its peak the Mississippi company had an inflation adjusted value of $6.5 Trillion, a price increase of nearly 40x, never recovered, and caused significant economic harm that laid the foundation for the French Revolution later that century. Personally, I think Mississippi takes the cake.)

The only thing I can say with high certainty is that bubbles will occur now and again. **What should you do when they inevitably appear? Don't participate.** Ignore them. That is your only hope.

But, you don't have to believe me though. Consider the words found on an anonymous pamphlet from the South Sea Bubble of 1720 (from this book):

The additional rise of this stock above the true capital will be only imaginary; one added to one, by any rules of vulgar arithmetic, will never make three and a half; consequently, all the fictitious value must be a loss to some persons or the other, first or last. The only way to prevent it to oneself must be to sell out betimes, and so let the Devil take the hindmost.

Few lines in a book have ever given me the chills, but this was one of them. For that reason, I HIGHLY recommend Devil Take the Hindmost because it is arguably the greatest financial history book ever written. Happy investing and thank you for reading!

Positions

LPL - On 4/24 lost 11.4% on 4.3x normal volume on another Negative Earnings Surprise. Consensus Earnings Estimates have been lowered for the next 2 quarters, while 2 analysts raised their recommendation to a Buy, another 2 lowered to Hold; 2 analysts raised, 5 lowered & 18 maintained their Target Price. While insiders once again bought, LPL no longer meets our Valuation criteria. An opportunity to sell came on 6/20 for the 3 clients holding LPL @ 7.7246.

NLY - On 6/17 we added 2% positions for 2 clients that didn't already have mREIT exposure at 9.1768 - .2089.

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
06/07/2019	1	Fallon Katie Beirne		2,780
05/17/2019	1	Hamilton Thomas		90,000
05/14/2019	1	Green Anthony		50,000
05/13/2019	1	Finkelstein David		100,000
05/06/2019	1	Keyes Kevin G		300,000

From High Dividend Opportunities on Jun 16th:

... We have today an opportunity to buy a stock yielding 11% from a recession resilient company. The company is an mREIT **Annaly Capital Management** (NLY). ... we are lowering the risk of our portfolio by taking a defensive position in NLY which is set to perform well, even in case of an economic downturn. **The recent pullback in NLY creates a unique buying opportunity!**

Action to Take

1. We are adding NLY to our Core Portfolio with a recommended allocation of 2% of the overall portfolio.
2. NLY, at the current price, is a "Lower Risk" stock and will be tagged as "**must own**".
3. The "Buy Under" price for NLY is at $9.75. The current yield is at 11%. NLY issues 1099 (No K-1s). So it is also suited for your international members. ...

Annaly Capital: An 11% Yield Today, That Could Double In A Recession

At High Dividend Opportunities, our top priority is finding investments that provide high-levels of current income. We have previously discussed how high-yield investing can provide psychological comfort and funds for reinvesting during a bear market. We have also discussed ways that income focused investors can become more defensive to recession-proof their portfolios. ...

While high current income is priority number one for us, we also like growth. Many think that high-income investments and growth are mutually exclusive, that in order to get high-income, you need to sacrifice growth. This simply is not true. ... we want a portfolio not only of investments that will maintain income, we also want investments that will **grow income**.

Today, we are looking at a stock that has a history of booming in recessions, that provided investors with an **increasing price and increasing dividends** during the 2000-2003 bear market and the 2007-2010 recession.

This stock has recently pulled back sharply creating unique buying opportunity! This stock is currently paying **a yield in excess of 11%**, and in the upcoming recession, we could **expect the dividend to be doubled.** It is a true example of an investment that is truly counter-cyclical. In other words, it performs very well in bear markets but tends to underperform in bull markets.

With recent declines, we believe now is the time to invest in this potentially powerful hedge. We can reasonably expect market-matching performance as the bull market enters its twilight and in 2-5 years, whenever the bear market starts, **we can expect it to experience price and dividend growth** as the rest of the market pulls back.

Annaly Capital

Annaly Capital Management (NLY) is a mortgage REIT (mREIT) that is primarily focussed on residential mortgage-backed securities (MBS). While they have diversified into other types of investments, NLY's core business remains agency MBS.

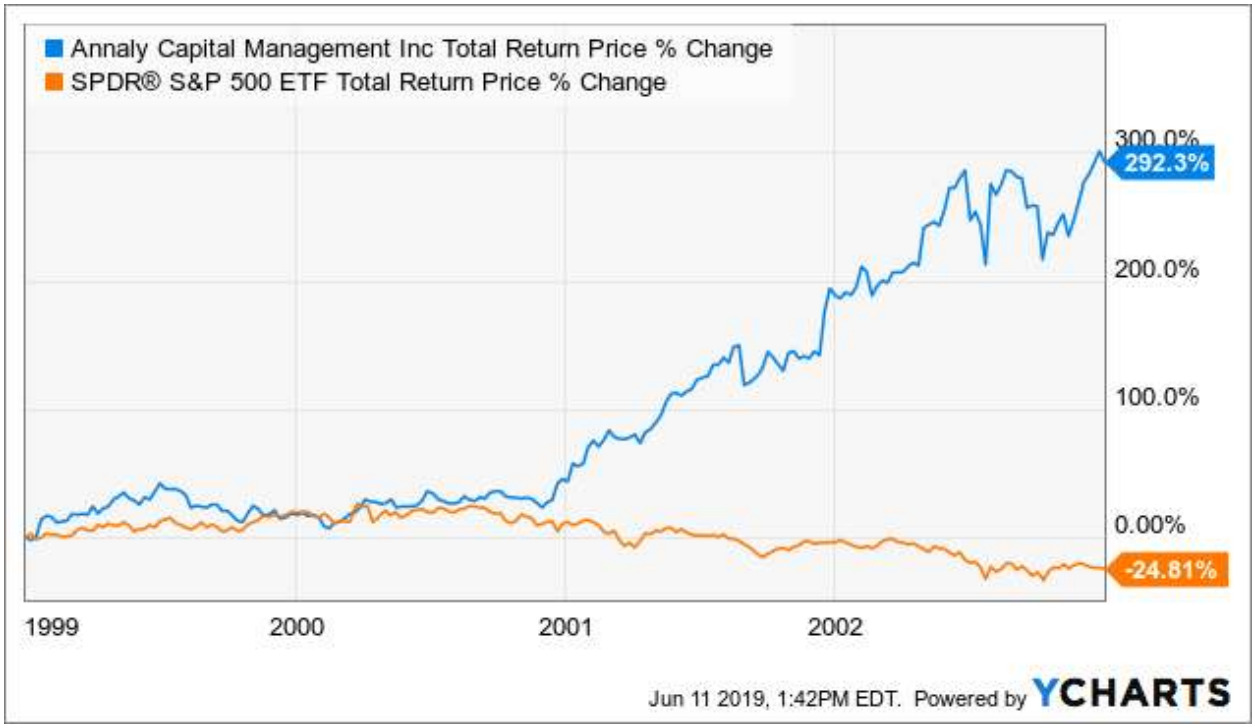
Quite simply, an MBS is a group of mortgages that a bank packages and sells to lenders. This allows the mortgages to be removed from the bank's balance sheet, allowing them to make new loans. The buyers of the MBS then receive the benefits as the underlying mortgages are paid off.

Many investors run in fear as soon as they hear "MBS", as rising mortgage defaults significantly damaged the value of many residential MBS investments. A situation that was a major contributor to the recession.

This might lead one to conclude that NLY must have really been crushed by the recession. In reality, the recession was one of the strongest periods in NLY's history.

In 2006, NLY had a total return of 32%, followed by 39%, 0%, and 27% in 2007-2009. An investor who invested $10,000 in January of 2006 would have seen their capital increase to $15,800 and additionally would have cashed out dividends of $5,700. In fact, by the end of 2011, an investor from 2006 would have extracted **more than 100% of their original capital in dividend payments**. While also having a **large capital gain**.

For NLY, the recession was not a problem, in fact, it fueled fantastic returns. Another fantastic time to be holding NLY? Try the bear market of 2000-2002.



While it only kept pace in 1999 and was only slightly better in 2000, NLY really kicked it into gear in 2001 and 2002 while the market was falling.

Looking at performance outside of recessionary times, we can see that in bull markets NLY tends to underperform in terms of total return (although often remains a decent dividend payer).

Historically, the best times to invest in NLY has been **a few years before a bear market** with the best gains occurring **during the bear market**. We believe that we are approaching a similar situation now where mREITs like NLY are beat-up and trading at multi-year lows. Dividends have been cut and general market sentiment is against them. Yet there is also some reasonable fear of a bear market brewing and it is only a matter of time before there is a flight to safety.

Why NLY Outperforms In Recessions?

1) Implicit Government Guarantee

The core reason that NLY outperforms during recessions is the perceived safety of their assets. NLY's primary investments are "agency backed" MBS, these are securities that are guaranteed through government-sponsored enterprises (GSEs) such as Fannie Mae or Freddie Mac.

These GSEs buy mortgages directly from lenders that meet their criteria. Then they "securitize" them, meaning they take a group of loans and sell them as a single mortgage-backed security. They then sell the MBS they created in the secondary market to investors like NLY.

The huge benefit of agency MBS, is that the GSE guarantee the payments on the mortgages. The result is that these MBS are rated AAA and the market has little fear about whether or not the mortgages would be paid. The GSE guarantees the payments, and while there is not an explicit guarantee from the United States (except for Ginnie Mae), the special privileges carved out for GSE's provide an implicit guarantee.

The implicit guarantee was tested in 2008, and it turned out that the government was willing to take extraordinary measures to ensure the GSEs could meet their guarantee.

As a result, agency MBS are extremely liquid, are considered interchangeable and are considered among the most secure investments on the planet.

2) Interest Rate Sensitivity

NLY makes money by borrowing short-term funds to buy long-term (usually 30-year) agency backed MBS. The safety of the underlying investment allows them to use very high-levels of leverage.

Another aspect of mortgages is that they are very interest rate sensitive. NLY's largest investment is in agency MBS with 4% coupons, so as mortgage rates decline, 4% becomes more attractive and therefore more valuable. As they increase, they become less valuable.

Their borrowings are typically very short-term, using repurchase agreements. These are agreements where they use their agency MBS as collateral, with the agreement that they will buy back the MBS at a higher price. These agreements are usually under 120-days.

		For the quarters ended				
		3/31/2019	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Financing Data	Repurchase agreements	$88,554,170	$81,115,874	$79,073,026	$75,760,655	$78,015,431
	Other secured financing	4,144,623	4,183,311	4,108,547	3,760,487	3,830,075
	Debt issued by securitization vehicles	3,693,766	3,347,062	3,799,542	2,728,692	2,904,873
	Mortgages payable	510,386	511,056	511,588	309,878	309,794
	Total debt	$96,902,945	$89,157,303	$87,492,703	$82,559,712	$85,060,173
	Total liabilities	$103,391,105	$91,669,726	$91,005,947	$85,059,141	$86,439,298
	Cumulative redeemable preferred stock	$1,778,168	$1,778,168	$1,778,168	$1,723,168	$1,723,168
	Common equity[1]	13,998,049	12,333,944	13,171,826	12,045,422	12,214,096
	Total Annaly stockholders' equity	15,776,217	14,112,112	14,949,994	13,768,590	13,937,264
	Non-controlling interests	5,227	5,689	5,862	5,266	5,671
	Total equity	$15,781,444	$14,117,801	$14,955,856	$13,773,856	$13,942,935
Key Capital and Hedging Metrics	Weighted average days to maturity of repurchase agreements	72	77	55	71	72
	Weighted average rate on repurchase agreements, for the quarter[2][3]	2.64%	2.43%	2.25%	1.99%	1.64%
	Weighted average rate on repurchase agreements, at period-end[3]	2.85%	2.96%	2.32%	2.17%	1.83%
	Leverage at period-end	6.1x	6.3x	5.9x	6.0x	6.1x
	Economic leverage at period-end	7.0x	7.0x	6.7x	6.4x	6.5x
	Capital ratio at period-end	12.0%	12.1%	12.6%	13.2%	13.1%
	Book value per common share	$9.67	$9.39	$10.03	$10.35	$10.53
	Total common shares outstanding	1,448,103	1,313,763	1,303,080	1,164,334	1,159,657
	Hedge ratio[4]	85%	94%	96%	95%	94%
	Weighted average pay rate on interest rate swaps, at period-end	2.20%	2.17%	2.10%	2.08%	2.00%
	Weighted average receive rate on interest rate swaps, at period-end	2.66%	2.68%	2.33%	2.31%	2.13%
	Weighted average net rate on interest rate swaps, at period-end	(0.46%)	(0.51%)	(0.23%)	(0.23%)	(0.13%)

Source: NLY Investor Supplement Q1 2019

Another issue that mREITs need to be careful of changes in either their borrowing rates or mortgage rates. Since the spread they are profiting from is so small, rapid movements can reduce their profits. This means that they need to pay for various hedges so that any adverse rate movements might reduce profitability, but not lead to insolvency.

We can see that the weighted average rate on repurchase agreements, their primary form of borrowing, increased from 1.64% in March of 2018, to 2.64% in March of 2019. During that same period, their average yield failed to grow enough to offset the additional costs.

So when a bear market occurs, NLY benefits. First, there is a flight to safety. With agency MBS seen as very safe, this raises the value of their holdings. It greatly increases the liquidity of the repurchase market, lowering their borrowing costs.

The federal reserve usually lowers the target rate, which impacts the short-term borrowing rates the most. In recessions, mortgage rates tend to remain elevated or even increase as mortgages are seen as riskier. The spread between the risk-free rate and mortgage rates increases.

This allows a company like NLY to borrow very cheaply while holding and buying more MBS at relatively high coupons. The excess earnings are then passed along to investors in the form of dividends.

Dividend History

Right now might be the best time to invest in NLY. They just reduced their dividend, recently had a decline in their NAV and shares are trading at 3-year lows. Many investors looking at this will freak out, not fully understanding that the last 3-years of a bull market with generally rising interest rates are the absolute toughest type of market for NLY to operate in.

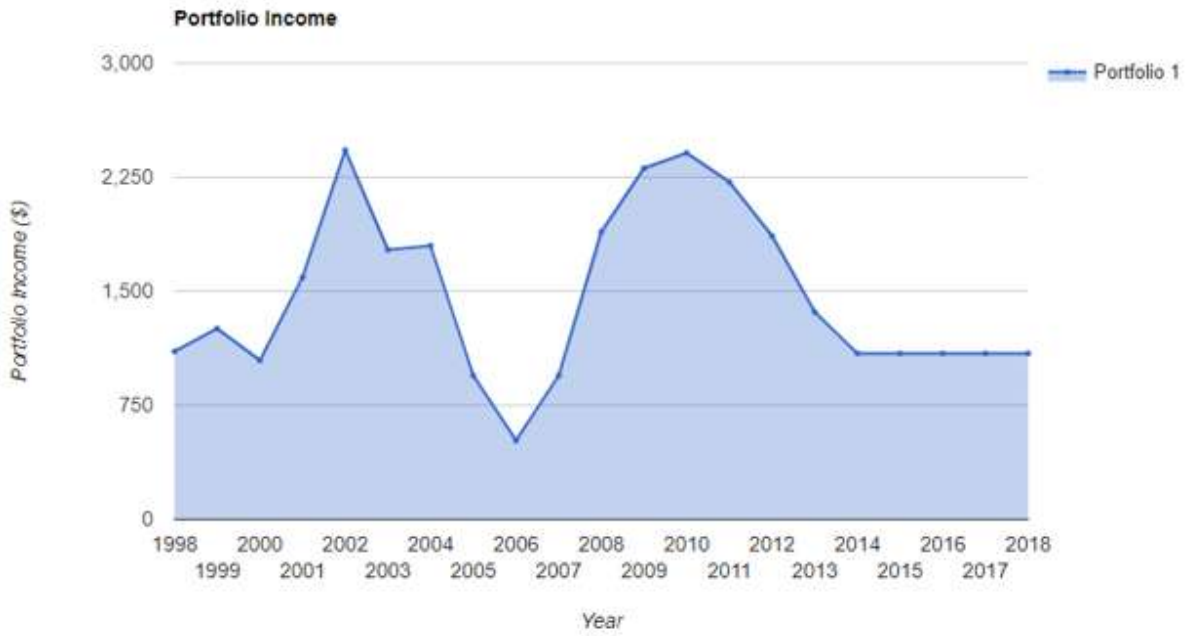
With an understanding of how NLY makes their money and how strong their assets can be in a recession, we need to look at what is likely in the future.

Long term treasury rates are falling, and the Federal Reserve is becoming increasingly dovish.

The US economy is showing small cracks, a recession is not here, but it is a safe bet that one is less than 5-years away.

We don't know exactly when a bear market and the resulting flight to safety will occur, but we know we want to be holding NLY when it does and we know that it is only a matter of time.

Being a REIT, NLY is required to distribute over 90% of their taxable income. This means that when they are doing really well, they have to increase their dividend. When taxable income declines, they then are forced to reduce the dividend.



Here is a look at NLY's dividends on a $10,000 investment at IPO with no additional investment and no DRIP. The initial yield was in excess of 12% and the dividend was cut in 2000 to a 10.45% yield on capital.

Shortly after the cut, the bear market started and NLY benefited. They dramatically raised their dividend from $0.25/quarter to a peak of $0.68/quarter in 2002. Investors who had bought in 1998 were receiving a dividend **in excess of 24% on their capital**.

After the recession, rising rates and a bullish market forced NLY to reduce their dividend once again. As we started heading into another bear market, **the dividend skyrocketed** once again.

This is what should be expected of NLY. In times of rising rates and a bullish market, their NII and their dividend is going to come down. When rates are declining and the market is bearish, rates will shoot back up. With the most recent cut, we believe that NLY's dividend has reached the bottom before the next bear market.

These cuts are not a sign of mismanagement or failure of management, they are a natural consequence of the business cycle. When the environment improves, we can expect NLY's dividend to shoot right back up. Investors in agency mREITs should understand up front that they can expect such variations in dividends.

With expected declines in short-term rates that should dramatically reduce borrowing costs, NLY can be expected to have modestly improving performance while we wait for the hammer to drop. We believe they will be able to maintain the $1.00/year dividend level until the next bear market.

Conclusion

The bearish sentiment towards NLY is exactly the type of opportunity we seek at HDO. The stock is beaten down due to underperformance in **market conditions it can be expected to underperform in**. Mr. Market has been caught looking backward, instead of considering the most likely events in the future.

Most likely, we are going to see NLY's borrowing costs continue to decline. Their NII will stabilize and they will be able to support their new dividend. Any reduction in rates from the Fed will help but is not necessary. NLY should be able to put up modest numbers while paying investors an 11% dividend to wait.

When the inevitable bear market finally arrives, history has shown that NLY is a significant outperformer. Even in 2008, when there were doubts and fears surround the GSEs that guarantee the MBS investments, NLY managed a flat year in a down market. Without those unique fears, NLY would likely have looked more like it did in 2001-2003, soundly beating the general market. **The recent pullback has created a unique buying opportunity!**

NLY is exactly the kind of investment we want to be **holding through a recession**. When the rest of the market is deep in the red, investments like NLY will be bright islands of green. Not only do we anticipate NLY's NAV improving, but we could also see significant increases in their dividend.

NLY is a **strong buy below $9.75**.

OXY - On 6/17 replaced MTDR, which doesn't pay a dividend, with this E&P that is also focused on the Permian Basin, and yields 6.3% for a client whose primary focus is Income @ 49.6342.

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
06/13/2019	1	Burgher Cedric W		4,100
06/12/2019	2	Brown Oscar, Poladian Aved		11,000
06/11/2019	2	Vangolen Glenn M, Brown Os		9,000
06/10/2019	5	Hollub Vicki A, Backus Marc		71,560

From Energy & Income Advisor's Jun. 19th issue:

"Shares of **Occidental Petroleum** (NYSE: OXY) sell for roughly 25 percent less than they did in early April, before the company outbid **Chevron Corp** (NYSE: CVX) for **Anadarko Petroleum** (NYSE: APC) (which was held by 3 of our clients). We continue to believe the merger has a solid industrial rationale, that investors over-reacted to the deal's cost, and that the stock will recover as we get closer to the expected second half 2019 close.

... **shares are cheap well below our buy target of 75.**"