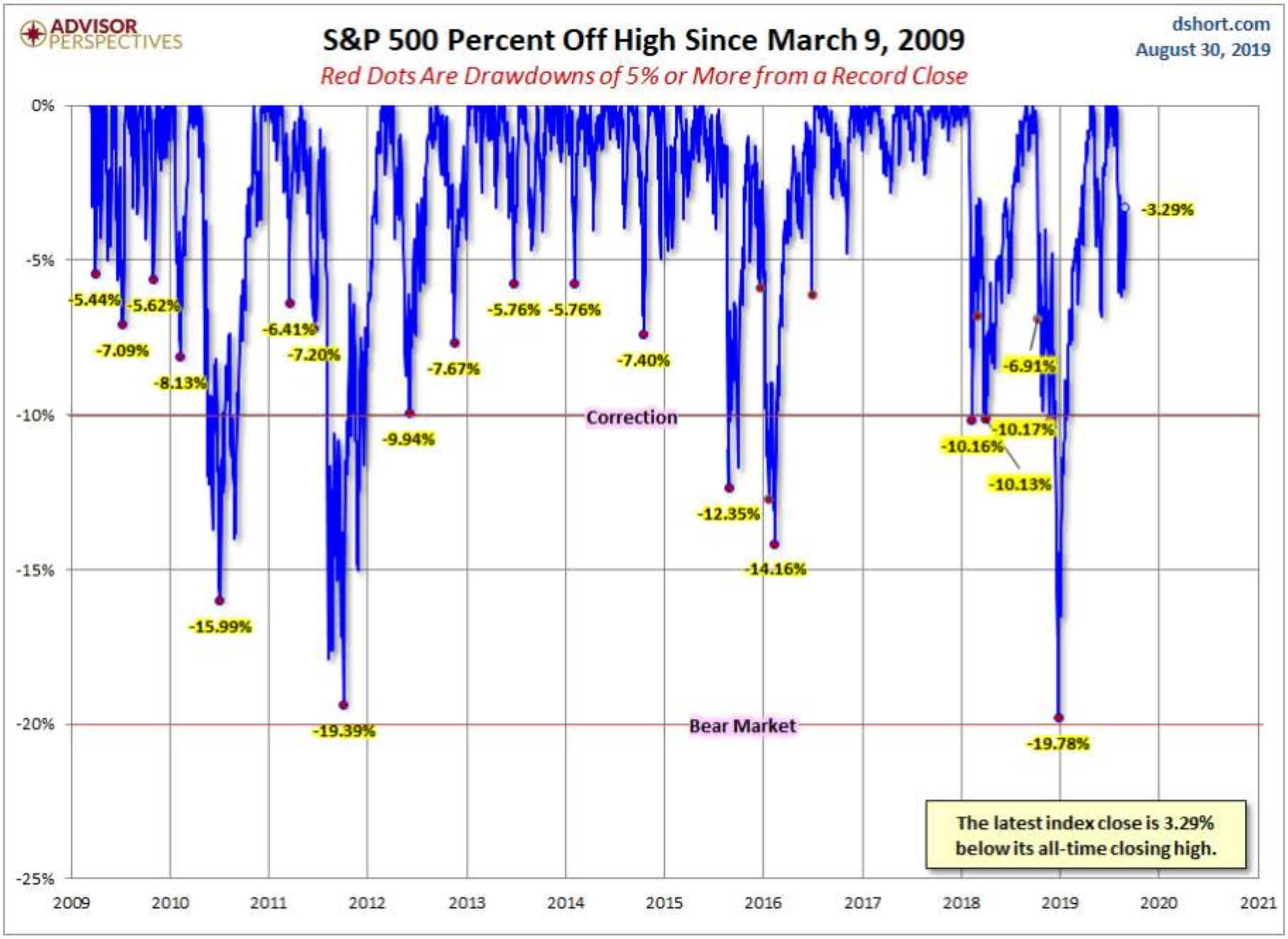
September 2019

Modest gains in September were insufficient to revisit all time highs in the S&P 500, NASDAQ, and DOW, which were established last July, or the Russell 2000 (Small Caps), which last saw its all time high in August of last year. The current selloff has plenty of company:



The biggest news in September was Trump's Ukraine Whistleblower Scandal, with Impeachment now seeming inevitable. While our political leanings should be clear to anyone that reads what we share, the question here is what impact this will have on the markets. From The Finance 202 on 9/26:

As this JPMorgan chart notes, the market rose during President Bill Clinton's impeachment:

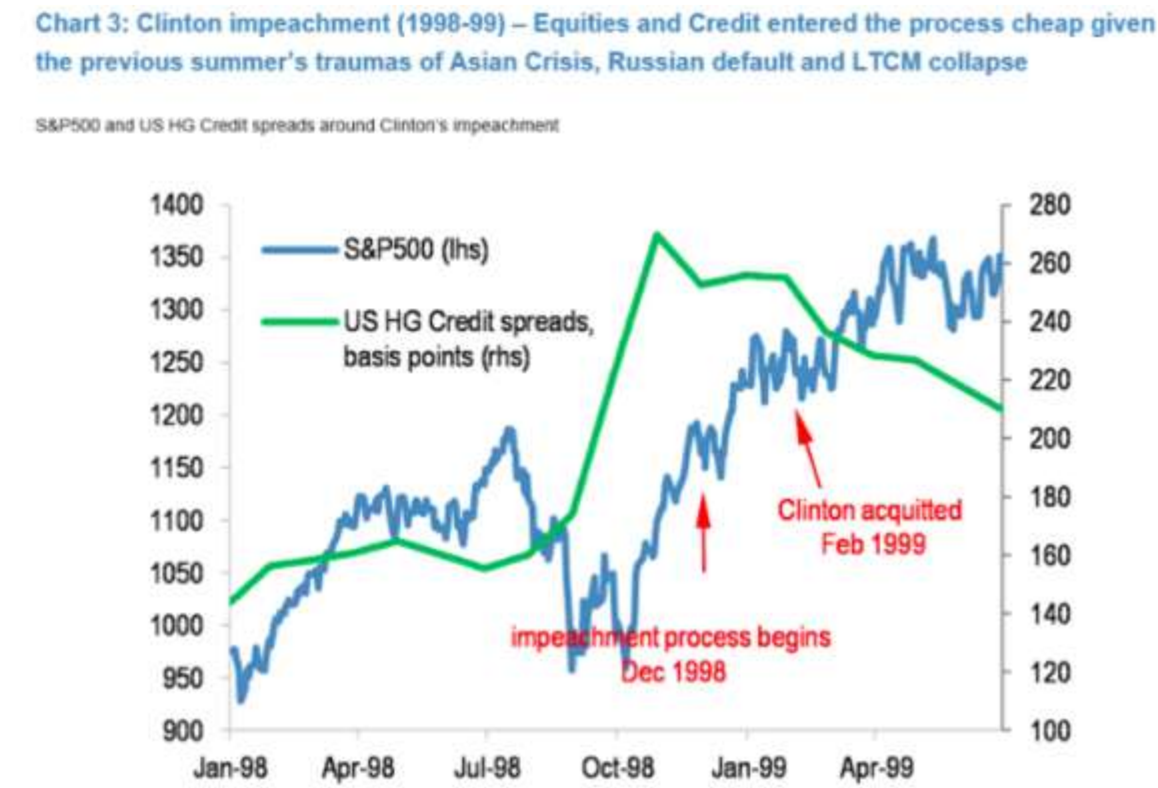
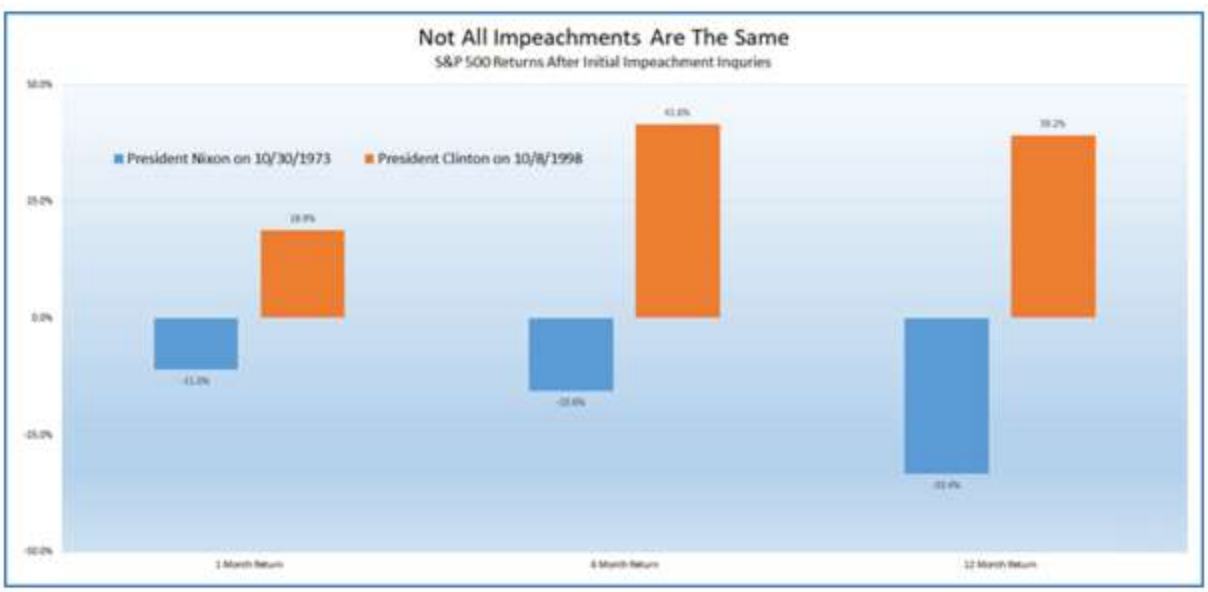


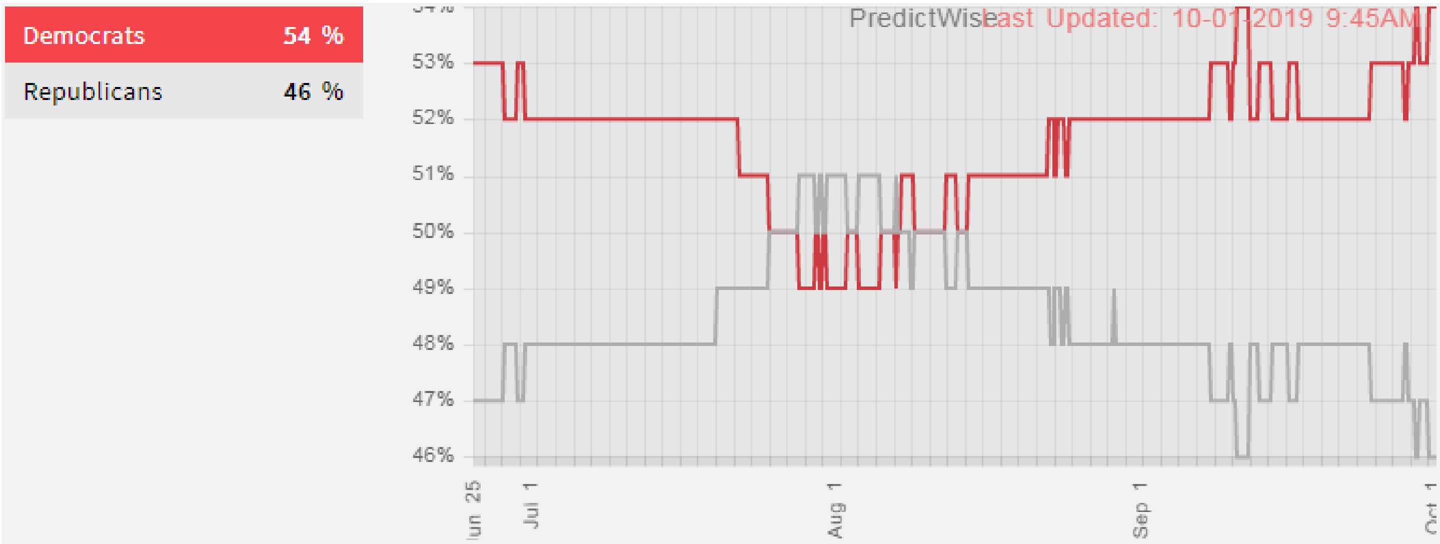
Chart JPMorgan sent to clients Wednesday showing the stock market's rise during President Bill Clinton's impeachment proceedings. (JPMorgan)

Stocks fell as Nixon's presidency unraveled, but then, as The Washington Post's Heather Long notes, "markets were a lot more focused in 1973 and 1974 on skyrocketing oil prices that tipped the U.S. economy into a recession." Via LPL Financial:



Now, investors are far more focused on the U.S.-China trade war. And by at least one line of thinking, a defensive Trump could be more likely to strike a deal, as Heather explains: "The thinking goes like this: The Chinese could perceive Trump as weak, making this a moment to try to push for something quick and puny. Trump’s words Tuesday on the sidelines of the U.N. General Assembly were aimed at fueling that thesis and pushing the market higher."

As we have previously shared, our far larger concern is Left-wing Economic Populism. Its history of economic disaster is clear. The likely hood of a Democratic victory in 2020 is rising:



So are the prospects of Senator Warren for the Democratic nomination, as shown as of 10/1 to the right from PredictWise. From Global Investment Strategy's September 13th Weekly Report titled Elizabeth Warren And The Markets, which was written prior to the current Impeachment explosion:

Elizabeth Warren	46 %
Joe Biden	21 %
Bernie Sanders	8 %
Pete Buttigieg	5 %

The Warren Factor

We remain bullish on global equities and other risk assets but continue to be on the lookout for evidence of any scenario that could undermine our thesis. One particular risk, which we explore in this week's report, is the possibility that a weaker U.S. economy further undermines Donald Trump's poll numbers, thus raising the odds that Democratic Senator Elizabeth Warren wins the White House next year.

Presidential approval ratings tend to correlate well with the state of the economy. Since 1952, no sitting president has lost an election when unemployment has been falling except for Gerald Ford in the wake of Nixon's scandal and unprecedented resignation. In contrast, two presidents (Jimmy Carter and George H.W. Bush) have lost against the backdrop of rising unemployment.

President Trump's approval ratings are quite poor given how low unemployment is these days. His perceived handling of the economy is the only area where he has continued to poll relatively well (**Chart 2**). If he were to lose his standing on this issue, his re-election prospects would deteriorate substantially.

Among the Democratic contenders, Elizabeth Warren is currently running behind Joe Biden in the polls, but bests Biden in online betting markets such as PredictIt.

It is not clear if Warren's standing in the betting markets is a statistical anomaly or truly reflects the "wisdom of the crowds." Warren tends to poll best among better-educated voters – the sort who are more likely to use betting markets. ... Warren's prospects may be inflated by the composition of the betting pool.

That said, Warren is benefiting from a deep-seated shift to the left in political preferences among Democratic primary voters, as BCA's Geopolitical Strategy recently observed in a report entitled "American Politics Warrants Near-Term Caution.1" **Chart 4** shows that the share of Democrats who identify as "liberal" has more

CHART 2

Trump Gets Reasonably High Marks On His Handling Of The Economy, But Not Much Else

SOURCE: BCA CALCULATIONS BASED ON DATA FROM REALCLEARPOLITICS. SHOWN AS A 30-DAY MOVING AVERAGE OF INDIVIDUAL POLLS. NET APPROVAL MEANS APPROVAL LESS DISAPPROVAL.

than doubled since the mid-1990s at the expense of those who identify as “moderate” or “conservative.” The “Great Awokening” is transforming the Democratic Party into a much more radical force than it was under Bill Clinton or even, for that matter, under Barack Obama.

Soak The Rich

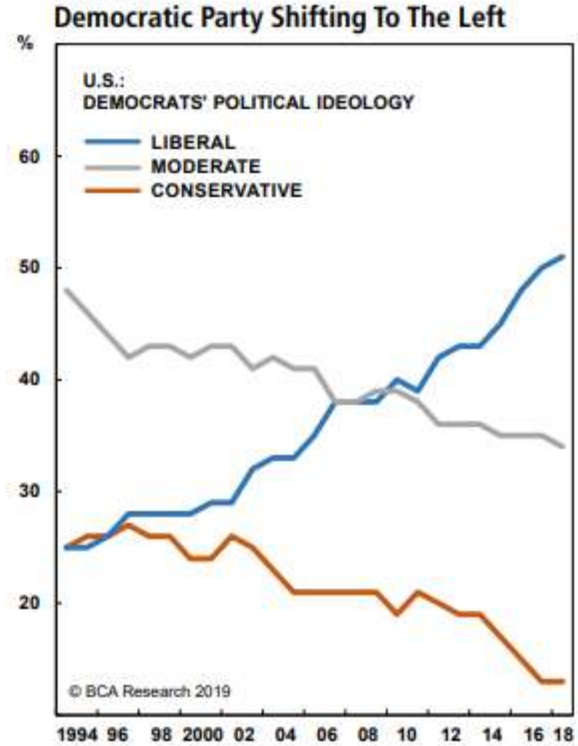
If Donald Trump was the right’s answer to populism, Warren, along with fellow traveler Bernie Sanders, is the left’s embodiment of the populist spirit.

Not only has Warren pledged to raise the federal minimum wage to $15/hour, she has promised to roll back Trump’s corporate tax cuts. If that were not enough, she has also touted a 2% annual wealth tax on households with a net worth in excess of $50 million (rising to 3% for those with a net worth above $1 billon).

Her team claims the wealth tax would bring in $2.75 trillion over a 10-year period (roughly 1% of GDP).3 It would help finance free universal health care coverage, fund a “Green New Deal,” and pay off most student loans.

CHART 4

Democratic Party Shifting To The Left



SOURCE: GALLUP.

A Different Type Of Protectionist

While Warren holds fairly protectionist views on international trade, they are qualitatively different from Trump's vision. Whereas Donald Trump has focused his efforts on reducing America’s bilateral trade deficits with other economies, Warren has concentrated on “social justice” issues.

In the first few decades following World War II, trade agreements strove to cut tariffs and other overt trade barriers. Once this had been largely achieved, negotiations began to focus on fostering what trade economist Robert Lawrence has called "deep integration." This involved harmonizing tax and regulatory policies across countries, strengthening intellectual property rules, and so on.

Warren and other critics on the left have complained that this newfound emphasis of trade policy has helped multinational companies at the expense of ordinary workers. She has espoused creating prerequisites for all future trade agreements, including stronger protections for human rights, collective-bargaining, and environmental standards. Such preconditions would make it difficult for many countries, China included, to reach a deal with the U.S. on trade.

What Warren Means For Investors

Regardless of what one thinks about the overall merits of Elizabeth Warren's political agenda, it is reasonable to conclude that equity investors would suffer if most of her preferred policies were implemented. In fact, as we were writing this report, Warren retweeted a CNBC story entitled "Wall Street executives are fearful of an Elizabeth Warren presidency" with a trollish comment saying "I'm Elizabeth Warren and I approve this message."

Follow-ups

We received the following, written by Verdad's Nick Schmitz, the day after sending our most recent Worth Sharing.

Is Value Back?

Value stocks posted their seventh best day in 20 years on September 10, while momentum stocks had their worst two-day stretch in a decade. Our friends at Alpha Architect crunched the numbers and concluded this was a five-sigma event for value and momentum stocks.

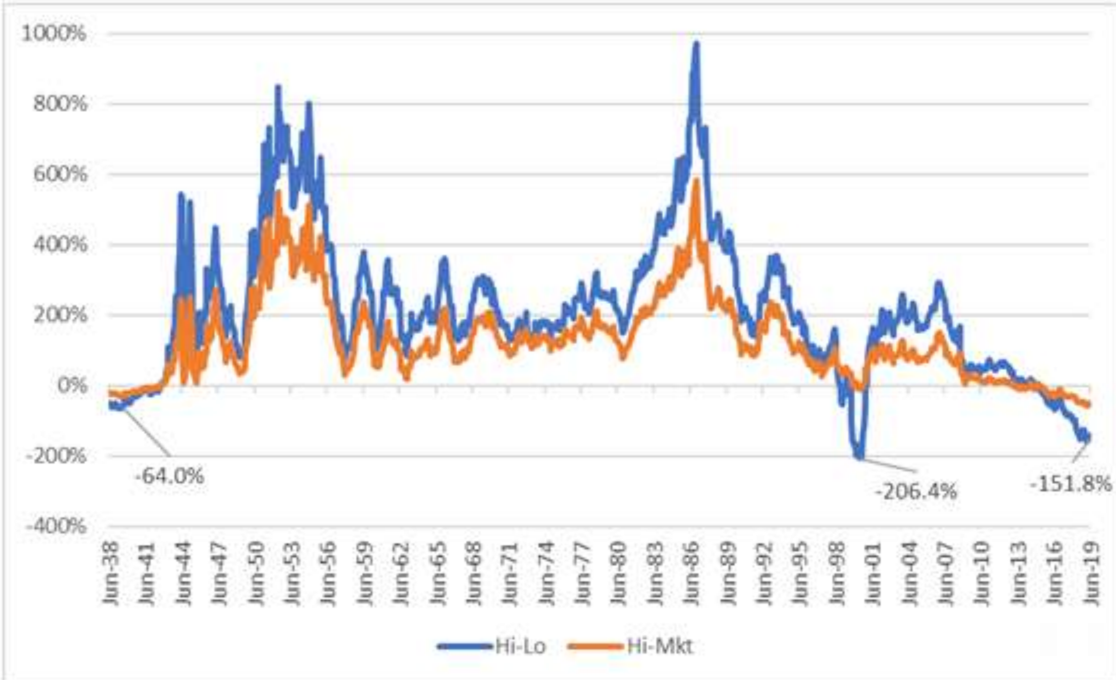
Financial commentators were quick to call it a paradigm shift. "Is the great value-stock rotation finally upon us?" asked Barron's. "Value stocks are acting like a tightly wound spring that has started to uncoil."

Though we are delighted by this development, we have no crystal ball on whether this really is the start of a big shift or merely a temporary respite from the grinding 12-year period of growth outperforming value.

And though we can't say if the spring has really started to uncoil, we can examine the historical data to understand just how tightly that spring is wound.

The last 12 years have been brutal for value relative to growth. This recent stretch of market history has been extreme by historical standards. Below are the trailing 12-year compounded relative returns for every month dating back to the Great Depression for the cheapest 30% of the market minus the most expensive 30% of the market (in blue) for both value-weighted and equal-weighted portfolios from the Ken French library. We also include Value minus the overall market (in orange).

Figure 1: Trailing 12 Year Value Relative Performance (Value Weighted)



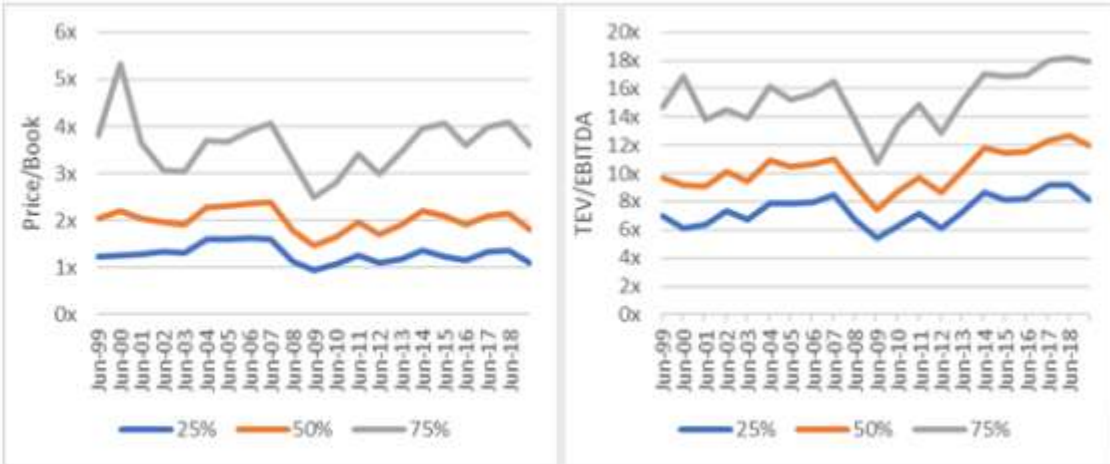
Source: Ken French Library

Value-weighted portfolios of the cheapest stocks have underperformed growth portfolios by 151.8% in the last 12 years, which was only exceeded briefly at the peak of the dot-com bubble. What's more, the same portfolio has underperformed growth in 9 of the last 12 calendar years, which has never happened historically.

Value's underperformance is primarily a result of the changing multiples for growth and value stocks. Growth stocks are now more expensive than value stocks by margins not exceeded since the peak of the dot-com bubble and the Great Depression. In both of those other two extreme periods of market history, valuation spreads between the most expensive and cheapest stocks had widened significantly. And in both cases, while the ride up the spreads was painful for value relative to growth, when spreads eventually mean reverted, value dramatically outperformed. ...

Implicit in high relative spreads are high relative expectations. In the last 12 years of steadily rising relative valuations, surprisingly little has changed for value stocks. They have compounded about +74% over those 12 years and remain at about the same trading multiples they've been at throughout the growth cycles. During these 12 years, value has traded at about 1.1x book and around 7x EBITDA while growth has gone from 2.5x book and 11x EBITDA to 4x book and 18x EBITDA.

Figure 3: Absolute Valuation Multiples of Growth and Value Stocks in the US over Time



Source: Capital IQ. All listed North American stocks by 25th percentile, median, and 75th percentile valuation breakpoints.

Growth stock financial statements have dramatically outperformed during this growth rally, so the multiples have also risen dramatically, baking in an expectation about the future drawn from these recent past trends.

But the higher expectations get, the less likely they are to be met in an uncertain future. And the higher relative expectations become, the less likely relative performance expectations are to be met in an uncertain future.

Expectations have grown ever higher for growth, causing value investors to worry that the last 12 years of value's relative underperformance, which falls well into the far extremes of historical data in its duration, scale and consistency, might be the signal that value investing no longer works.

But value investing is not plausible simply because it fits a very specific, knowable "true" trend that we can calculate with perfect precision. To the contrary, it has probably worked and worked best when other market participants do lose faith in it from time to time.

And value has actually done fine over the 12 years on it's own, compounding annually in the high single digits. What's more exceptional is the distinctive rise in expectations for growth stocks. On a historical basis, we can see that this rise in expectations has coincided with most periods of value relative underperformance. This phenomenon has been one of the most consistent historical signals of decreased returns to growth on a forward-looking basis.

And for those who remain fully invested for the long haul, unpopular assets after periods of poor relative returns and measurably lower relative expectations have most regularly made for the best long-term investments. Value is, admittedly and encouragingly, at a very rare historical extreme combination of those attributes right now: completely unpopular, at a crisis of faith, deprived of short-term results, and at extreme low relative valuations compared to much more popular segments of the market. These are the ingredients of mispricing.

Our long standing advice to avoid IPO continues. From the NYT:

Wall Street Deflates America’s Favorite Start-Ups

By **Matt Phillips**, **Stephen Grocer** and **Erin Griffith**

Published Sept. 26, 20199

This was supposed to be the year when America’s biggest start-ups would finally make their triumphant debut on the stock market.

Billionaire Silicon Valley investors, sneaker-clad founders and button-down bankers all expected enormous stock sales to turn companies like Uber, Lyft and WeWork into a new generation of corporate giants.

It hasn’t quite turned out that way. Last week, WeWork postponed its planned initial public offering. Uber and Lyft sold shares earlier this year only to see their prices collapse. On Thursday, Peloton joined the list as its shares slumped in their first day of trading. Investors took a look and backed away, seeing overpriced companies with no prospect of making money any time soon, in some cases led by untested executives.

The rejection threatens Silicon Valley’s favored approach to building companies. The formula relies on gobs of money from venture capitalists to paper over losses with the expectation that Wall Street investors will eventually buy shares and make everybody rich. If mutual funds and pension funds are no longer willing to buy once the companies go public, fledgling companies are unlikely to find funding in the first place.

“When the I.P.O. market is hurting, it has a domino effect on valuations and venture capital deals,” said Steven N. Kaplan, a professor of finance and entrepreneurship at the University of Chicago. If it persists, that could make it harder for start-ups to raise money, he said.

Much of the recent concern has been directed at WeWork, a shared office space company based in New York. As it began to approach stock market investors, the company revealed losses of $1.37 billion in the first half of 2019. Investors also questioned financial dealings of WeWork’s chief executive, Adam Neumann, and the company’s accounting.

On Tuesday, Mr. Neumann stepped down under pressure from directors and investors. It is now uncertain when the company will return to the market.

Uber, by comparison, cut its expected price in May. Even so, its shares have fallen about 30 percent as the company’s financial losses have deepened. In the three months through June, the company said it lost more than $5 billion and reported its slowest revenue growth in its history.

Shares of its rival Lyft have fallen 40 percent since the company’s debut in March.

The fitness start-up Peloton has also reported deep losses on its business of selling high-end exercise bikes and live-streaming classes into users’ homes. On the stock’s first day of trading Thursday, it ended 11 percent lower than its I.P.O. price. Such a sharp drop in a first day is a rare occurrence for a new listing. ...

Other companies have delayed their plans. Airbnb, the vacation-rental business, said last week that it did not plan to go public until 2020, later than expected. Palantir Technologies, the data mining firm the billionaire investor Peter Thiel helped found, now does not expect to go public for years, because it can continue to raise money from private investors, two people familiar with its plans said. ...

In many ways, the current standoff between Wall Street and these giant start-ups comes down to a simple issue: price.

Because of expectations set by venture capitalists, and given the risks they face, the companies simply asked for too much.

Uber, which private investors valued at roughly $72 billion before its I.P.O., is now worth about $54 billion in the public market. Lyft, once said to be worth more than $15 billion as a private company, now has a market capitalization of roughly $12 billion.

WeWork was last valued at $47 billion in the "late stage" market of mature private companies. In the run-up to its failed attempt to list shares, executives and bankers had discussed slashing the valuation to $15 billion — but were still unable to gin up enough interest.

The tepid response to these companies stands in stark contrast to the dot-com bubble of 20 years ago, when shares of start-ups with little revenue or prospects for profit — like Webvan and Theglobe.com — were greedily bid up in their market debuts. ...

Now, the verdict from the stock market is that it's the private investment binge that has gone too far. With a flood of cash, private investors backing the hottest start-ups have inflated their valuations to a point that public investors cannot tolerate. ...

The recent troubles may stem from the long incubation period the largest start-ups have had. Flush with funding from venture capital and other private investors, the companies have not been forced to go to the public markets to secure financing like they might have in the past.

It was not always this way.

Traditionally, the I.P.O. market has allowed investors to put their money into relatively small, higher-risk firms with enough potential for fast growth that stock buyers are willing to overlook their often numerous warts.

Amazon.com sold shares to the public just three years after its founding in 1994, raising just $62 million in a deal that valued the company at more than $400 million. The company has a value of more than $800 billion now.

Google was a much bigger, and older, company when it went public in 2004, valued at roughly $23 billion, a deal that was enormous by the standards of the time. But it was also incredibly profitable — with an annual profit of more than $400 million the year it went public — and still fast growing. ...

Positions

CLF - On 9/4 Citigroup lowered their Target Price from 10 to 8, while maintaining their Buy rating. This Buy list stock ended down 14.6% on 3.6 times average volume. We bought for 5 clients @ 6.9.

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
09/05/2019	1	Baldwin John T		9,000
08/28/2019	1	Rychel Eric M		3,000
08/23/2019	1	Harlan M Ann		3,721
08/22/2019	2	Koci Keith, Baldwin John T		19,500
08/08/2019	2	Baldwin John T, Fisher Robe		9,000
08/07/2019	1	Koci Keith		30,000

JE - On 8/15 reported a Negative Earnings Surprise of -1.82 actual vs. +.05 estimated, dropping 39.4% on 11.1x average volume, followed by a further drop of 9.0% on 5.2x average volume on the 16th. By 9/4 1 of 2 analysts had lowered their earnings estimate for the 9/19 quarter by .11, and by .18 for the quarter ending 12/19. With 2 Buys, and 3 Holds (1 of which had been a Sell), and an average Target Price of 2.89, which 1 analyst increased and 4 decreased. We sold for all 7 clients @1.11.