Corporate Bond Bubble

by **dmckee03** February 28, 2019 11:47 pm Comments Off **Uncategorized**

"The Federal Reserve will not monetize the debt."

- *Ben Bernanke, June 3, 2009, then Chairman of the Federal Reserve, in response to a direct question on the subject during a congressional hearing*

Maybe he really believed that at the time. There were plenty of skeptics out there on this point. Many of us worried that once the Fed started using the power of its balance sheet to create demand for debt securities, especially US Government bonds and mortgage-backed securities, that they would, in effect, be stuck with them. We are seeing this concern play out in real time today.

The Fed is the only entity in the world which possesses the enormous privilege of being able to create, at will, and near-zero marginal cost, US dollars. For now, the US dollar still enjoys its status as the most important currency in the world, and will probably remain so for the foreseeable future. Being able to print up as many as a situation calls for (or their digital equivalent) is an enormous privilege.

For the entire history of the Federal Reserve from its creation in 1913 until the onset of the Great Financial Crisis of 2008-09 (GFC), most people believed that if the Fed ever started blatantly printing up dollars in order to directly finance a ballooning US government fiscal deficit, that people would begin to lose faith in the dollar and its reserve currency status would be jeopardized. In short, it would be highly inflationary, much as it was when Germany did it after World War I, and as dozens of other examples of central bank "accommodation" played out throughout history.

Interestingly, it hasn't really happened (yet). Of course, there has been broad inflation in certain places (housing, financial assets, health care, higher education), but generally speaking, most of that money never really made it out through the banking system into the “real” economy. These inflationary fears were reflected in the price of gold, which continued its rise leading up to and through the financial crisis before peaking in 2011 at around $1,900 per ounce. But then it started a steady decline, and while it looks like it is starting to rise in price again, it still sits about 30% below its peak 7 ½ years ago.

Prior to her departure from the Fed over a year ago, Janet Yellen laid out a plan for shrinking the Fed’s balance sheet back towards pre-crisis levels. And to their credit, they implemented that plan exactly as advertised. That plan continues to this day, allowing up to a maximum of $30B per month in treasuries and $20B per month in mortgage-backed securities to “roll-off” the balance sheet and allow those dollars to disappear back into the financial ether from which they came.

As outlined in last month’s post, the new chair of the Fed has intimated that they are much more open to reversing this normalization than had been broadly believed as recently as a few months ago. If they do in fact stop this process of “rolling off”, then it will effectively freeze the Fed’s balance sheet near current levels ($3.98T as of Feb 20 2019).

Prior to the GFC, the Fed’s balance sheet had always been comfortably below $1 trillion.

So, if they do what it looks like they are going to do, which is to stop their balance-sheet reduction plan in its tracks, they will have effectively blown up their balance sheet by a factor of 4x and will be holding around $3T worth of debt securities that were funded directly through the Fed’s dollar-creation process. This is the legacy of quantitative easing (QE).

If that is not monetizing the debt, then I don’t know what is.

This is precisely why, in my mind, both the stock and bond markets were selling off so dramatically from early December until Christmas. Recall, this is when President Trump’s criticism of the Fed and Jay Powell were reaching a crescendo. You can get away with these shenanigans for a while, but once the perception takes hold that the Fed is captive to the politicians, the game is over because the quality of the currency and its appropriate role as a reserve currency for the world will be brought into question.

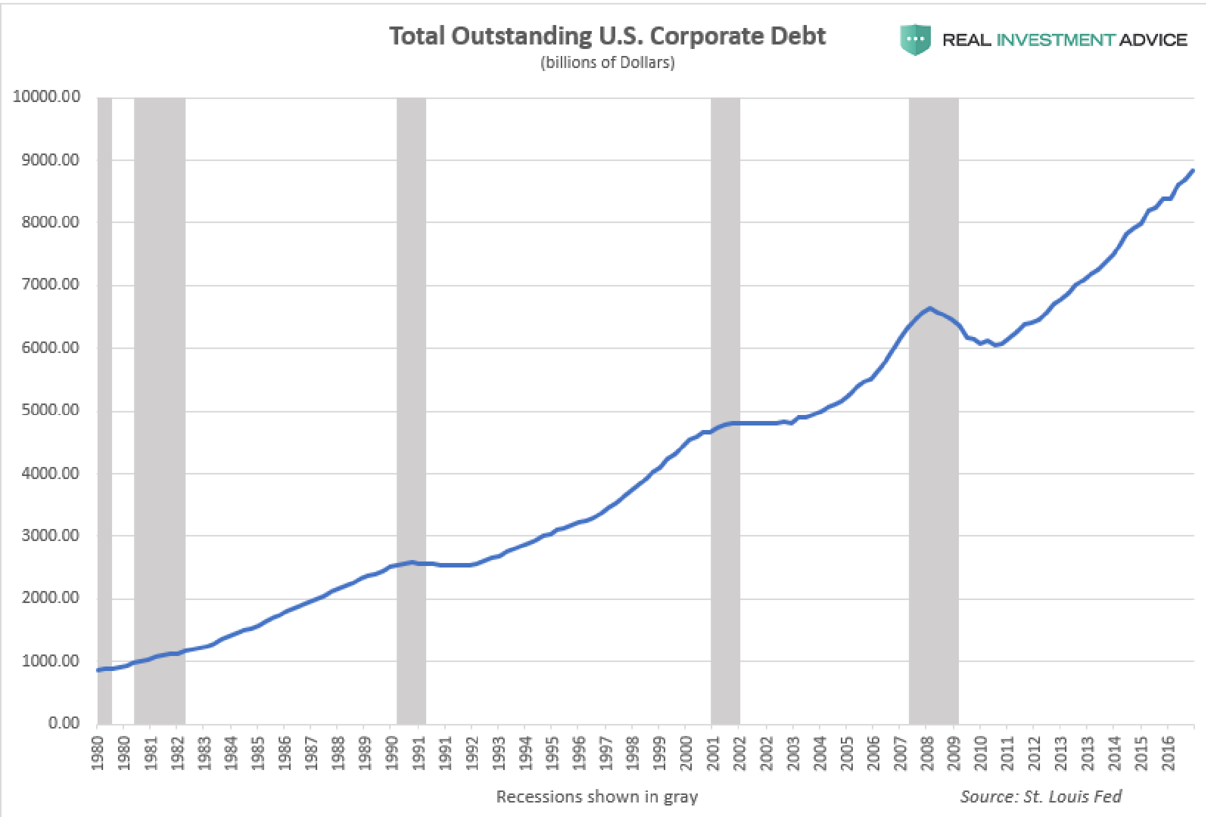
Only once it was made clear to the markets that Jay Powell’s job was safe did the markets start their dramatic recovery, which continues to this day.

The ultra-accommodative policies of the Fed (and the other central banks of the world) has had a dramatic effect on the values of financial assets. The most immediate effect of QE was to create additional demand for debt securities by introducing a very large and price-insensitive buyer of government bonds and mortgages. Even though the Fed has not directly purchased corporate debt securities (yet), this has happened elsewhere in the world. Even so, the immediate effect of the US QE program was to lower the interest costs for the issuers of those bonds (especially the US

Government), and since the entire credit market takes its cues from interest rates on US government bonds, rates were brought down across the entire spectrum.

So even though the Fed was not directly providing financing to US corporations or other issuers of debt, they all directly benefitted from their activities because they were able to issue debt at much lower interest rates than would otherwise had been the case.

And issue they did:

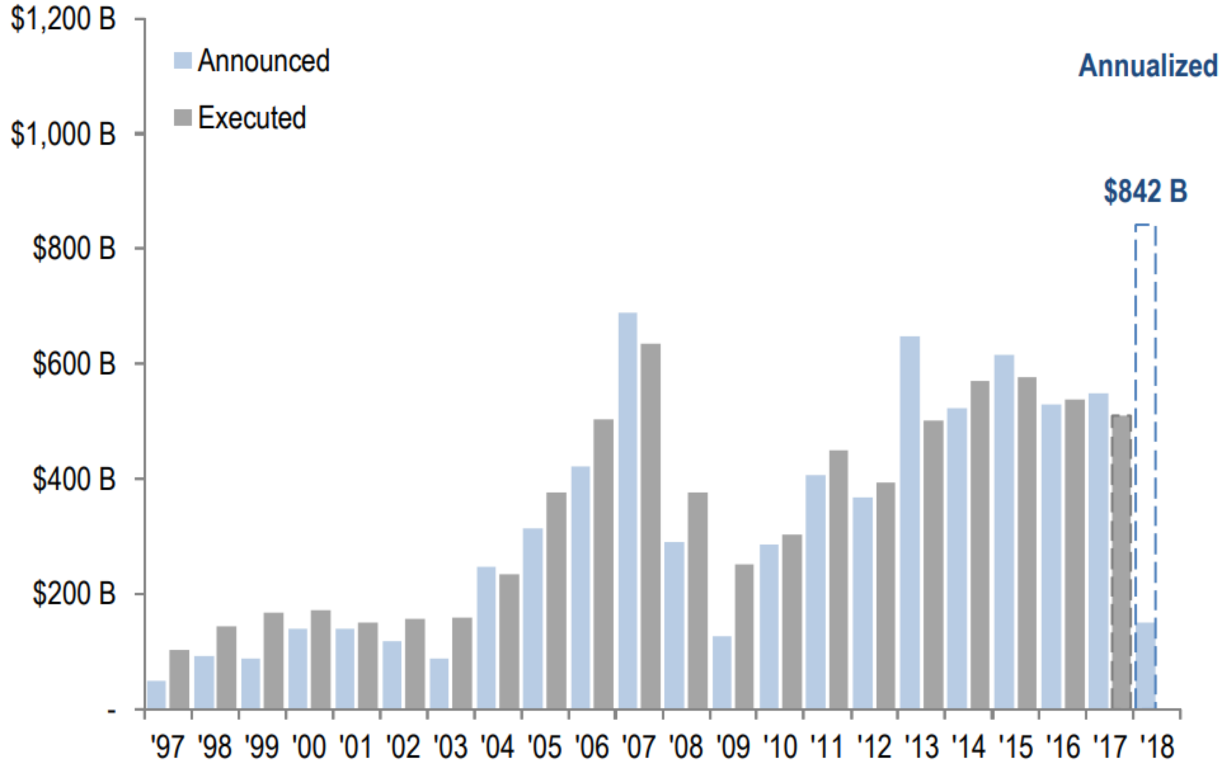


And why not? Just as artificially low financing rates encourage consumers to borrow money to buy cars and appliances, artificially low rates in the corporate bond world encourage companies to borrow money for all sorts of reasons.

One of the most popular uses of all of this cheap money is to buy back the company's own stock:

Figure 8: Announced vs. Realized Buybacks

S&P 500 Companies



Source: J.P. Morgan US Equity Strategy and Quantitative Research, Bloomberg

The actual total of announced buybacks for 2018 exceeded $1 trillion, and there has been no slowing of this trend in spite of increasing criticism being leveled by prominent people, including elected officials.

I am not taking issue with stock buybacks, per se. If a private company wants to take full advantage of artificially cheap credit and harvest that available cash from investors, and then turn around and give that money to their shareholders by reducing the outstanding share count, that is their business. It actually makes sense, *as long as the stock is being purchased at an attractive price.*

And there is the catch. Unfortunately, corporate America has a pretty bad track record in this regard, as can be seen in the above chart. Stock buybacks hit their peak in the previous cycle in 2007, right before the S&P 500 lost 57% of its value.

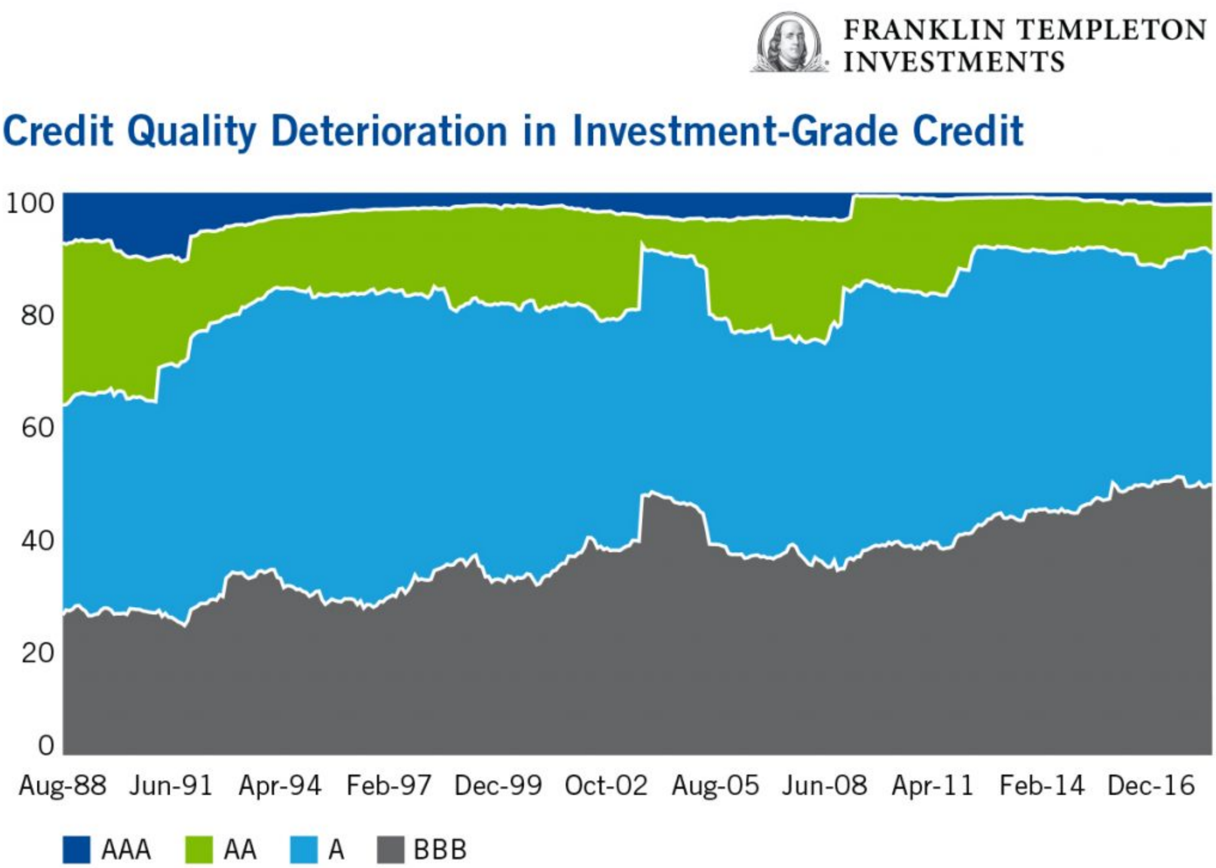
Now we find ourselves with a situation that can be fairly described as such – corporate America is in the later stages of completing a leveraged buyout on itself. In the grand scheme of things (recall that central bank accommodation has enabled the global debt bubble to grow from $170T to $250T over the past decade), this swelling in US corporate debt up to $9.3T or so is a relatively small piece of the puzzle but a very important one. Despite the fact that the US comprises only about a quarter of global GDP, it's publicly-traded stocks comprise closer to half of the value of all stocks traded around the globe.

It is important to remember at this point that, as an equity investor, you are at the bottom of the food chain in the corporate structure. Yes, you, as a group, are the only ones who are entitled to share in the profits of the companies you invest in, *but only after everyone else has been paid.* This includes the employees, the parties who have contracts with the company, preferred stockholders, and all creditors.

As an investor in US stocks, understanding that you have the most junior claim on companies assets and cash flow if they fall on hard times, how do you feel about the fact that these companies have taken full advantage of these artificially low rates, borrowed trillions of dollars, and used most of it to leverage up their balance sheets instead of investing in things that will create future revenues?

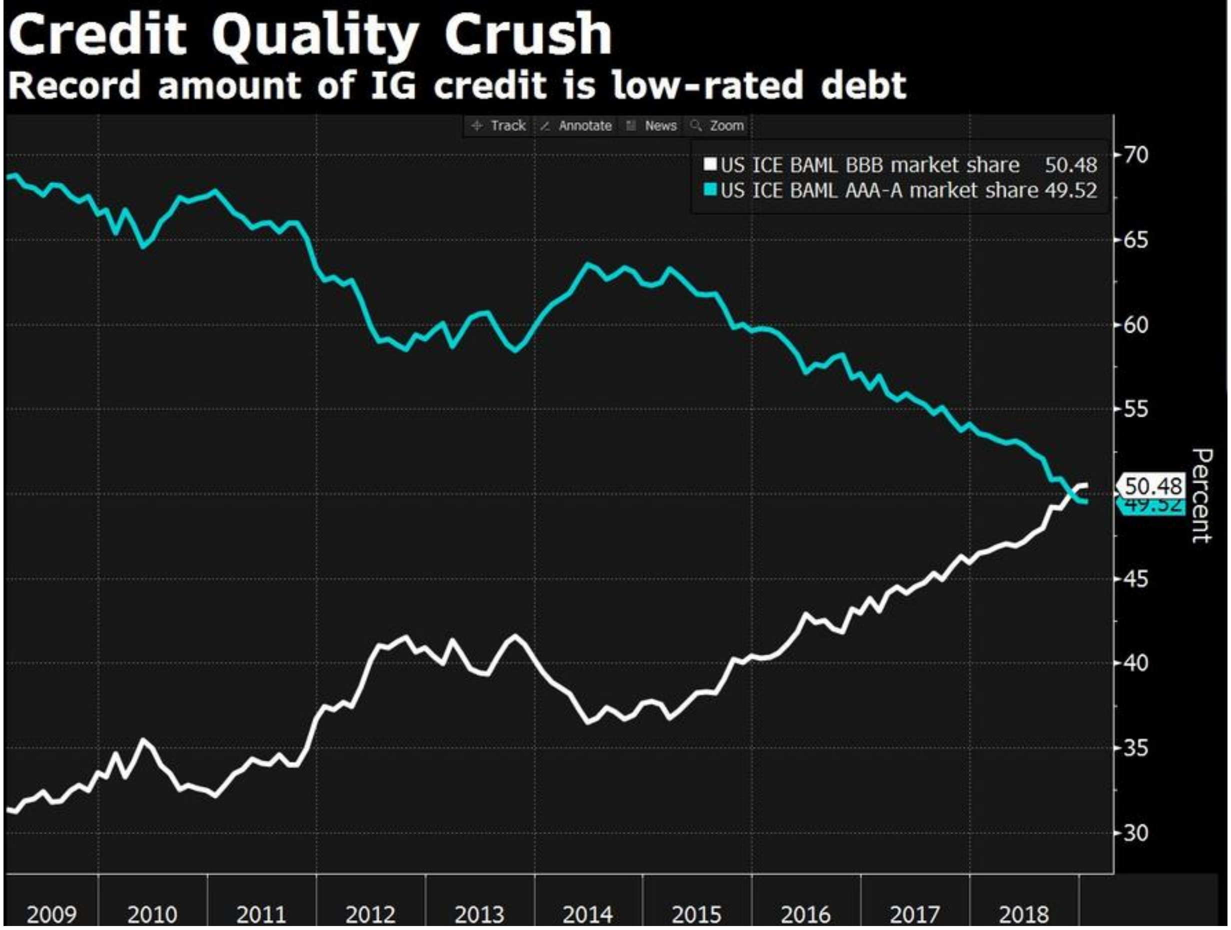
Uneasy – that's how I feel about it. And again, these junior claims on US companies comprise about half of the value of the global stock market.

The picture looks even worse when you start to look at the quality of all that corporate debt:



Source: Bloomberg Barclays US Corporate Index, as of July 2018. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges.

Its' arguably never looked worse. BBB-rated bonds are the lowest level of so-called "investment grade bonds". As you can see, that sleeve has grown to become a larger and larger share of the investment grade US corporate debt universe. At the onset of the GFC 11 years ago, it made up around 30% of the total. Now it is over half:



(*Source: Bloomberg)*

Its' actually 54% now. The reason this is so important is not simply that it is a reflection of the deteriorating credit quality of the pile of US corporate debt. All of these issuers of BBB-rated debt are one downgrade away from a BB rating, and that is significant because BB is considered non-investment grade, or "junk".

While there is a time and place for most investors to have some exposure to these "junk bonds", a lot of institutions can't and won't hold them. So, if we were to see the economy slow down, or interest rates rise, or both, we should expect to potentially see a record amount of debt added to the pile of junk (which is already around $3T when including bank loans made to non-investment grade issuers).

When a company loses its investment-grade credit rating, its interest expenses go up, a lot. Given the amount of debt which is due to mature over the next few years, forcing these issuers to either retire the debt or refinance it, potentially at much higher rates than were on offer when the Fed's QE program was in full swing, it would not be surprising to see these companies cash flow and earnings deteriorate over the next few years.

This is the point of this post. There has rarely, if ever, been a better time to focus on quality.

One of the biggest problems with index funds, particularly those designed to track capitalization-weighted indices (S&P 500, MSCI EAFE et al), is that they are indifferent when it comes to fundamental issues such as the balance sheet and leverage ratios. The only thing that matters with these cap-weighted indices (which comprise the vast majority of index funds and are capturing virtually all of the net new investment dollars these days), is the total market value of the company, or put another way, price. In theory, a highly-leveraged company which has been issuing debt with reckless abandon and not showing much in the way of net profits, should have its stock price marked down as a consequence, but it doesn't always work out that way (Hello, Netflix).

Since these cap-weighted index funds have become so incredibly popular, we are seeing a record amount of money being allocated to stocks on the basis of price alone, without regard to other issues such as quality.

It doesn't have to be this way. There is no rule that says that we have to invest in companies carrying record levels of debt who will almost certainly be facing much higher interest costs at some point in the future, and maybe the near future. One might expect to have to pay a premium on the basis of top-line sales or bottom-line earnings to own these higher quality companies with stronger balance sheets, and there are certainly examples of that out there, but in general, it doesn't appear to be the case at this point in time.

As an investor trying to earn a decent return on your capital, and rightfully concerned about risk, why wouldn't you do that? I look at the pile of US corporate debt today the same way I would look at an active volcano that may not be erupting right now, but could conceivably do so at any moment. I want to stay as far away from it as I reasonably can.

Investing in oil involved special risks, including the potential adverse effects of state and federal regulation and may not be suitable for all investors.

Same as the Old Boss

by **dmckee03** February 5, 2019 9:00 am Comments Off **Uncategorized**

For those of us who were hoping that Jerome Powell would represent a new type of Fed Chair, or might be able to at least begin the process of weaning us and the rest of the world off the dependency of easy credit and ultra-low interest rates, the recent words and actions of Mr. Powell and his comrades on the Board of Governors can only be seen for what it is – full capitulation and a massive disappointment. Capitulation to the market? Capitulation to the president? Take your pick.

In this letter I am going to review the year just finished in light of the extraordinary changes we have seen in the past few months from the new Fed Chairman, place the implications of this pivot against the backdrop of economic and fiscal reality, and draw some conclusions with respect to an appropriate investment strategy.

When one looks more carefully at what happened in the financial markets since the beginning of last year, you see that it really unfolded in 4 distinct phases:

1. The market continued its momentum from 2017 and started off the year virtually on fire, with the S&P 500 rising approximately 200 points or 7.5% by January 26th. International stocks, including emerging markets, were along for the ride, as were commodities. The Bitcoin Bubble had already burst and was changing hands around $11,000 (down from $19,000 the month prior). Interest rates were rising rapidly, which may well have been the trigger to catalyze a transition to the next phase.

- Late January turned out to be the high for virtually every international market, and the major international stock indices (MSCI EAFE and MSCI Emerging Markets) remain well below those highs to this day. US stocks, on the other hand, managed to recover from their sudden decline in late January and early February and worked their way to an all-time high on October 3rd, with the S&P up more than 11% YTD at that point. The divergence between US stocks and their international counterparts was noteworthy to say the least. While the S&P sat around 3% higher from it's January high, the EAFE index (developed international stocks) was down about 8% and emerging markets were down more than 14% over the same period. Many people wondered, myself included, how is this performance gap going to close? Are international stocks going to catch a bid and catch up to US stocks, or are US stocks going to succumb to the weakness that had been reflected in the overseas markets for most of the year?

- We got our answer in October – that was it for upside on the S&P 500 for 2018. What happened on October 3rd? That's where Mr. Powell comes back into the picture.

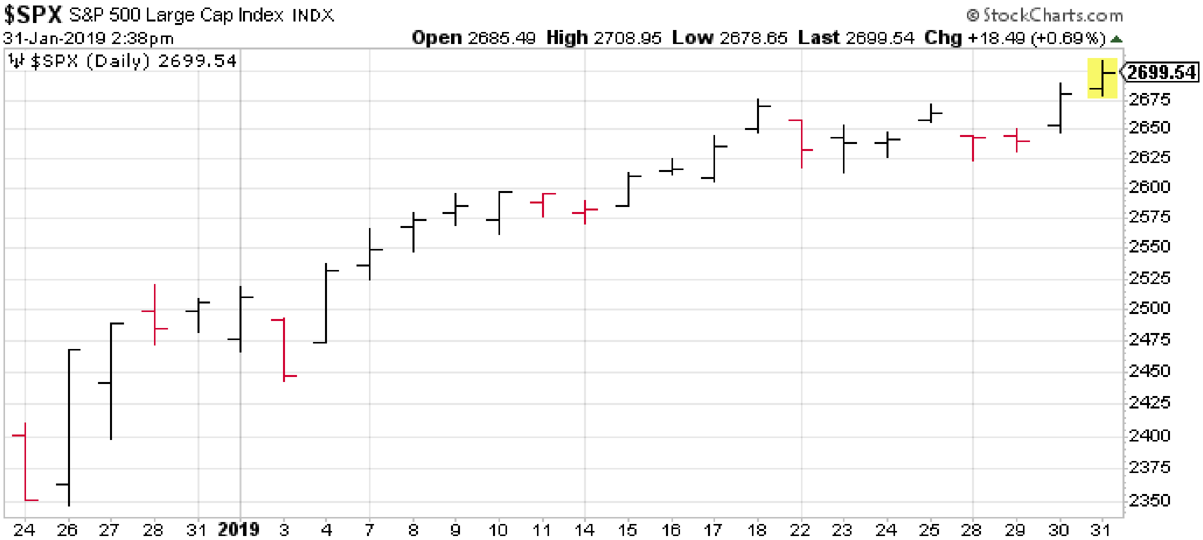
"The really extremely accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore. They're not appropriate anymore……interest rates are still accommodative, but we're gradually moving to a place where they will be neutral. ***We may go past neutral, but we're a long way from neutral at this point, probably****." – Jerome Powell, interview with Judy Woodruff, PBS, 10/3/18*

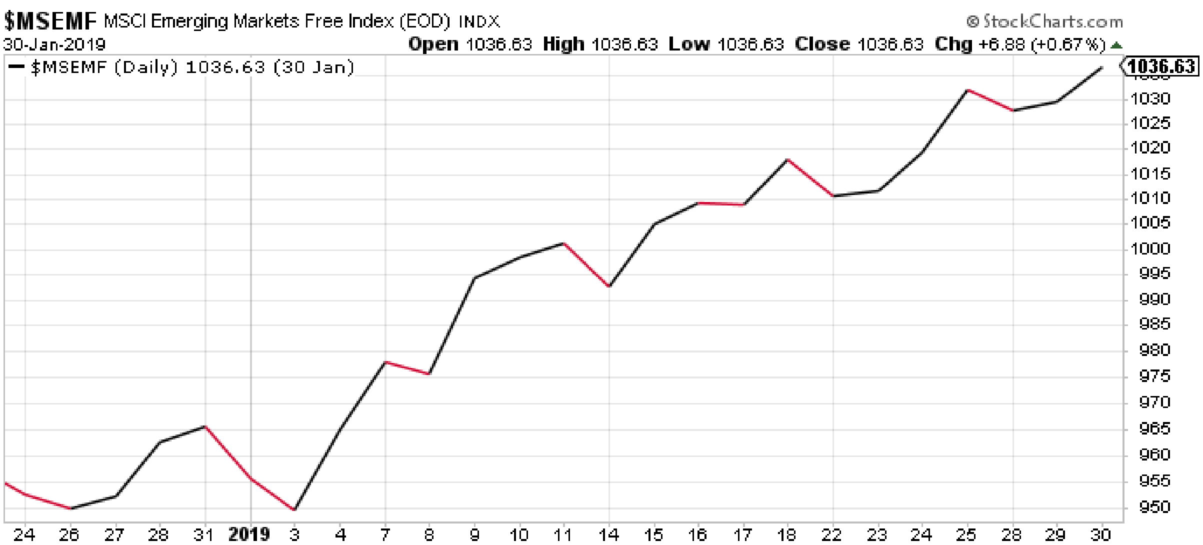
Hello, bear market:

- Christmas Day, as it turned out, offered a welcome and much-needed one day reprieve from the carnage. Meanwhile, Kevin Hassett, Chairman of the Council of Economic Advisors, was preparing for media appearances the next morning with the Wall Street Journal and Fox Business Network. It appears this was deemed necessary in light of President Trump's repeated and relentless criticism of the Fed and Jay Powell himself.

"The president has voiced policy differences with Jay Powell, but Jay Powell's job is 100 percent safe. The president has no intention of firing Jay Powell." – Kevin Hassett, 12/26/18

Here is what has happened with the S&P 500, EAFE, and emerging markets since then:





I think the market from early October to the present can best be understood within the context of the words that were spoken by four key players. In addition to Jay Powell, Kevin Hassett, and Donald Trump, I will include John Williams, President of the Federal Reserve Bank of New York. Of the twelve regional Federal Reserve Banks, the New York Fed is widely regarded as the most important and influential of them all.

Starting with President Trump's tweets and remarks to the media following Jay Powell's "long way from neutral" comment on interest rates:

October 10 – The Fed is *"so tight. I think the Fed has gone crazy."* The Fed is *"going loco"* by raising rates.

October 16 – The Fed is his "*biggest threat.*"

October 23 – Tells the Wall Street Journal he "*maybe*" regrets appointing Powell to head the Fed.

November 20 – Tells reporters the Fed is a "*problem*" and he would "*like to see the Fed with a lower interest rate.*"

November 26 – "*I think the Fed right now is a much bigger problem than China. I think it's incorrect what they're doing. I don't like what they're doing. I don't like the $50B. I don't like what they're doing in terms of interest rates. And they're not being accommodative at all. And I'm doing trade deals, and they're great trade deals, but the Fed is not helping." – Donald Trump, interview with The Wall Street Journal, 11/26/18*

The "$50B" he refers to here is the Fed's stated plan to allow up to $50 billion worth of Treasury and mortgage-backed securities to mature each month and not be reinvested, effectively allowing that money to disappear from the system, which is the exact opposite of the "quantitative easing" which was implemented by all of the major central banks following the last financial crisis of 2008-09. He believes that this "quantitative tightening" will obviously have the opposite effect that quantitative easing did (which was to artificially suppress interest rates and provide a major pillar of support for risk markets worldwide), and he is almost certainly right about that.

So now the president has taken aim at both of the Fed's major policy tools – direct manipulation of short-term interest rates through their policy rate (the "Federal Funds Rate"), and the size of the Fed's balance sheet, which through the money creation process, clearly can and has kept longer term interest rates down by lending that newly created money directly to the government and homebuyers through the purchase of Treasuries and mortgage-backed securities. The other major central banks have also ventured into using this free money to buy up corporate debt (Europe) and even stocks (Japan and Switzerland), but that is a topic for another day. Trump is rightly concerned that by both raising short-term interest rates every quarter, and effectively shoveling up to $50 billion per month into the proverbial furnace, the Fed is risking creating the conditions to kill off the economic recovery he likes to take credit for, and the price action in financial markets in the last quarter of 2018 certainly reflected those concerns as well.

That doesn't mean that he should be openly criticizing the Chairman of the Fed, however. This monetary system of ours is most certainly doomed if the free money gravy train is turned over to the politicians. If that perception ever really took hold, then the jig would truly be up. In my mind, that is the biggest concern that the market was screaming about throughout this period.

The very next day after the interview with The Wall Street Journal, he continued:

"I'm not even a little bit happy with my selection of Jay…..I think the Fed is a much bigger problem than China." – Donald Trump, interview with The Washington Post, 11/27/18

This is all leading up to Jay Powell's appearance at the Economic Club of New York where he gave a speech indicating his views on the appropriate Fed policy rate had evolved somewhat:

"Interest rates are still low by historical standards, ***and they remain just below the broad range of estimates of the level that would be neutral for the economy*** *– that is, neither speeding up nor slowing down growth." – Jay Powell, 11/28/18*

Just below the neutral range? What happened to being a long way from neutral / may go past neutral? The Fed's policy rate hadn't changed. The economy was supposedly still going full bore, so what had changed since October 3rd? Good question!

Amazingly, the S&P 500 rallied from the mid-2600s at the time of this speech to roughly 2800 a week later by early December. Clearly, the Fed Chair, whoever that may be, hadn't lost their ability to jawbone markets higher when needed. Now we bring John Williams, head of the New York Fed, into the picture, Remember, he is arguably the second most important voice at the Fed, right behind Jay Powell:

"Given this outlook I describe of strong growth, strong labor market and inflation near our goal – and taking into account all of the various risks around the outlook – I do continue to expect that ***further gradual increases in interest rates will best foster a sustained economic expansion and a sustained achievement of our dual mandate****." – John Williams, 12/4/18*

Confused? I was too! Are we near the lower end of the range of neutral on interest rates, or do we need to keep raising them because the economy is so awesome? Needless to say, we all remember what happened next:

Leading up to the Fed's Open Market Committee Meeting on December 18-19, where they were expected to raise short-term rates for the 9th time in this cycle to 2.25 – 2.5%, the president did not hold back on expressing his opinions, and certainly didn't seem too concerned about the perceptions building that he was trying to exert undue influence on the central bank:

"I think it would be foolish for the Fed to raise interest rates."- Donald Trump, talking to Reuters, 12/11/18

"It is incredible that with a very strong dollar and virtually no inflation, the outside world is blowing up around us, Paris is burning and China way down, the Fed is even considering yet another interest rate hike. Take the Victory!" – Donald Trump, via Twitter, 12/17/18

"I hope the people over at the Fed will read today's Wall Street Journal editorial before they make yet another mistake. Also, don't let the market become any more illiquid than it already is. Stop with the 50Bs. Feel the market, don't just go by meaningless numbers. Good luck!" – Donald Trump, via Twitter, 12/18/18

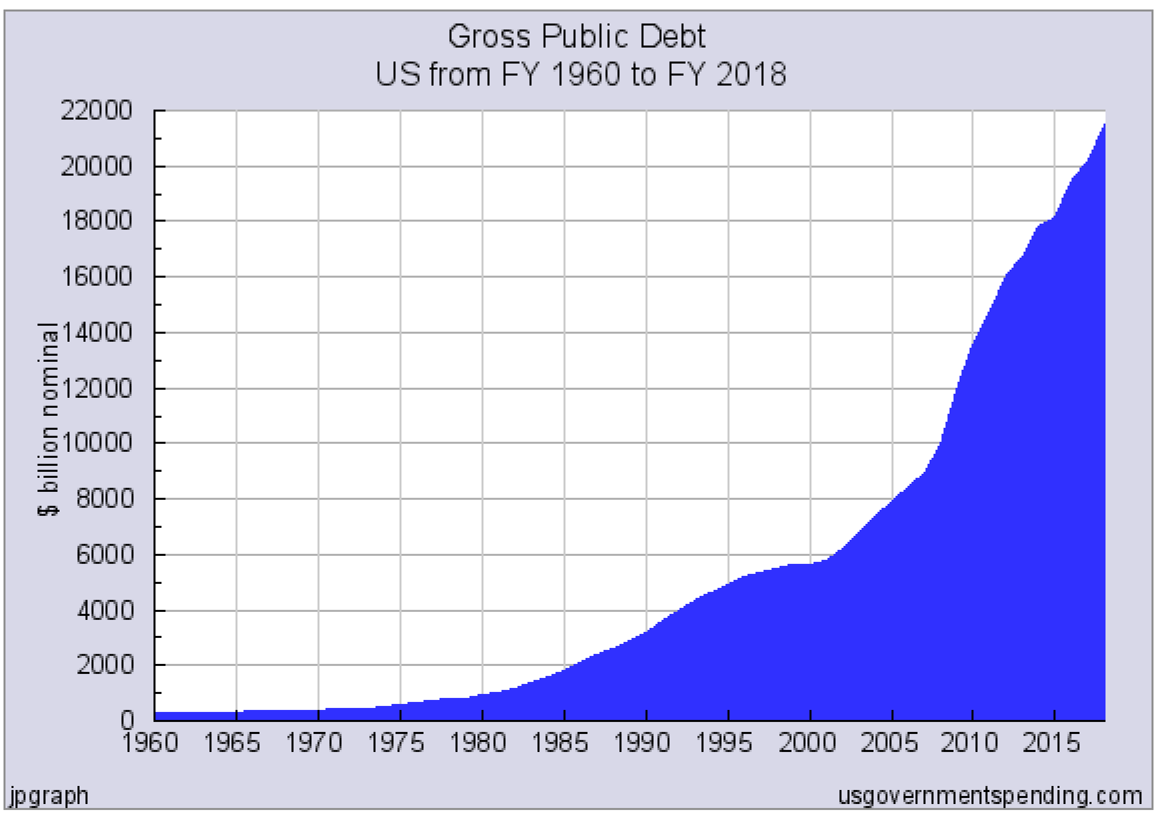
Did Jay Powell really have a choice as to what they were going to do? In the face of such full-throated and open criticism of the Fed, and clearly stating his preferences regarding their choices regarding both interest rates and management of their balance sheet, was it even remotely conceivable that they could cave to the president and materially change direction? Probably not, because as I said, everyone would then plainly see that the central bank had been co-opted by politicians, and the jig would really be up.

As expected, the Fed raised interest rates by another quarter point on December 19th. Up to this point, they had avoided elaborating too much on their plans to continue to shrink their balance sheet ("quantitative tightening") – but there is little doubt that investors were beginning to get concerned that this "50Bs" policy was starting to have a real effect on credit conditions and asset prices. And it wasn't just stocks, as can be seen in the previous chart. Look at what was happening to the prices of two popular ETFs which invest in corporate debt (HYG – high yield or "junk" bonds, and SRLN – senior or "floating rate" loans):

You can see the ultimate wave of selling pressure hit the markets after Jay Powell decided to wade into the topic of the balance sheet and their stated plan to continue to shrink it by up to $50B per month in his press conference following their decision on interest rates:

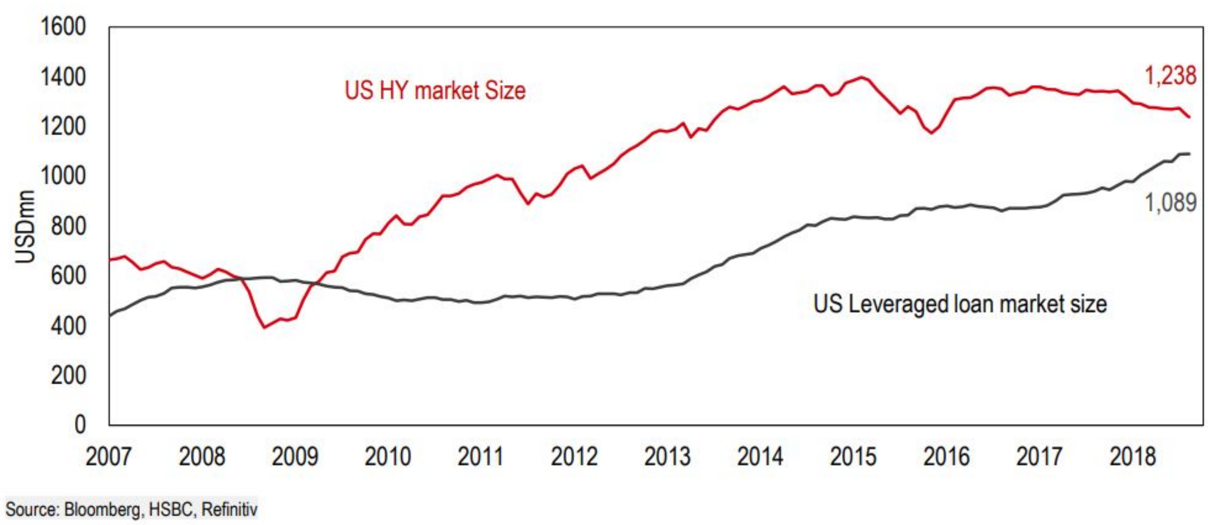
"I think that the runoff of the balance sheet has been smooth and served it's purpose. I don't see us changing that……we don't see the balance sheet runoffs as creating significant problems." – Jay Powell, 12/19/18

Obviously, investors saw this quite differently, and the bottom fell out. Maybe on account of this, and wondering where all this money was going to come from if not the Fed:

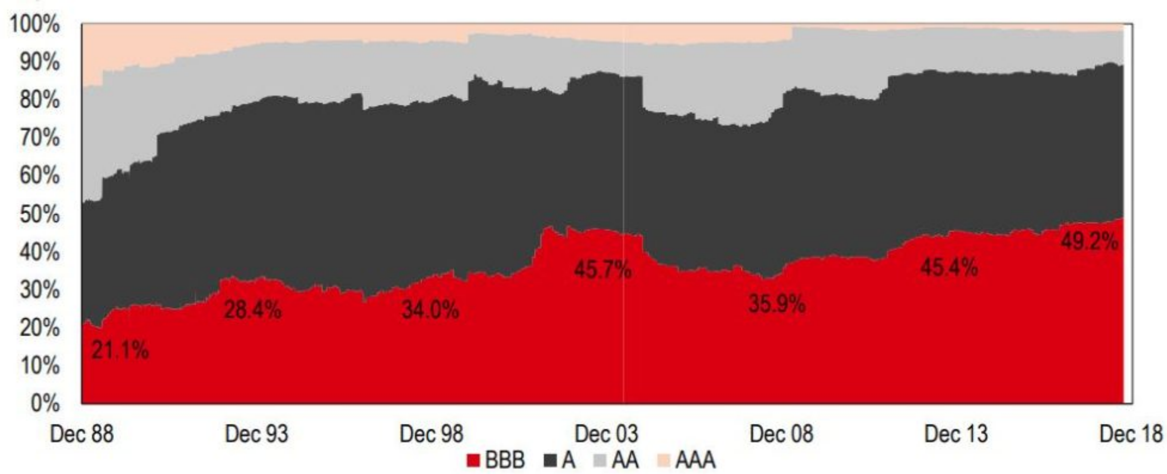


And let's not forget the borrowing binge corporations have been on (this is a global phenomenon, not just limited to the USA):

This includes impressive growth in riskier high yield bonds and leveraged loans:

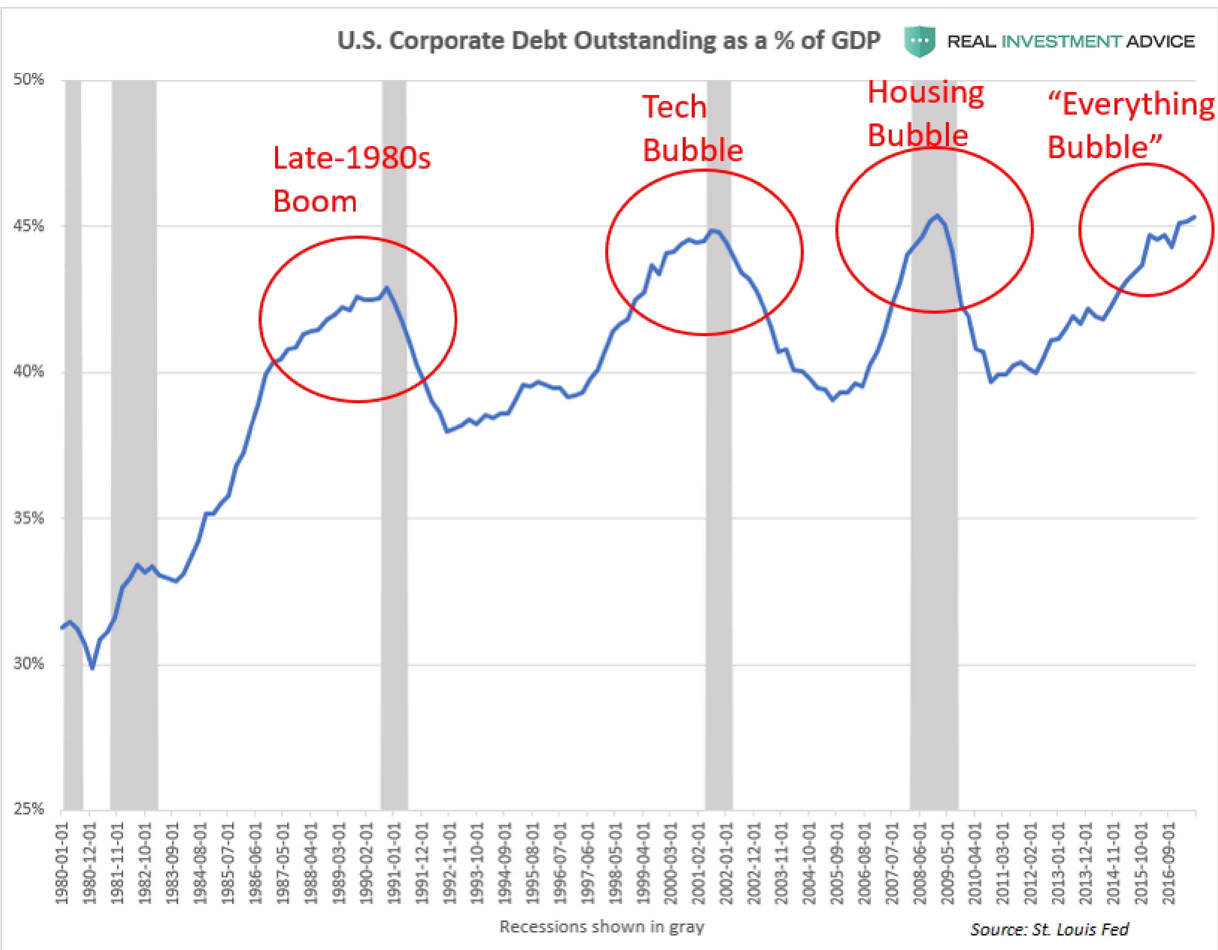


Meanwhile, the quality of so-called "investment grade bonds" has never looked worse:



Source: Bloomberg, HSBC. All USD IG index constituents, including financial and nonfinancial companies

Put it all together and take a longer-term view, and this is what you have:



The two clearest messages from that chart are this:

1. Dating back to the Greenspan era, the Federal Reserve has enabled a series of financial bubbles which have burst and led to recessions every 7-10 years.
2. With US corporate debt back over 45% of GDP, we are in a zone which has always led to immediate, major problems in the past.

Many investors have come to realize (correctly in my view) that this debt binge we have been on, which has led to more than $250 trillion in debt worldwide (up from "only" $170T in 2009), made possible by quantitative easing and all of the other highly experimental policies from the major central banks of the world, has left us with no good options. Either we allow interest rates to find their own natural level, which would risk driving the whole world into bankruptcy, or we continue to artificially suppress them by any means possible, and hope for the best.

Jay Powell's statement on the Fed's balance sheet, "*I don't see us changing that……we don't see the balance sheet runoffs as creating significant problems,"* allowed people to think, momentarily, that they may actually give the first option a try. For a few days at least.

The markets continued to tank. Oops! Better send John Williams, Head of the NY Fed, (who arguably started the December bloodletting with his statement about continuing to raise interest rates on December 4th) over to CNBC for an interview!

"What we're going to be doing going into next year is reassessing our views on the economy, listening to not only markets but everybody that we talk to, looking at all the data and being ready to reassess and reevaluate our views." – John Williams, interview with Steve Liesman, CNBC, 12/21/18

Listening to markets and reassessing our views – that sounds a little better, right? And quite a turnaround in only 17 days too! But the real damage would not stop until the day after Christmas, when Kevin Hassett was talking to reporters and fielded a question about the president's ongoing criticism of Jay Powell and the Fed:

"The president has voiced policy differences with Jay Powell, but Jay Powell's job is 100% safe. The president has no intention of firing Jay Powell" – Kevin Hassett, 12/26/18

So, there you have it. The Fed is truly independent from political influence. They said so themselves! Let's not bicker and argue about the role they have played in enabling this massive buildup of liabilities! For those of you who might be worried that they have played a starring role in all of this, and a primary reason we are in this mess, including $22T of US Government Debt outstanding, is on account of their "accommodation" – don't worry! Buy stocks! Don't you know the floor is in because now Mr. Powell is free to "turn dovish" and he is **not** being influenced by politicians when he does that! And if stocks ever sell off again like they did in December, he's got your back! Just like Janet Yellen and Ben Bernanke did! And Alan Greenspan before that!

Party on, Garth.

On the first Friday of the new year, Jay Powell found himself on a stage in Atlanta with his two predecessors, Janet Yellen and Ben Bernanke, for a roundtable discussion and took the opportunity to find his new voice now that he was apparently free of political influence:

*"With the muted inflation readings that we've seen coming in, **we will be patient** as we watch to see how the economy evolves.…**We're always prepared to shift the stance of policy and to shift it significantly if necessary.**" – Jay Powell, speaking at the American Economic Association annual meeting, 1/4/19*

The following week, when it was time to release the minutes from the Fed meeting in December, somehow, the message had seemingly been managed in light of the intervening events. If you recall, at that meeting, they decided to raise interest rates, and effectively stated that the plan to burn up to $50B per month and send it back to from where it came, was on "autopilot."

The minutes from that meeting of December 18-19, released on January 9th, read in part:

*"Many participants expressed the view that, especially **in an environment of muted inflation pressures, the committee could afford to be patient about further policy firming**."*

What. The. Hell? Was there any mention of "**patience**" at the press conference in December, when the markets were getting crushed? I can assure you there was not.

Just in case the message was not crystal clear, Mr. Powell took the opportunity to amplify and clarify his new perspective for those who hadn't heard the massaged message from the minutes clearly enough the very next day. Finding himself on another stage, this time at the Economic Club of Washington, he was being interviewed by David Rubenstein, co-founder of The Carlyle Group:

*"Especially with **inflation low and under control** we have the ability **to be patient** and **watch patiently** and carefully as we figure out which of these two narratives is going to be the story of 2019" – Jay Powell, 1/10/19*

Maybe next time he finds himself on a stage he should just grab the nearest microphone and channel his inner Axl Rose and go full karaoke:

Said woman take it slow, and it'll work itself out fine
All we need is just a little patience
Said sugar make it slow and we'll come together fine
All we need is just a little patience

The messages are equally clear, and the reposts of the video clip to social media will get the attention of a lot more people to boot!

Following their next meeting on January 29-30, where they were not expected to change their policy rate (they did not), he used the opportunity of the post-meeting press conference to re-open the possibility of not only stopping the roll off of $50B per month from the balance sheet, but to actually crank up the printing presses (or their digital equivalents) yet again in the near future should they deem that necessary:

*"The committee would be prepared to use its full range of tools, **including altering the size and composition of its balance sheet**, if future economic conditions were to warrant a more accommodative policy than can be achieved solely by reducing the federal funds rate." – Jay Powell, 1/30/19*

Let there be no doubt. In the space less than four months, we have witnessed a complete reversal in policy out of the Federal Reserve. The punchbowl has been refilled, for now. The biggest lesson in this is that, unfortunately, markets are far more immediately influenced by the thoughts and words of a few important people in a few important cities than economic fundamentals. And there is little doubt that we will continue to live in a world of massive distortions for the foreseeable future. Look at the yields on 10-year government bonds around the world (Japan – negative 0.01%, Germany – 0.15%, Italy – 2.59%) and ask yourself if that prospective return in any way compensates you for the risks you are taking by lending to those governments until 2029. While we're at it, what does it say that against this backdrop of free money and trillion-dollar annual deficits as far as the eye can see, the 30-year US Treasury still only pays you 3%? Are you kidding me?

So where does all of this leave us? The bearish case can best be summed up by the chart of US corporate debt, which is just one relatively small piece of the global debt picture, but an important one, especially for US investors. And remember, all of the shares of stock held by investors stand in line behind that debt in the capital structure. This is critical to remember for at some point, we will run into real economic trouble. If future economic weakness leads to a series of credit downgrades and defaults, the stockholders of those companies will likely be wiped out. And clearly, every time US corporate debt has exceeded 45% of GDP, a crisis followed. Why would it be different this time?

On the other hand, if one were inclined to see this pivot from the Fed for what it is – an attempt to reassure investors that they stand ready to accommodate with all of the tools available to them – that's a pretty powerful argument against getting too bearish on risk assets. The trick will be to find the appropriate balance between these two conflicting arguments and invest accordingly. And if one were inclined to take on more risk this late in the credit and economic cycle, then the investment implications of this Fed pivot seem pretty clear, so here is where I will be looking to add exposure to client portfolios in the near future, where appropriate:

- Weaker dollar, which should help:
    - Gold, silver and oil
    - High-quality US multinationals with a lot of overseas revenue
    - International stocks, including and especially:
        - Emerging markets, since they tend to have a lot of dollar-denominated debt

Meet the new boss

Same as the old boss

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Here Come Higher Interest Rates

by **dmckee03** February 20, 2018 10:40 am Comments Off **Uncategorized**

After years of artificially low interest rates, the world is finally waking up to the very real possibility that interest rates are beginning to return to their natural levels (higher). It is difficult to overstate the significance of this in terms of its investment implications and potential effects on the global economy.

In the wake of the financial crisis of 2008-2009, the world's central banks, led by the Federal Reserve Bank of the United States (The Fed), embarked on what was then considered a highly experimental monetary policy which quickly became known as "quantitative easing" (QE). At its core, QE is nothing more than creating money out of thin air, usually on a computer at the central bank, and using those funds to purchase securities in the open market. This is done at essentially zero marginal cost to the bank (it's just ones and zeros on a computer after all), but it has the immediate effect of creating significant demand for the securities being purchased by the central bank and being added to their newly-expanded balance sheet.

Whatever securities they choose to buy are getting a bid and will trade at a higher price than would be the case if they were not in that market. This is simple supply and demand. When they buy government bonds and mortgages, as was the case with The Fed, it raises the price of those bonds and by definition lowers interest rates, as the borrowers or issuers of the bonds reap the rewards of the generosity of the non-natural buyer. The European Central Bank followed suit and expanded their buying program to include corporate bonds, which has had the perverse effect of allowing European corporations with non-investment grade (junk) ratings to issue debt at lower interest rates than the U.S. Government. Japan and Switzerland decided to include equities in their programs, and consequently are now some of the biggest shareholders of both the Japanese stock market and American mega-cap corporations, such as Apple and Microsoft, respectively.

As an aside, how do you think most people would react if our own central bank started buying shares of these companies directly? But I digress….

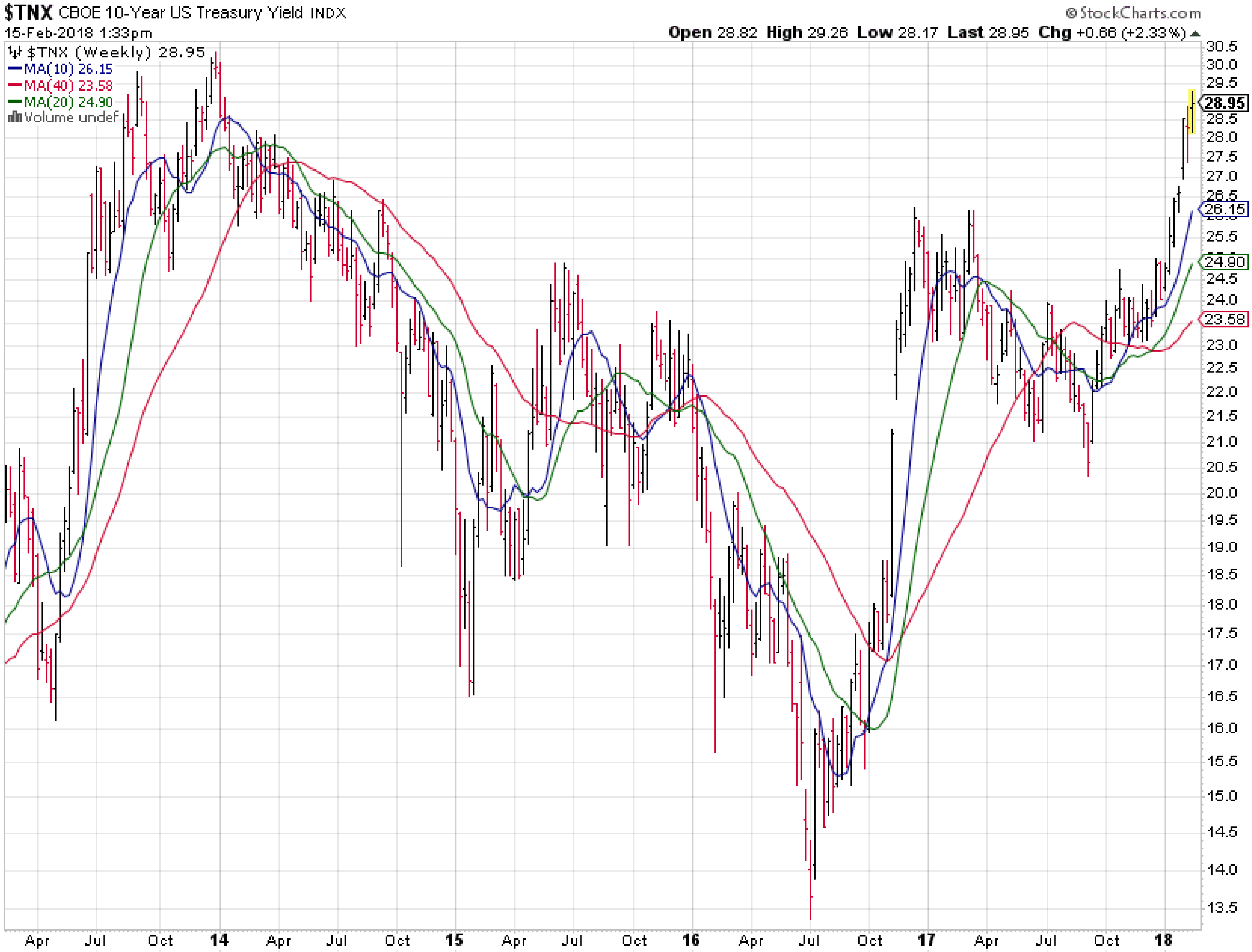
Here is another interesting facet to these shenanigans. Guess what The Fed is required to do with the interest it earns on all of these bonds it buys? Remit it back to the U.S. Treasury! That's right. The U.S. Government has been able to partially finance itself on an interest-free basis through the QE program at the Fed because whatever interest it pays on the debt it issues and ends up on The Fed's balance sheet comes right back to the U.S. Treasury. Pretty slick, huh?

Prior to this worldwide experiment which saw the major central bank balance sheets (US, Europe, Japan and China) swell from about $7 trillion to $20 trillion, most observers believed that this was banana-republic type of behavior. After all, you can't just print money and monetize the debt in such a brazen fashion forever before everyone realizes that the value of the currency equals its marginal cost of production (zero). This is what happened in Weimar Germany after World War I and Zimbabwe more recently.

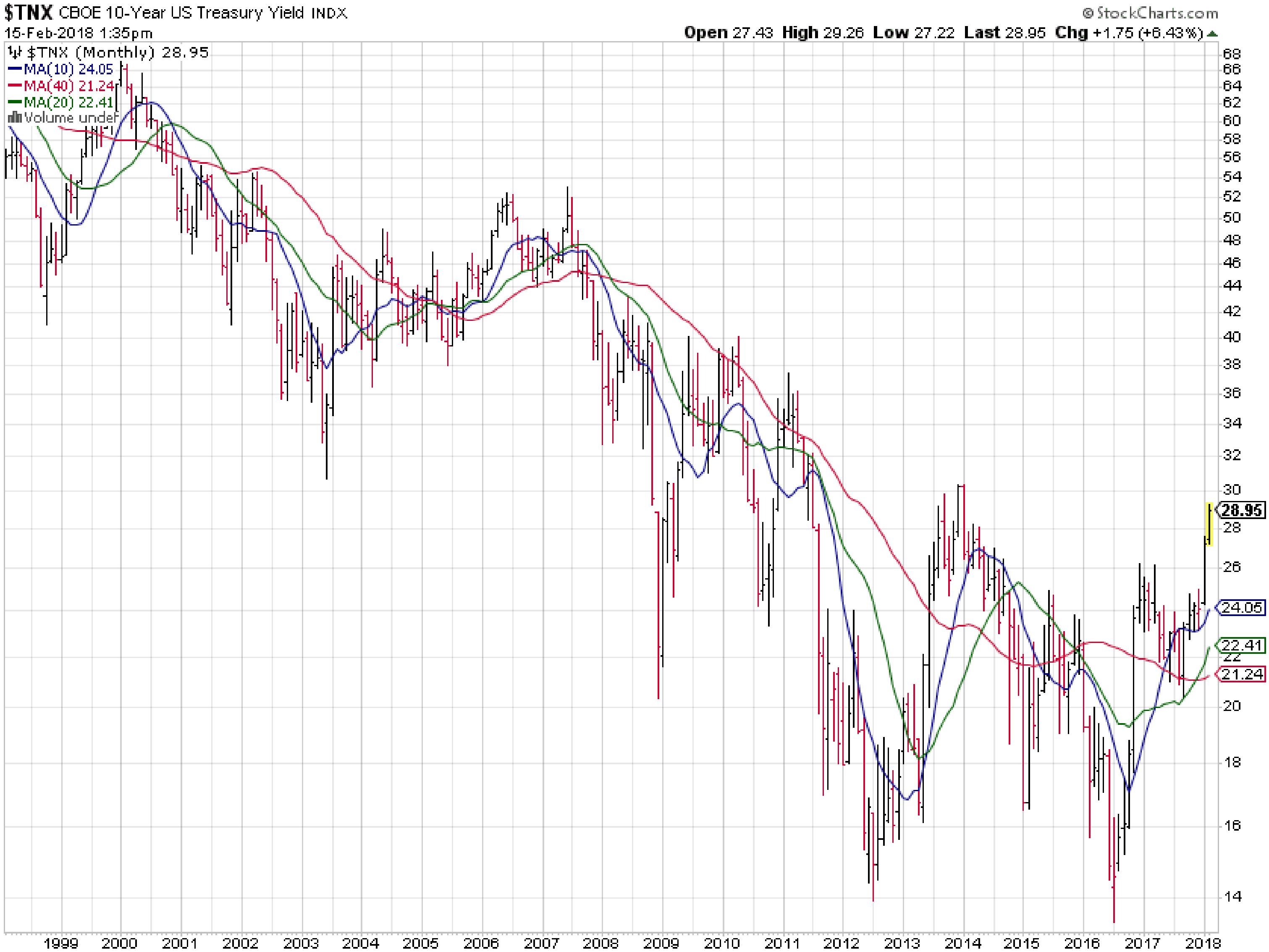
At the turn of the century The Fed owned about $500 billion of bonds. When the crisis hit in 2008, it was around $900 billion. After three rounds of QE, it has swollen to nearly $4.5 trillion, and it still sits pretty close to that number today at $4.4T. And they were not alone – they were joined by Europe, Japan, England, Switzerland, Canada, and China, among others. Few people believe that the central bank should hold so many bonds. After all, we got along fairly well for a long time before it grew by a factor of roughly 5x in the span of six years. So now it has come time to try and unwind all of this. The only way to do this is to reverse the whole process and allow the bonds to mature and not make the proceeds available to purchase more debt. This "rolling-off" has the exact opposite effect of QE, by decreasing demand for bonds, thereby increasing interest rates, all else being equal.

Prior to Janet Yellen's retirement as Chair of the Federal Reserve, she was careful to lay out a plan for this unwinding of the balance sheet, and announced it to the world. The process started in Q4 2017, whereby they started allowing $10 billion per month ($6 billion of Treasuries and $4 billion of mortgage-backed securities) to mature and not be reinvested into new debt. The plan is to allow that number increase by $10 billion per quarter, keeping the proportion constant, until 4Q 2018, by which time they will be allowing $30 billion of Treasuries and $20 billion of mortgages, or *$50 billion in total per month* to disappear back into the monetary ether from which it came.

$600 billion per year is a lot of money. That is $600 billion per year that the issuers of these bonds are going to need to find new buyers for, since the central banks are in the process of stepping back. Of course these facts are well known amongst institutional investors, but it seems that the reality is finally beginning to set in. Look at these charts of the yield on a benchmark 10-year treasury bond:



And a 20-year perspective:



It has been over four years since this bond traded at a yield in excess of 3%, and has been seven years since it saw 3.05%. Just a little bit higher from where we are today and we will start seeing headlines proclaiming these facts. I think that will really start to get people's attention.

Any change which has the effect of either increasing available supply of debt or diminishing demand will cause interest rates to move higher. Consider:

- The U.S. recently passed the most sweeping tax reform in 31 years, and the most sweeping corporate tax reform in over 50 years. Regardless of where you stand on the longer-term supply-side benefits of these tax cuts, most would acknowledge that they are going to have the immediate effect of reducing revenue to the Treasury.
- Congress recently punted the budget issue, again, by passing another Continuing Resolution which will add another $200 billion annually to baseline Federal spending ($2 trillion over the next decade).
- Consequently, the projected budget deficit over the next few years has swollen to more than $1 trillion annually.

And this is during a time when the economy is supposedly going gangbusters! What do we think is going to happen to the deficit when we go into a recession? The longest economic expansion ever recorded was 10 years, ending in the wake of the dot com bubble in March 2001. The current expansion will reach its 10th birthday in June of next year. Do we really want to bet the farm that things that have never happened before are likely to happen? That is what the budget numbers, which don't even come close to balancing over the next decade, are assuming.

So to sum up the interest rate picture, it appears that the path of least resistance is higher, and potentially much higher, on account of both increased supply of bonds (budget deficits, and refinancing needs of both government and corporations over the next several years) and diminishing demand (central banks stepping back, other buyers becoming more concerned about inflation and demanding higher rates to compensate them for the increased risk of holding longer-term bonds).

What are the investment implications? Some seem pretty obvious.

Avoid:

- Intermediate and long-term bonds
- Income-oriented, slow-growth equities, such as utilities, REITs, MLPs and consumer staples
- Low-quality balance sheets which are facing refinancing needs at higher rates

Embrace:

- High-quality, cash-rich balance sheets with lower financing needs
- Assets which would benefit from higher rates, inflation, or both, such as financials, resources and related stocks, and commodities, including gold.

It is not a foregone conclusion that stocks will suffer immediately in this environment. It is important to remember that there is a lot of money sloshing around in the world looking for an investment home. If bonds look ugly, stocks could benefit by comparison, at least for a while. And at least for now, both Japan and Europe are still expanding their central bank's balance sheets. As I see it, the stock market is currently engaged in a tug-of-war, with both sides of the battle armed with significant forces at their disposal.

On the one hand, the economy is growing at a healthy pace right now. That fact, combined with the boost in corporate profits anticipated from the recently-passed corporate tax cuts, have analysts quite optimistic about the prospects for corporate earnings growth over the next several years. According to the excellent work of Howard Silverblatt at Standard & Poors, GAAP earnings for the S&P 500 companies for calendar year 2017 should come in around $110 per share. However, earnings for the current year are estimated at over $145 per share, representing growth of over 30% year-over-year. In reality, forward-looking estimates tend to be overly optimistic, sometimes blatantly so, but let's suppose that we get 20% earnings growth, which is not at all unrealistic given a strong economy and the benefit of a reduced tax burden. That would put 2018 GAAP earnings for the S&P 500 at around $132 per share.

If investors are still willing to pay 25x earnings to own the S&P, as they are today, then that works out to a value on the S&P 500 Index of (132*25)=3300. The index is trading around 2720 as I write this. On the other hand, if we get some compression on that multiple, which would be expected in a high-rate environment, the picture changes significantly. In a "normal" environment, most of the time, investors have paid between 14 and 20 times earnings to own "the market." This makes sense when you consider that 1/20 equals 5 percent and 1/14 is about 7 percent – in other words, investors have historically demanded an earnings yield of 5-7 percent to compensate them for the risks of owning stocks instead of, say, guaranteed instruments like Treasuries and insured bank deposits. Today they are only demanding a 4 percent earnings yield, but I believe that will go away as interest rates continue to rise (the earnings yield will rise as well).

At the upper end of this range, 20x earnings, you get a value on the S&P 500 of (132*20)=2640. Essentially, no return after factoring in dividends.

If on the other hand, people start to doubt the earnings-growth story, maybe on account of higher interest rates and the effect that will have on consumer demand, or the cost of refinancing corporate debt at higher rates, then all bets are off. You could easily end up a year or two from now where earnings are coming in at or below where they are today, and investors are paying a much lower multiple for those earnings. For example, (100*14)=1400, or a loss of nearly 50 percent from here.

I am not making this prediction at this point, just pointing out the possibility. If we did suffer a loss of 50% on the S&P 500, it would mark the third such episode since the turn of the century, so it is hardly without precedent. Given that the global debt bubble has swelled to $233 trillion as of the end of 2017, you have to believe that higher interest rates are going to hurt – governments, corporations, individuals with car loans, student loans and credit cards – a lot. It's simple math.

What could change the trajectory of interest rates? Here are three possibilities:

- The other central banks, especially Japan, China and Europe, continue to print money, helping offset the effects of a shrinking balance sheet at the Fed
- The new Chair of the Fed, Jerome Powell, senses the danger or weakness coming and changes course
- Worries about the economy take hold and make investment-grade bonds, which may well be offering much higher yields in the near future, attractive again, stimulating demand of them and helping put a cap on rising rates

Stay tuned!

US government bonds and treasury bills are guaranteed by the US government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. US government bonds are issued and guaranteed as to the timely payment of principal and interest by the federal government. There is an inverse relationship between interest rate movements and bond prices. Generally, when interest *rates rise, bond prices fall and when interest rates fall, bond prices rise. The S&P 500 is an unmanaged index of 500 widely held stocks. It is not possible to invest directly in an index. Views expressed are not necessarily those of Raymond James & Associates and are subject to change without notice. Information contained herein was received from sources believed to be reliable, but accuracy is not guaranteed. Information provided is general in nature, and is not a complete statement of all information necessary for making an investment decision, and is not a recommendation or a solicitation to buy or sell any security. Past performance is not indicative of future results. There is no assurance these trends will continue or that forecasts mentioned will occur. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success. Raymond James Financial Services is not affiliated with Janet Yellen, Howard Silverblatt or Standard & Poors. Not approved for rollover solicitations.*

The Matrix Revisited

by **dmckee03** October 26, 2017 6:56 pm Comments Off **Uncategorized**

In individuals, insanity is rare; but in groups, parties, nations and epochs, it is the rule.

– Friedrich Nietzsche

In my last blog post I laid out a fairly simple system we use to evaluate opportunity in the market and help guide our investment process for our clients. If you did not see it, I would encourage you to review it at **https://planaccordingly.com/the-matrix/**

Today I want to focus on where we find ourselves at this point in time within this paradigm and make a prediction as to where we might go next.

First, with respect to valuation – we find ourselves in the most expensive decile observed over time. Just to highlight some of the metrics we look at to evaluate this:

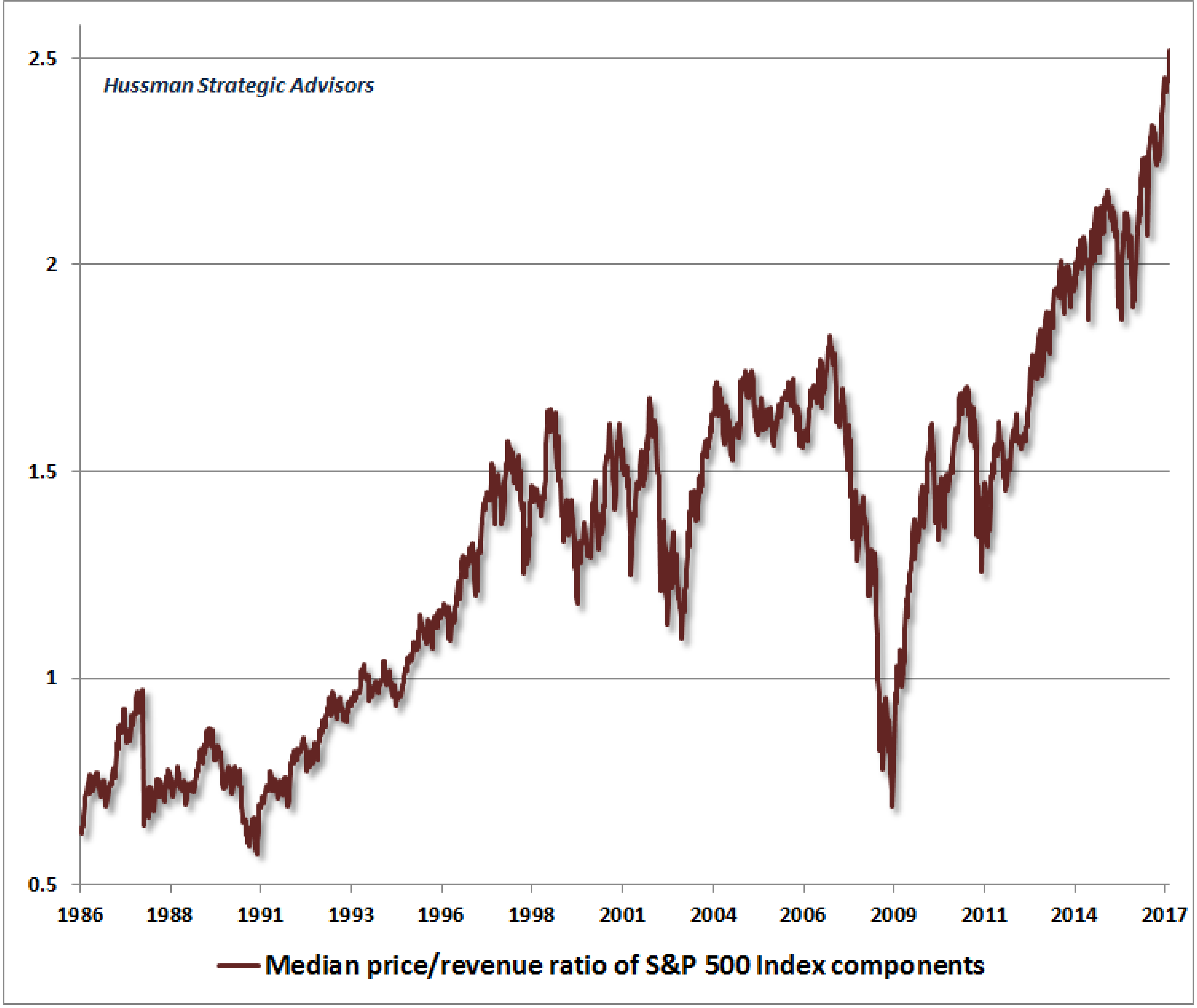
Price to Earnings Ratio: The last complete quarter for which we have reported earnings on the S&P 500 is 2Q2017, and the final calculation came in at $104.02. As I write this, approximately one-quarter of the S&P 500 companies have reported for 3Q2017 and the official estimate from S&P Dow Jones is $106.96. There is obviously a little uncertainty around what the final number will be when reporting season wraps up, but let's agree that at present the S&P earnings are around $107 per share. As an aside, this will finally get us back to and slightly surpass the previous high in per-share earnings of $105.96 observed in 3Q2014 (3 years ago!).

Today, October 24, 2017, the S&P 500 closed at 2569.13. When you divide the index value into the earnings figure (2569.13/107), you get a price-to-earnings multiple of 24x. To put this into context, you are paying $24 for every dollar of earnings this basket of companies, weighted by market value, is generating at present. Is this a good deal?

Well, 1/24 equals an earnings yield of 4.17%. Does that sound reasonable? Maybe it does against a 10-year treasury yield of 2.4%, but historically it lands in the most expensive decile.

Price to Sales Ratio: These two charts speak for themselves. The first is the price-to-sales ratio for the index overall, weighted by index components (market capitalization) (Source: multpl.com):

The second looks at the median price-to-sales ratio among the 500 components of the index. In other words, if we were to look at all 500 companies and rank them on this one statistic, where would we find the middle observation, where half of the companies are more expensive on this one measure of value and the other half are less?:

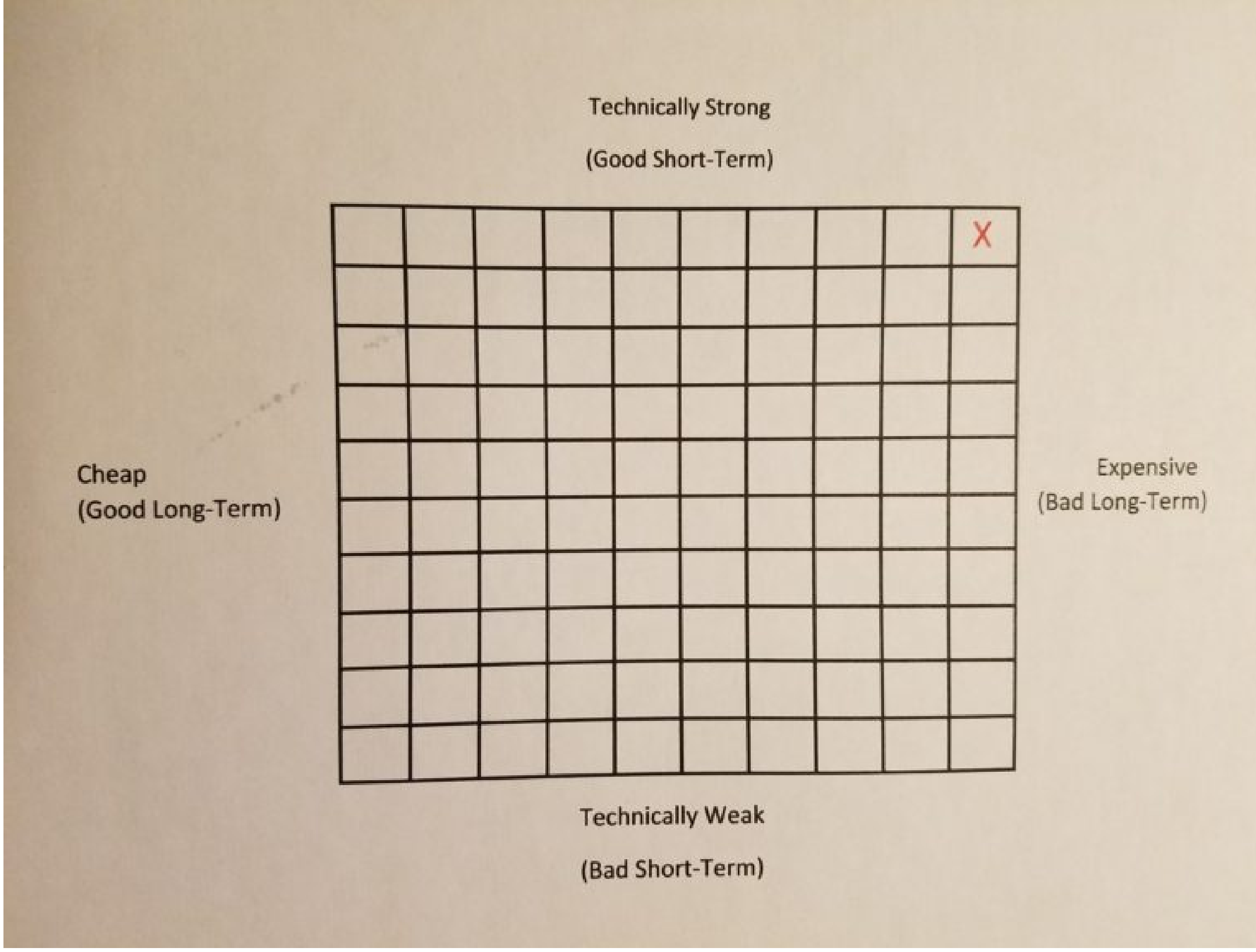


Gets your attention, doesn't it?

Any time you observe a statistic such as this one at an extreme reading, in this case easily an all-time-high, you have to stand up and take notice. This is especially true given that this particular statistic has a long history of reverting back to its long-term average observation of approximately 1.5x.

So, we know that within The Matrix, we currently find ourselves in the furthest column to the right, which implies disappointing returns over the next 10-12 years for buy-and-hold investors in strategies which closely mimic the S&P 500 index.

What about the y-axis? Well, that is the good news. On all ten of our questions surveying technical strength in the S&P 500 index, the answer is "yes." Visually, this puts us here:



So, for the time being, we are moderately aggressive in holding equities for our clients. Despite the fact that the market looks very expensive on a historical basis, virtually every segment of it appears to be firmly in an uptrend. “Party on, Garth!”

I suspect that the next destination in the Matrix will be the dreaded Southeast quadrant, where both long-term and short-term prospects will look disappointing. It seems very unlikely that we will witness enough improvement in the fundamentals (growth in both sales and profits among the S&P 500 companies) to correct the overvalued observations without having a bear market in the process. The only way this would be possible would be for the collective top and bottom lines to grow faster than the index over the next several years, without experiencing any technical weakness over the intervening period. Anything is possible, but such an outcome seems like a very remote possibility to me.

In summary, I have a lot of respect for the current strength of the market, especially given the broad-based nature of it, and fully recognize that it may continue for a while longer and extend these valuation metrics even further than one would think possible.

Keep in mind that Nietzsche quote. We remain vigilant for signs of changing trends.

All investing involves risk and you may incur a profit or a loss. There is no assurance that any investment strategy will be successful. Keep in mind that individuals cannot invest directly in any index. The foregoing

The Matrix

by **dmckee03** October 12, 2017 1:36 pm Comments Off **Uncategorized**

Over time, investors have developed hundreds if not thousands of systems to use as guides in trying to answer the two most basic questions of portfolio construction – what to own, and when to own it. Some of these are rather complex or downright arcane, while others are so simple they can almost seem silly. In 23 years in this business, I have come across many systems which seem like they have worked at various times, and may even be worthwhile to try and implement, but more often than not, it is easy to come up with reasons to pass because the case is either not compelling enough or there are practical limitations to implementation, such as trading costs or scalability.

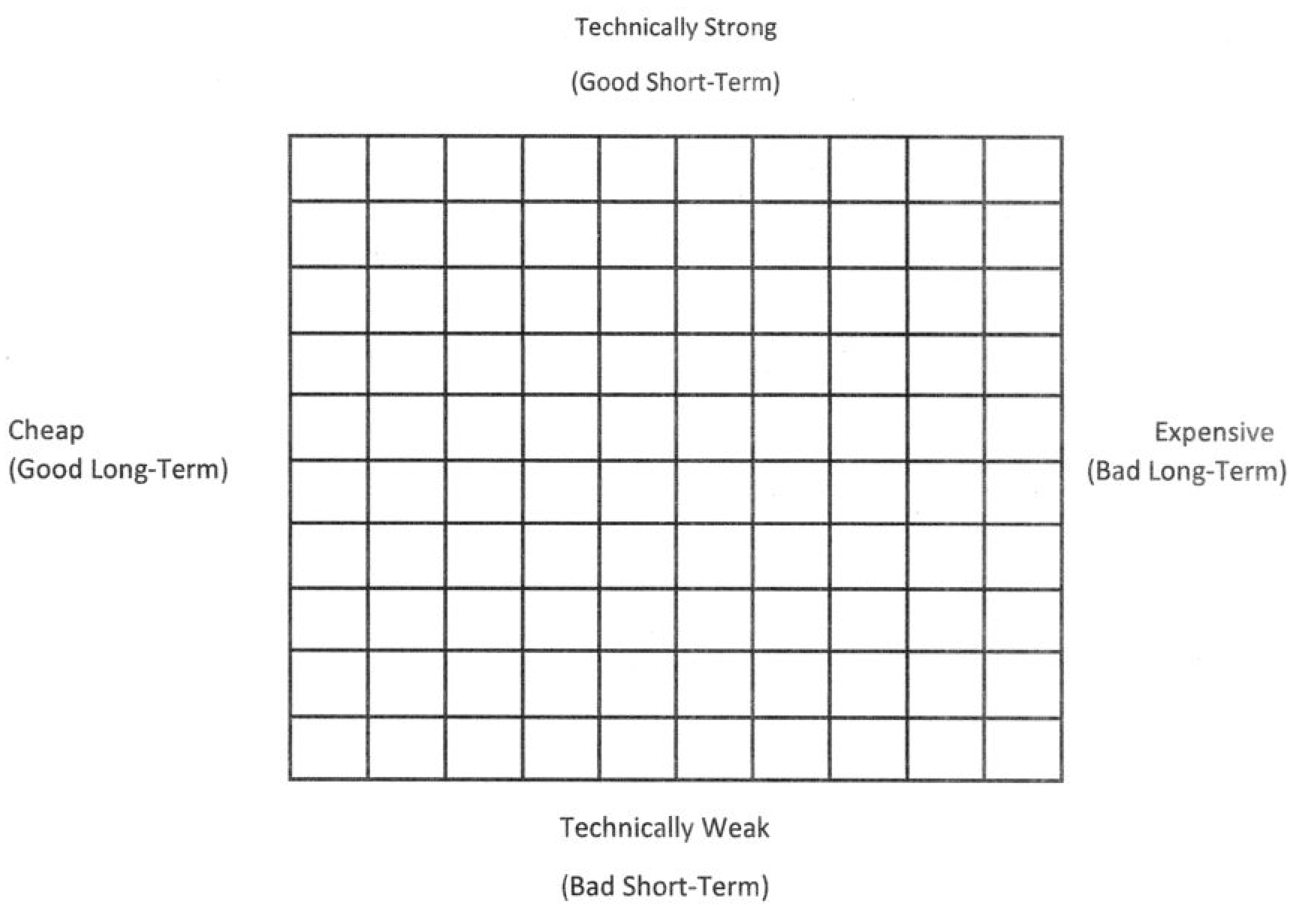
There are two basic principles, however, which for me have cut through the clutter and have left an enduring impression on me. And I would argue that both are fairly uncontroversial in the world of investing.

The first is that you want to try and buy things when they are cheap and avoid them when they are not. Pretty obvious in principle, but deceptively hard to follow in practice for many investors.

The second is captured in the saying "the trend is your friend." Specifically, for whatever reasons it may be in place, once a trend is established, it is more likely to continue into the near future than not. Of course that will not always be true, but in this business it is about stacking the odds in your favor, and logic would dictate that you want to own things while they are in an uptrend, price-wise, and avoid then when they are not. Again, kind of a no-brainer. If there are many (a majority of) components and sectors of a market in uptrends, we can call this "technically strong."

We can look at these two simple principles in conjunction with one another to provide us with a sensible way to evaluate risk and make portfolio management decisions in a logical and dispassionate manner.

The Matrix is a tool I use to visually evaluate the present risk and reward relationship in the US stock market. It is presented below:



It is a simple 10-by-10 grid, where the horizontal or x-axis is valuation, and the vertical or y-axis is technical strength. I will describe how we evaluate the market along these two variables and apply the observation to our approach to investing in stocks.

The Standard and Poor's 500 Index (S&P 500) generally consists of the 500 largest publicly-traded companies in the US. The actual number of components will vary slightly around this number on account of mergers and reorganizations but will always be pretty close to 500 – and while there are actually 7x that number of publicly-traded companies in America, the top 500 typically comprise more than 80 percent of the total value of US stocks at any point in time. As such, looking at what is going on with these 500 stocks is a good place to start.

It is also important to understand that the S&P 500 (and the Russell and MSCI indices for that matter) are all market-cap weighted. The practical consequence of this is that large companies, based on market value, have an outsized influence on the index. For example, as I write this, Apple Inc. comprises 3.66% of the S&P 500 Index. If all of the stocks in the index were weighted equally, that would be 0.20% each. At 3.66%, Apple has more than 18x the influence on the index that Micron Technology, which at #120, does carry a 0.20% weight. This implies that approximately 380 companies in the index each have even less influence than that. The point here is that these cap-weighted indices tend to be more than a little "top-heavy" and it can be very helpful to look beyond the changes in the index value itself to try and figure out what is really going on.

Although the S&P 500 has origins back to the 1920's, it was expanded to 500 holdings in 1957, so we have data on this measure of US equities going back 60 years we can look at.

In terms of valuation, we look at four measures, and compare them to past observations. By developing a composite of these four numbers we make sure that we are not placing too much emphasis on any one of them:

- Price-to-Earnings Ratio for the Index, as weighted by market-cap
- Median Price-to-Earnings Ratio of the index components
- Price-to-Sales Ratio for the Index, as weighted by market-cap
- Median Price-to-Sales Ratio of the index components

After evaluating all four and comparing them to their histories, we can place the market into "decile" along the cheap/expensive axis. If the market is "cheap", meaning that a composite of these statistics produced lower than average values, historically-speaking, then it would be in a lower decile and placed somewhere on the left hand side of The Matrix. If it is "expensive" (higher than average values) then it would land in a high decile on the right-hand side.

It should be said at this juncture that merely determining the market is cheap compared to its own history is a very poor timing tool. Just because something is cheap, that doesn't mean that it can't, or won't become a lot cheaper before the overall trend reverses. Likewise, an expensive market can get a whole lot more expensive. As John Maynard Keynes once quipped, "The markets can remain irrational a lot longer than you can remain solvent." In fact, the frustration which this tries to express has been a hallmark of human nature for centuries. Isaac Newton lost a whole lot of money in the South Sea Bubble of 1720. In the wake of this, he famously said "I can calculate the motion of heavenly bodies but not the madness of people."

That is the bad news. In the short run, markets can do just about anything, no matter how disconnected from reality or what a prudent investor might consider reasonable in term of providing a fair trade-off between risks and anticipated returns informed by economic principles and history.

The good news is that, in fact, these valuation metrics have a long history of reverting to their respective means, and as such, are very valuable in terms of evaluating prospective returns over a longer time frame, such as 10 years or longer. I have seen valuation models using various measures of these two metrics (price-to-sales and price-to-earnings) which have better than a 90% coefficient of correlation to *future* 12-year returns. If we are trying to invest for something a decade or more into the future (virtually everyone), then failing to take full account of this data and the predictive value of it is extremely foolish. This is why the horizontal axis of The Matrix is labeled "Cheap (Good Long-Term)" and "Expensive (Bad Long-Term)" By "Long-Term" we are talking 10-12 years or more.

So, how does the vertical axis (Technical Strength) fit into this? It informs us as to what we should anticipate, or at least the most likely outcome, over the shorter run.

The methodology here is similar, except that here we are simply asking 10 yes-or-no questions about the S&P 500 Index and its components:

- Six questions about what has happened to the index value itself over the previous 50, 125 and 200 days
- Four questions which survey the 500 components and give them equal weight in the answer

The number of "yes" answers we get determines which decile the market is in from a technical perspective and where to place the market into The Matrix along the vertical axis.

Ideally, you want to see a situation where you end up in the Northwest quadrant (potentially good for both short and long-term), and if the overall market doesn't get you there, then try to find markets that do (a sector, or overseas?). Alternatively, you clearly want to avoid markets when this exercise puts you into the Southeast quadrant (technically weak and expensive).

Where are we today? I will leave that for a future post in the near future – stay tuned!

A Consolidation of Power

by **dmckee03** October 12, 2017 9:02 am Comments Off **Uncategorized**

Andrew Adams, CFA, CMT, Senior Research Associate discusses public company consolidation and its impact on investors.

October 10, 2017

Is the stock market experiencing a consolidation of power among a few of the largest companies, and if so, why?

The stock market is shrinking in terms of the number of publicly-traded companies, a fact that is both a result of, and contributing factor to, the increasing importance of a select few, large companies. Since 1996, the total number of listed stocks in the U.S. has been cut in half – from 7,322 to about 3,600 – as annual mergers and acquisitions have doubled and the average number of initial public offerings per year has dropped considerably. Meanwhile, the share of gross domestic product (GDP) generated by America's 100 biggest companies rose from about 33% in 1994 to 46% in 2013 according to *The Economist,* meaning not only are there fewer firms in total these days, but a small number of them are taking a greater piece of the pie.

The concentration at the top is, of course, primarily weighted toward the big technology companies, all of which have seen their products and services become increasingly integrated into the lives of their loyal customers. Through innovation, acquisition and the power of so-called 'network effects,' these modern-day conglomerates have built dominant, industry-controlling brands that continue to gain value as their huge user bases expand. The digital age has witnessed data evolve into the most important commodity in the world, and much of the success of these large tech companies is due to the ever-widening 'data moat' that exists between them and up-and-comers lacking that established network of billions of existing customers.

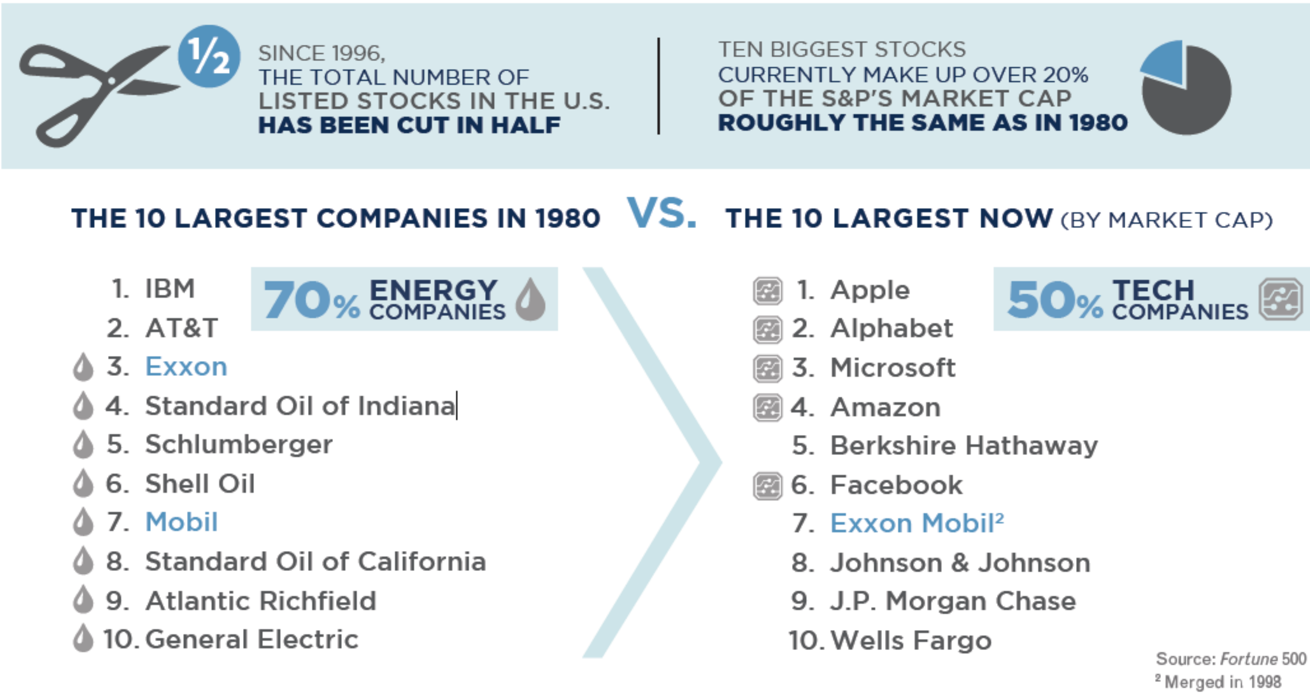
Should investors and consumers be worried about the growing importance of mega-cap companies?

Despite the growing importance of these technology companies, the impact of the ten largest stocks in the S&P 500 has not really changed much over the last 40 years, even if the specific names on that list have changed. The ten biggest stocks currently make up a shade over 20% of the index's market capitalization, which is right around the average since 1980 when the more cyclical energy sector helped the ten largest companies represent a dominating 25% of the S&P 500. Today's large tech companies also happen to be some of the most profitable, with Apple, Google, Facebook and Microsoft alone accounting for about 10% of the S&P 500's total profits. As such, technology's place at the top of the market is not unwarranted. Moreover, the roughly 23% of the S&P 500 that technology represents today is nothing compared to the 34% it comprised back in March 2000 at the peak of the dot-com bubble. Considering American corporate profits (as a percentage of GDP) are higher than they have been any time since 1929, elevated valuations in the stock market are warranted and investors don't appear overly concerned.

Consumers have also benefited in a big way, with technological innovation throughout history helping to bring down costs and prices, while making lives more convenient and requiring less manual labor. Per *The Economist,* tech companies provide Americans and Europeans with an estimated $280 billion-worth of "free" services per year, such as search results or directions. Even the stuff customers purchase provides tremendous bang for each respective buck. In their book *Abundance,* authors Peter Diamandis and Steven Kotler estimate that modern smartphones contain roughly $900,000 worth of applications based on each piece of technology's original manufacturer's suggested retail price in 2011 dollars (video conferencing, GPS, video camera, etc.), which illustrates the value being created by tech's game-changing companies. It's no wonder these disrupting forces are raking in the profits and the cash.

How are the big companies using all that cash?

The success of the mega-cap stocks has not only produced extraordinary profits, but it has also left the big tech companies with unprecedented levels of cash. As of June 2017, Apple, Alphabet, Microsoft, Amazon and Facebook together held $330 billion in cash (net of debt), and the S&P 500's corporate cash as a percentage of current assets has basically doubled since 2000. Naturally, companies have had to find effective ways to use this cash; there has been a clear uptick in dividends, share buybacks, merger & acquisitions activity, and capital expenditures over the last several years. The share buyback policies have come under some criticism since they can help artificially boost earnings and sales per share numbers. However, buying back stock has been shown to help shareholders, and that is not the only way companies have been able to grow their businesses. The five aforementioned tech firms alone spent $100 billion last year on research and development (three times more than half a decade ago). These firms are definitely investing in the future. Finally, there is an estimated $2.4 trillion in cash held by U.S. companies overseas that is just sitting there not contributing much. Should tax reform occur next year and overseas cash comes home, Raymond James estimates share buybacks and the repatriated cash could improve S&P 500 earnings by an additional 1% – 2.5%. ■



Savvy Steps to Stay Cyber-Safe

by **dmckee03** October 5, 2017 10:52 am Comments Off **Uncategorized**

Defend yourself with simple, everyday practices that can help protect your identity, your accounts and your devices.

October 3, 2017
Americans lose tens of billions of dollars each year to financial fraud. In the digital frontier, many crimes – including identity theft, tax fraud and elder abuse – are committed by online outlaws, making cybersecurity all the more important. As cybercrime becomes more prevalent, learn how to defend yourself with simple, everyday practices that can help protect your identity, your accounts and your devices.

Fighting Fraud

Familiarize yourself with common scams to help protect your assets and your identity. Often, identity thieves pretend to be someone they're not, whether they're claiming to be from a legitimate organization, acting as though they are in love or purporting to be someone you trust. The effort is an attempt to induce you to reveal personal information, such as passwords or credit card numbers. Crimes such as these fall under the umbrella of phishing, a popular fraudulent activity.

Never click on the unknown. If you receive an email from a reputable company, go directly to their website. If you receive an unexpected email from someone you know, call them before opening it. Additionally, never reveal your passwords and only use credit card numbers on sites you're confident are secure. If you have any doubt, refrain from revealing personal information.

Tax season is a notable time to take extra precaution as email compromise and mail theft tend to crop up each year and more than 237,750 tax fraud victims are reported to the IRS annually. Remember that the IRS will never request personal or financial information by email, phone, text message or social media, nor will they threaten you with lawsuits, imprisonment or other enforcement action if you have done nothing wrong. Elect to receive your tax forms online rather than in your mailbox, where they may be at risk of physical theft, and file as soon as possible to decrease the likelihood that someone will maliciously file on your behalf.

Prudent Prevention

By taking small steps toward a safer online presence, you and your loved ones will be less likely to experience a loss of personal information and privacy. There are a number of everyday practices everyone should follow.

- **Improve your passwords:** Use complex and unique passwords that are different for each account. Include numbers, capital and lowercase letters, and symbols.
- **Take it one step further:** Turn on two-step authentication for your accounts – a security process in which the user provides two means of identification rather than one.
- **Opt for biometric identification:** On top of your standard password, consider adding a photo of your face, the sound of your voice or an image of your fingerprint to your protective arsenal.
- **Keep an eye on apps:** Before you download an app, review the privacy policy and what data (such as location) the app can access.
- **Clean up your mess:** Keep your electronics free from malware and viruses. Apply updates and patches on computers and mobile devices as soon as possible, and wipe computers and mobile devices of data before selling or disposing of them.
- **Use public wireless networks with caution:** Avoid visiting sensitive websites or conducting financial transactions on an unsecure network.
- **Post prudently:** Be mindful of what you're posting to social media platforms, and avoid sharing personally identifiable information. Check privacy settings to ensure that you are not sharing your profile with people you don't know.
- **Be alert to risks online**: Never open attachments or links in suspicious emails or from senders you don't recognize.
- **Secure your information:** Keep software up to date and install an antivirus product. Shred sensitive material or store securely in a digital or physical vault.

Post-Theft Protection

The Federal Trade Commission reports that 11.7 million people are victims of identity theft each year. Should your information be compromised, these are the actions you should take.

- **Contact the Federal Trade Commission:** Call to report the issue or access the online complaint form. Visit the FTC's identity theft website for more information.
- **Report the incident:** File a police report, and retain a copy as proof.
- **Contact creditors' fraud departments:** Close affected accounts and speak with someone in the security or fraud department. Notify credit card companies and banks in writing. Follow up with a letter for affidavit as well as copies of any supporting documents. Order new debit and credit cards.
- **Alert credit bureaus:** Report the breach to one of the three major credit bureaus and ask for credit monitoring, fraud alerts, credit freezes and copies of your credit reports.
- **Keep good records:** Notify businesses and agencies by phone and in writing. Log dates, times and the names of people you spoke with as well as what they tell you. Keep copies of any correspondence, and use certified mail, return receipt requested.
- **Reset your passwords:** Consider using password manager software if needed. Experts blame weak or stolen usernames and passwords for 76% of data breaches.
- **Check for additional fraudulent activity:** Watch your monthly statements, emails and regular mail, sign into Investor Access, and call your advisor to report suspicious activity.
- **Other steps:** Contact the Social Security Administration, the Postal Inspection Service or your issuing driver's license office if your Social Security card, mail or driver's license has been stolen.

Talk to your advisor about these and other ways you can protect yourself and your accounts. Together, you can explore options like secure file sharing, fraud and consumer preference text alerts, and two-factor authentication. ■

Equifax Cybersecurity Incident

by **dmckee03** September 18, 2017 2:00 pm Comments Off **Uncategorized**

On September 7, Equifax – one of the three largest American credit agencies – **announced** a cybersecurity incident potentially impacting consumer information, including Social Security numbers, birth dates, addresses, etc., leaving them vulnerable to identity theft.

I want to make sure you're aware of available resources to ensure the protection of your personal and financial information. Please follow the steps below to determine if you or anyone in your household was impacted by this incident:

1. Go to **https://www.equifaxsecurity2017.com**
2. Click on the "Potential Impact" link, and you will be asked to provide your last name and the last six digits of your Social Security number.
3. Based on that information, you will receive a message indicating whether your personal information may have been impacted by this incident.
4. If your information has been compromised, Equifax is offering free identity theft protection and credit file monitoring to all U.S. consumers. The deadline to request your complimentary one-year monitoring is November 21, 2017. Learn more, **here**.

While Raymond James and other financial firms employ the most up-to-date safeguards to protect client account numbers and other important personal information, you play a vital role in keeping your information secure. There are many ways for you to help keep your information secure.

- **Protect passwords, PINs** and answers to any security questions by not sharing them with anyone you don't want to have access to your accounts. Avoid easily guessed passwords (e.g. family members' names, birthdates, Social Security numbers, etc.).
- **Keep firewalls and security software up to date,** and use encryption software on your laptops.
- **Use your personal computer for financial transactions,** avoiding public-use computers if at all possible.
- **Do not give out vital information over the phone**, by email or through in-person requests. Type in the URL of the site you want rather than clicking a link provided in an email.
- **Check your financial accounts regularly** to ensure no unauthorized activity is taking place. Contact your credit card company or financial account institution immediately if you notice anything suspicious.
- **Monitor email, social media and online financial accounts for unauthorized changes**. If you receive an email that changes have been made to one of your accounts (e.g. new contact details, new addresses, etc.) that you did not authorize, follow the instructions provided by your service provider to protect your accounts.

- **Only click on links or open attachments that you expect** and are from sources you know and trust. Even if an email is from someone you know, if it looks suspicious, play it safe and confirm with the sender before opening.

I'll be happy to discuss this incident and other aspects of financial and personal information security. Just give me a call.

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