CUBIC ASSET MANAGEMENT, LLC

2017 3rd Quarter Stock Market Commentary

OF SEAT BELTS, SKI HELMETS AND MARKET RALLIES

"There are two kinds of people, those who do the work and those who take the credit.
Try to be in the first group; there is less competition there."
-Indira Gandhi

Automobile safety has come a long way since the introduction of the Model T by Henry Ford in 1908. Innovations like disc brakes, safety glass, collapsible steering columns and air bags have saved countless lives. Surprisingly, though, many improvements fail to produce the reduction in accidents and fatalities forecast at the time of their introduction. An interesting case in point is provided by the introduction of anti-lock braking systems (ABS) into taxi cabs in Munich, Germany in the early 2000s. Half the fleet received ABS, while half did not. An analysis of traffic accidents found that the overall frequency of crashes was the same for both groups. Cars equipped with ABS were involved in 18% fewer multi-car crashes, but also experienced 35% more off road crashes.

This is hardly an isolated example of counter-intuitive behavior. A 1981 study of seat belt legislation in eighteen countries found little difference in fatalities in places which mandated their use. A theory to explain such unintended consequences was first proposed by Gerald J.S. Wilde, a professor at Queen's College in Ontario, Canada. Wilde had examined data from Sweden both prior to and after 1967 when the country changed from driving on the left (as drivers do in Great Britain) to driving on the right (like in the United States and the rest of Europe). For a year and a half after the change there was a pronounced decline in the rate of traffic fatalities, after which it returned to its previous rate. Wilde hypothesized that drivers felt less safe driving on the opposite side of the road and compensated by reducing their speed. Once they became habituated to the change, though, they resumed their previous speed. He dubbed this idea *risk homeostasis*. It has also been called risk compensation. The theory suggests that people modify their behavior to account for a change in their perception of risk, acting more cautiously when the perceived risk is higher, and more recklessly when they feel safer.

Risk homeostasis has been observed in disparate settings. Skiers wearing helmets tend to ski faster than those without. Motorcycle riders wearing helmets tend to ride more aggressively. Advances in sky diving equipment have resulted in more aggressive maneuvers by participants. This last has become known as Booth's Rule #2, which states that "the safer sky-diving gear becomes, the more chances skydivers will take, in order to keep the fatality rate constant."

These musings were prompted by a series of recent thought pieces by Wall Street strategists about the supposedly contradictory forecasts for the economy implied by the divergence of the stock market and the bond market. The argument usually runs along the following lines.

With yields near the low or the year, the bond market is signaling the probability of a recession sometime next year. The yield on the ten-year Treasury inflation protected security, or TIPS, fell in late July to only 0.43% from a level of 0.65% earlier in the month. TIPS yields are a measure of "real" yields, which is the benchmark yield on ten-year treasury bonds minus the inflation rate. It is generally believed that lower real yields imply lower growth potential for the economy.

Further, the Federal Reserve is signaling fewer rate hikes this year than originally anticipated, presumably because the economy is growing too slowly and inflation remains subdued. In fact, inflation has been moving down from the Fed's 2% target. Other harbingers of inflation, like gold and silver prices, have been stagnant. Federal Reserve Chairman Janet Yellen stated that the Fed's current rate was not too far away from neutral. This sentiment has been echoed by other Central Bankers. After indicating that the ECB (European Central Bank) was likely to start to wind down its bond buying program, ECB President Mario Draghi reversed course and stated that inflation is not showing convincing signs of picking up.

Finally, the failure of the Administration to implement any of its major policy initiatives, like tax reform, regulatory reform, repeal and replacement of Obamacare, and significant infrastructure spending, have produced uncertainty amongst business leaders. The result is reduced capital spending.

But the equity markets around the globe are telling a much different story. The Dow Jones Industrials, S&P 500 and NASDAQ have each surged to record highs, with the majority of the gains being generated by a small set of high-flying technology companies. Earnings growth for the companies in the S&P 500 grew 11% year-over-year in the first quarter, despite the drag of energy stocks. Earnings are forecast to rise at a similar pace for the next eighteen months. Markets around the world are rising simultaneously. As of this writing, this is the only year in history in which none of the three principal markets, the United States, Asia and Europe, have experienced a 5% decline. Stock markets are forecasting robust economic growth.

A recent headline from the CNBC website neatly captures the conundrum faced by investors. "Bond market's recession warning is at odds with the stock market trading near all-time highs."

But what if there is, in fact, no contradiction? It seems to us that both stock investors and bond investors are actually sending the same message. The Federal Reserve, European Central Bank, and Bank of Japan have indicated that they intend to keep interest rates low for the foreseeable future, and in the case of the Fed and the ECB they will continue to hold an unprecedented amount of debt on their balance sheets. Such loose monetary policy is the equivalent of putting seat belts and air bags into cars. The system has been made much safer. Investors are performing risk compensation, assuming more risk individually to adjust for the reduction in systemic risk. Bonds thus seem safe to buy, in the near term, if there will be no risk of a significant rate rise, and stocks seem safe to buy since they offer a dividend yield in excess of bond yields plus the likelihood of earnings growth.

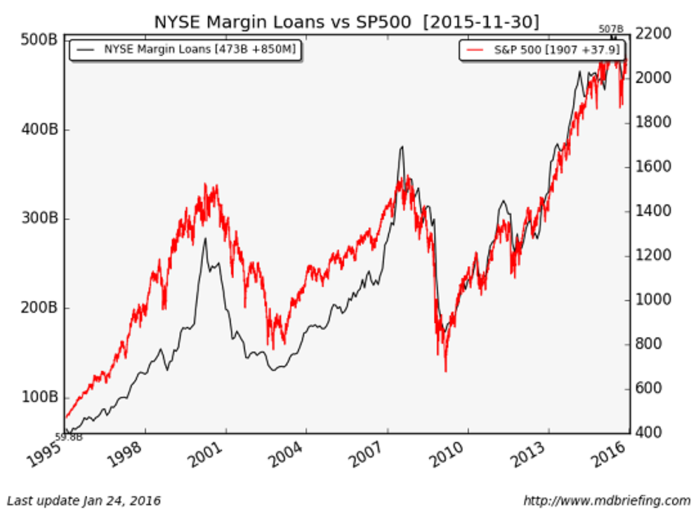
This is not the first time that investors have engaged in risky behavior when they perceive the financial system to be safer. In 1976 two professors at the Haas School of Business at the

University of California at Berkeley, Hayne Leland and Mark Rubenstein, devised a portfolio management tool to protect against large losses should the stock market begin to fall. The technique involved the selling of stock index futures against an existing portfolio. The greater the decline, the more index futures needed to be sold. This dynamic hedging strategy was dubbed “portfolio insurance,” and it was broadly adopted by portfolio managers in the 1980s.

From January 1980 to November 1982 the United States suffered a severe recession. Inflation in the late 1970s had accelerated to unacceptable levels, and newly appointed Federal Reserve Chairman Paul Volcker decided to dampen price increases by sharply increasing the federal funds rate. By 1982 money market interest rates soared to 22%, while long-term U.S. Treasury Bonds were yielding nearly 15%. The economic recovery of 1983-4 was one of the strongest in the post-World War II era, but by 1985 growth had started to slow down. Despite mediocre growth, money managers bought stocks with abandon, lifting the Dow Jones Industrial Average (DJIA) by a whopping 44% in the twelve months up to August 1987. After all, they reasoned, there was little risk, because they had portfolio insurance.

On October 15, 1987 the DJIA fell 95.46, or 3.8%, at the time a record one-day decline. The next day it fell another 2.4%. In the midst of this nervousness, Iran sunk an American flagged oil supertanker, followed by the sinking of another American ship. The U.S. retaliated by bombing Iranian refining facilities, and the Dow fell yet another 4.6% on Friday, October 16. Over the weekend, there was heavy selling on foreign exchanges, resulting in a wave of sell orders when American markets opened on Monday, October 19. Portfolio managers responded as they had been taught to do, by selling index futures in ever greater numbers as markets fell. The buyers of those futures, in turn, tried to protect themselves by shorting stocks, creating still more downward pressure. The result was a drop of 508 points, or 23% in a single day. Stock investors had been lulled into a false sense of security. After all, they thought they had “insurance.” They compensated for the perceived lower risk level by driving stocks to levels unjustified by fundamentals.

The persistence of near zero interest rates around the world for nearly a decade has induced a false sense of security in investors that downturns are a thing of the past. This feeling has been reinforced by subsequent central bank actions. For example, in 2013, when then Federal Reserve Chairman Ben Bernanke announced that the Fed would begin a gradual tapering-off of



its massive $85 billion per month bond buying program, interest rates rose sharply and the stock market sold off. This so-called "taper tantrum" prompted the Fed to reverse course a few months later. After all, in the "every child gets a trophy" era, no government official wants to be blamed for causing stock or bond investors to become losers. The current euphoria can be seen by considering the graph shown above, which shows how margin debt (borrowing to buy stock) has accelerated in lock-step with the market's rise. Clearly, the high level of stock prices has only served to cause investors to leverage their bets, rather than to promote caution.

One way for high stock and bond prices to move into line with historical averages is for them to experience a "correction," typically defined as a drop of greater than 10%. This is certainly a possibility, and one which several notable investors like Jim Rogers and George Soros (co-founders of the Quantum Fund) are predicting. But there is another way for overvaluation to be remedied which is much less painful. Markets may simply stagnate as earnings continue to grow. There is certainly precedent for this more benign view. At the start of 2001 the S&P 500 was 1335.63. Five years later it was 1278.73, a nominal drop of slightly more than 5%. (With dividends reinvested, though, an investor who held on through these doldrums would have earned 0.5% per year, competitive with today's money market returns.) But during this same five-year period aggregate S&P 500 earnings rose from $34.23 to $86.92. The overvaluation of the dot-com bubble was corrected through growth.

At such a time it is worth pausing to recall the quote by legendary value investor Sir John Templeton. "The most dangerous four words in investing are 'It's different this time.'"