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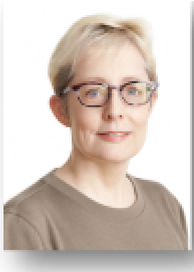

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The History You Do Not Know And The State Of Financial Markets

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Harry Truman once said, “The only thing new in the world is the history you do not know.” In late 1999, five of the largest US stocks in terms of market cap were in the tech and telecom sectors (not surprisingly). Five years later, only one tech company remained in the top ten. As of December 2018, five of the largest ten companies were again tech and e-commerce companies, even after a twenty-five percent decline from the highs for the beloved FAANG stocks. What would you expect the composition to be five years from now? Certainly, bubbles have been bursting over the past few months, but valuations are still not at trough levels, despite a company like Apple experiencing over a $400 billion decline in market cap.

Market strategist Dave Rosenberg recently stated, “we keep getting asked if the stock market correction is over and the answer is that it ends only once we stop being asked the question.” I also agree with his sentiment that recent market turbulence is much more about liquidity than about China. While trade tensions have not been helpful, China was already experiencing debt issues and facing a bear market before these tensions arose. If everything depended on China, sectors in the US like homebuilding and financials would not be under-performing as much as they have.

One can point to signs of tightening liquidity in a few areas. For example, “the number of contracts available to buy or sell S&P 500 futures at the best available price has dwindled in recent years and dropped 70% over the past year alone, hitting a decade low,” according to Goldman Sachs and noted by the WSJ. Other indicators of stress in the financial system include a recent spike in the Japanese Yen vis-à-vis the US dollar, as well as a sharp move in the repo rate (or short-term overnight bank lending rate.) The repo rate spiked temporarily on the last day of the year from 2.50% to 6.125%, the highest level since January 2001. Year-end liquidity suddenly seized up in essentially risk-free, short duration debt. What does this portend?

This liquidity stress coupled with higher interest rates does not bode well for areas like private equity, which will likely face a pin prick in the near future. As Strategas recently stated, “Given the explosion in the number of private equity shops since 2000 (100 then vs. 4,000 today) and the low probability of another 10-year period of such extraordinarily low rates, it seems unrealistic to expect future returns to come anywhere close to those achieved in the past two decades.” It is eerily reminiscent of hedge funds multiplying exponentially until their returns went south. The private equity business, based on cheap plentiful debt, will face significant headwinds as banks and investors demand higher rates of return. The balance of power is finally shifting to the lenders and investors in a liquidity starved environment. One would be much better off directly purchasing selected high-quality value stocks in the publicly traded sphere, as they have not only significantly under-performed private equity, but also their growth brethren over the last decade. I would bet on mean reversion kicking in soon.

While we have experienced a trifecta of recent declines in equities, credit and commodities, which all signal some future weakness in the economy, I stress investor patience will pay off tremendously in high-quality defensive value equities that have the flexibility to focus on shareholder returns, as well as diversified midstream pipelines that are trading at cash flow multiples last seen in 2009. Maintaining some liquidity to take advantage of the expected continued market volatility will provide investors the ability to hunt for bargains as more will inevitably materialize. As the late Tom Petty said, “the waiting is the hardest part.”

I am Managing Director and Chief Equity Market Strategist at HighTower and Chief Investment Officer at the Rosenau Group, and have over 30 years of experience in the financial industry. I focus on equity portfolio management strategies. I also perform due diligence on the firm's third party research relationships and continue to add, monitor, and prune research providers where necessary. Prior to joining HighTower I worked for various sell-side firms, beginning my tenure at Wertheim & Co./Schroders Plc. I was recently ranked #15 in Forbes 2018 America's Top 250 Women Wealth Advisors and #2 in Barron's 2018 Top 1,200 Financial Advisors By State (Colorado). She was also ranked #17 in Barron's 2017 Top 100 Women Financial Advisors and was ranked #67 in Barron's 2017 Top 100 Independent Advisors. Ms. Rosenau holds series 63 and 65 licenses.