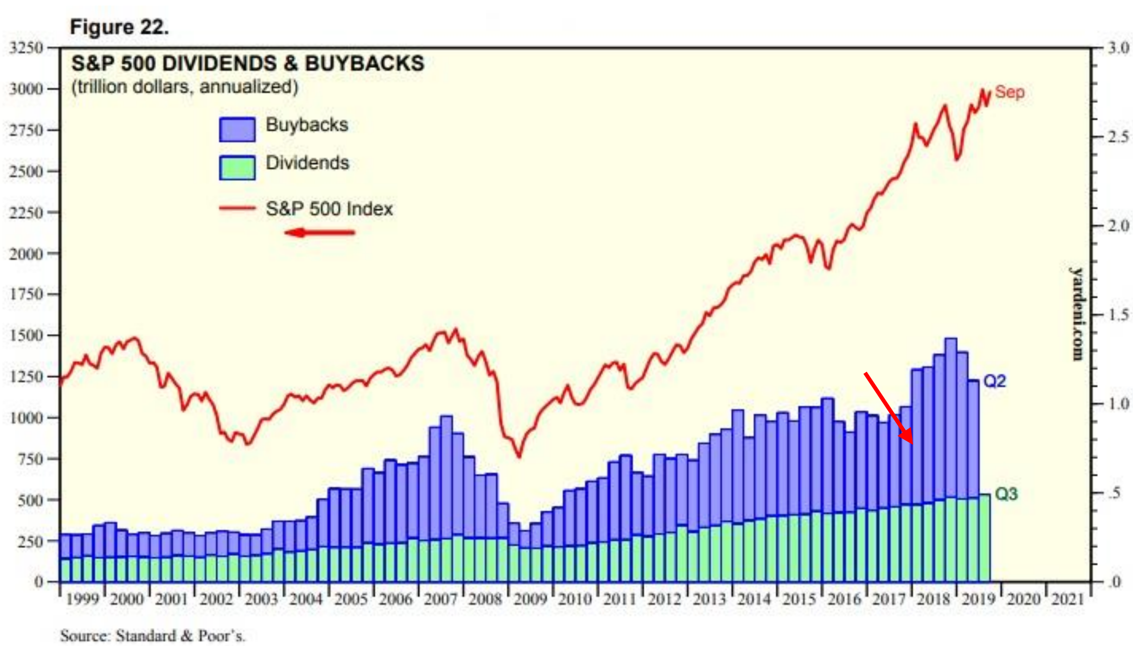
October 2019

Dear Valued Clients and Friends,

In this installment of our quarterly update, we'll first briefly highlight possible changes in trends that have supported the bull market thus far. Then, we'll examine the small cap space and ponder the question of whether investors are too bearish.

Two trends that have provided support for rising stock prices since the bull market started over a decade ago are stock buybacks and corporate insider buying. Since 2010, increasing corporate buybacks have fueled a significant portion of stock gains. Companies, possibly lacking sufficient investment opportunities to grow top line revenues, have found that one expeditious route to higher earnings per share has often been to simply reduce the number of outstanding shares. Some companies have gone so far as to leverage historically low interest rates, issuing more debt to fund their corporate buybacks, a practice that might come back to haunt them.

From the chart below, the last two quarters have seen a notable drop in the dollar volume of company stock repurchases. While a two quarter drop is not alarming, a continuation of the decline could negatively impact share prices.



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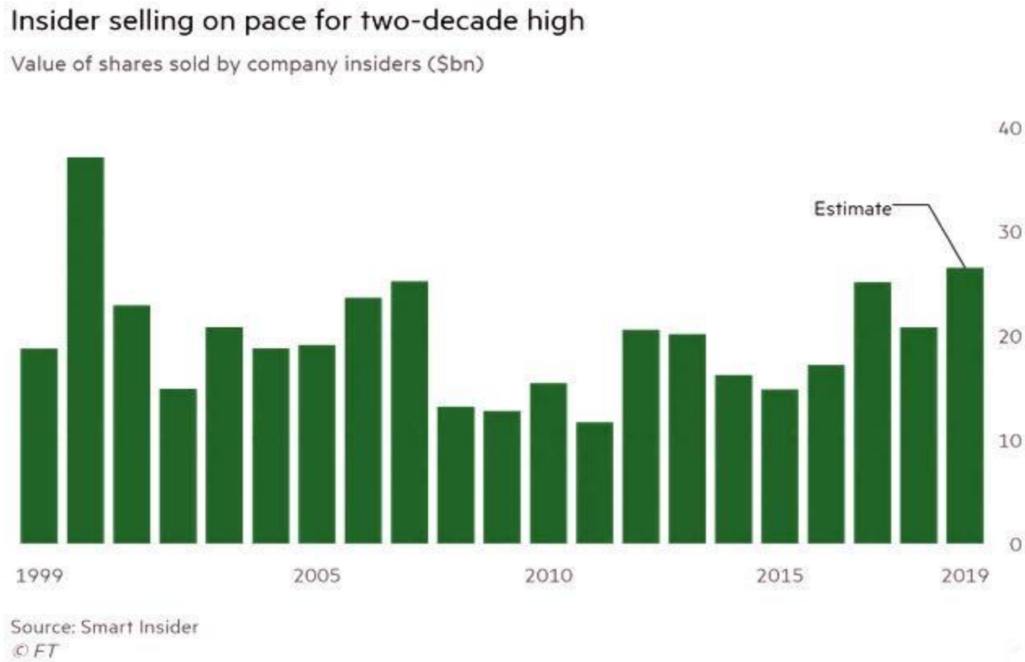
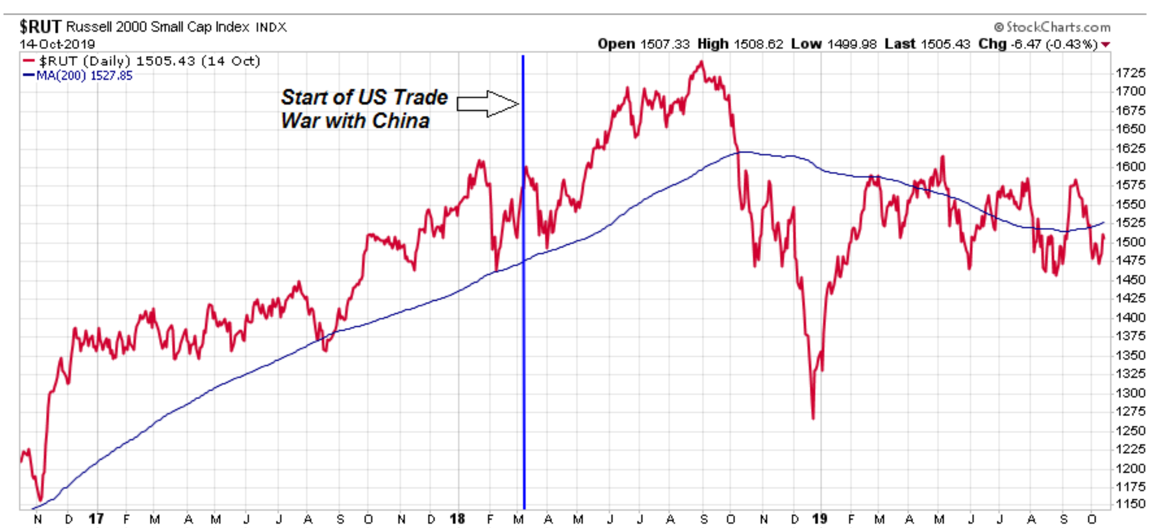
Also noteworthy is that corporate insiders, no doubt eager to capture gains from the bull market, are selling near record amounts of company shares. In fact, insider share sales are at a two decade high. Again, one year is not a trend. But historically, insider selling can be a bearish sign for stocks.



As we head into the home stretch to finish out the year, bearish investors can easily point to the behavior of small cap stocks as justification for their concern. As is readily apparent in the chart below, small cap stocks have gone nowhere for two years.



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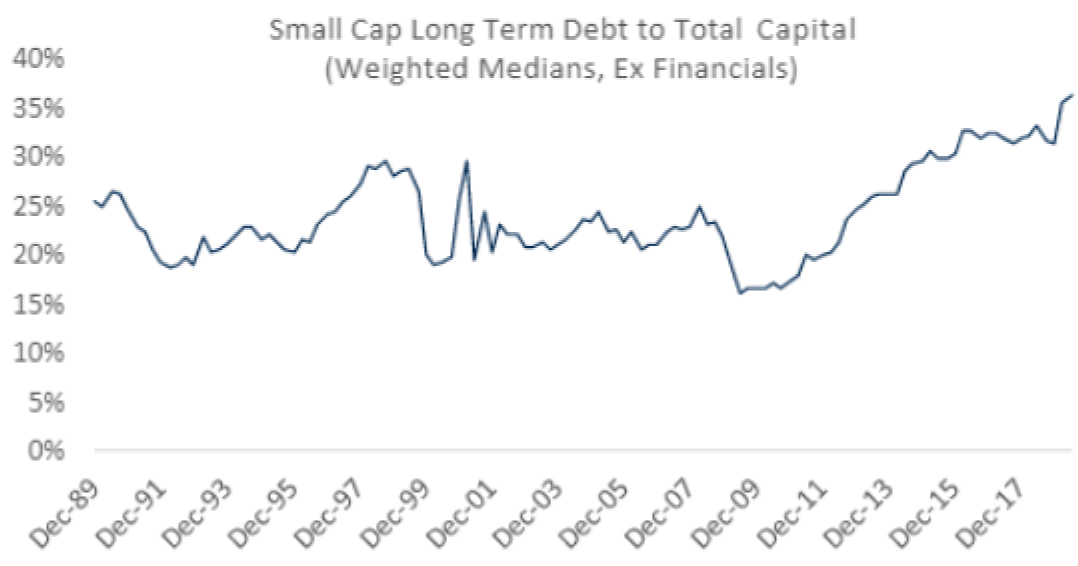
Before we delve into what is going on here, we'll examine the Russell 2000 index ("small caps") so we can have a sense of what they may, or may not, be telling us about the future direction of the market. The Russell 2000 index is a market capitalization weighted index and is the most widely used benchmark representing US-based small capitalization "small-cap" companies. These companies are not really all that small however with an average valuation of $2.4 billion and the median valuation of over $800 million. Domestically focused, Russell 2000 constituents generate about 82% of their revenues in the US (roughly double the percentage of domestic revenues of their large cap brethren). The index has companies from all sectors of the economy but differs somewhat in sector weightings from the S&P500. Compared to the S&P500 and other large cap indexes, it tends to be underweight technology, owing to the dominance of the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google) which make up nearly 10% of the S&P500 on their own. Also however, the Russell 2000 is overweight in financials, due primarily to an abundance of regional banks. These attributes collectively make the Russell 2000 perhaps a better proxy for the health of the US economy. The recession fears that have held down interest rates and are routinely discussed in the financial press appear to be reflected in both the volatility and the lack of upward progress in the small cap space. Another surprising note about small caps: 1 out of 4 of them are currently unprofitable. This seems almost inconceivable in a healthy economy. But it turns out to be about the normal range for this group, compared to 1 out of 20 for US large cap stocks.

What has not received so much attention about these companies is that during the current bull market, they have binged on debt enabled by historically low interest rates. Debt among Russell 2000 companies is at an all-time high as shown in the chart below.



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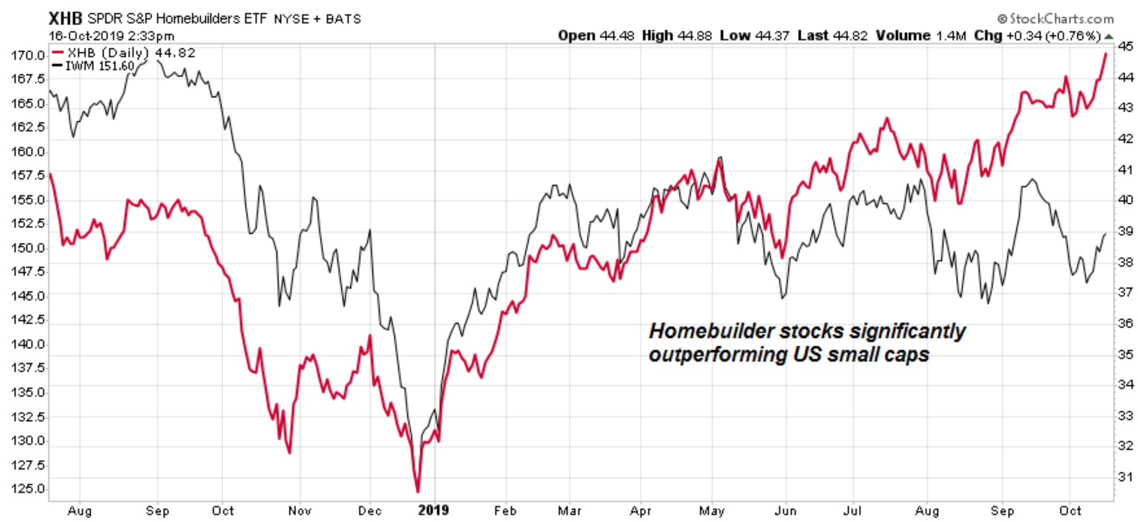
The obvious concern is that when the inevitable recession arrives, which many view as likely in the next couple of years, the financial squeeze on these companies will be enormous. This is clear risk for these stocks.

Still, in the short term, the myriad of woes that have restrained the market may actually be a bit bullish. Stocks have held up shockingly well. Any good news: a Brexit resolution, an easing in the trade war/tariffs, a jump in home and/or auto sales resulting from low interest rates etc. could be enough to boost markets in the short term, especially given investors' low expectations and recent memory of the traumatic collapse in stocks only a year ago. The list of economic and political worries is long, but as JP Morgan Chase CEO Jamie Dimon remarked in the company earnings call this week, "The consumer is not under strain. The consumer is doing fine." Perhaps reflecting Mr. Dimon's bullish view: US homebuilders are trading at a 52-week high!



Inevitably one of these world views is going to break, either homebuilder stocks will tumble, or the rest of the stock market will follow their lead upward. We obviously don't know which of the above forces will win out in the near-term. But, as always, we are paying close attention.

To future profits,

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