Basis Points – August 30, 2018

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Above the Fold

- The strength in the red-hot retail sector produced very strong second quarter 2018 earnings reports from Walmart, Target, Home Depot and TJ Maxx. That list now also includes DSW, the branded footwear retailer. DSW reported same store sales gains in the quarter of 9.7 percent, compared to the 2.7 percent that was expected by analysts. Free shipping on online orders also drove website traffic and sales for DSW. Investors cheered the strong store sales news, as the stock popped 20 percent for the day, and has now gained 55 percent in 2018.
- With all the positive economic news that has been released this year, the one negative outlier has been the recent weakness in the housing market. Existing home sales fell 0.7 percent in July compared with June, which is the seventh straight month of year-over-year declines. Buyers have been struggling to find affordable homes this year, as the supply of homes for sale has fallen for most of the year. It will take a significant amount of new housing inventory for sale to both cool prices and boost sale closing numbers. Affordability is being further weakened by higher mortgage interest rates as the average rate on a 30-year fixed mortgage is about a half a percentage point higher now than it was at the start of this year.

Three Things

- Strategas Research notes that the S&P 500 had gone more than six months before making a new 52-week high last Friday. Historically, breaking out from a similar consolidation has been consistent with above-average forward returns, so this new all-time high is a very positive event. Since 1950, there have been 24 instances where the market took a break of at least six months during a bull market, then resumed hitting new highs. Looking at the next six months in all those instances, 92 percent of the time the market has risen, at an average gain of 7.2 percent. This is compared to a forward six-month average gain of 4.3 percent for the S&P 500 on all other days.
- Even with the S&P 500 gaining a very healthy 10 percent year to date, a popular negative take of the rise in the index has been that a large part of the index gain has been due to the five largest stocks in the index, the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google). While this statement is true, it is also true that this concentration is not unusual at all. AQR did a study looking at the last 20 years, and because of the market-cap weighted nature of the S&P 500, it is very normal for five large stocks to generate returns that comprise 50 percent of the index gain in a particular year. They use the analogy of the Golden State Warriors basketball team. The team's three best players, Steph Curry, Kevin Durant and Klay Thompson, accounted for 50 percent of all the points their team scored last year. They still won the NBA championship, even with a point distribution that was not broad or equal. So fear not, as it is very common for the total return of a market-cap weighted index to be dominated by a few large winners in any given year.
- The *Harvard Business Review* noted the 50 percent decline in the number of public companies traded on U.S. exchanges since 1996. However, they do not see this decline as negative nor do they believe that it is a worthwhile goal to increase that number. This trend comes directly from the shift in corporate America from hard asset-based firms to digital knowledge and process-based firms. New companies these days are far more likely to be cloud-based and compete with knowledge, strategy and human capital. They are also much more likely to operate as lean organizations with less need for factories, capital equipment or large inventories of goods. Digital age businesses like this are also more likely to need the help, wisdom and advice of private equity partners to succeed, so are more likely to seek funding from private sources rather than the IPO market, where new shareholders would be of no service as business advisers or incubators. Most importantly, there is no evidence that the recent decline in the number of listed firms has adversely affected the U.S. economy, as unemployment is very low, the total market cap of the stock market is steadily increasing and the U.S. retains its leadership in technological progress globally.

Did You Know

You may not have noticed this odd fact before, but the dividing line in most cities between wealthy and poor neighborhoods is east and west. The large majority of the population of the eastern areas of cities are less well off and more disadvantaged than those in the western half. The list of cities is long, but includes East St. Louis, East Detroit, East L.A., East Lansing, East Orange and even East Palo Alto. This fact is similar in other countries as well, as seen in East London, East Jerusalem, East Paris and East Vancouver. Why is this the case? It is because of the wind. The Earth rotates counter-clockwise, so the wind in both hemispheres blows east. If you are setting up chairs around a campfire, you should avoid placing your chair to the east of the fire, if you don't like smoke in your face.

Heblich, Trew & Zylberberg released a fascinating study in 2016 titled, "East Side Story: Historical Pollution and Persistent Neighborhood Sorting." It was a geographical study of where 5,000 smokestacks in England were located in 1880. They concluded that as smoke blows east, the wealthier folks settled on the west side of cities, while the less powerful and more disadvantaged citizens were relegated to the east side. Cities in America and around the world were settled in this manner as well. This is even where the term "from the wrong side of the tracks" came from. The wrong side of the tracks was usually the east side, where the smoke from the trains blew. Although pollution from trains, industrial plants and utility smokestacks have declined considerably since the 1800s, the demographic sorting effect in cities around the world is still visible.

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