Basis Points – February 19, 2019

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Above the Fold

- The equity markets have enjoyed a sharp rebound in 2019 from the broad decline in risk assets in 2018. The S&P 500 has risen 11 percent this year, and smallcap stocks, MLPs and growth stocks have risen even more. Crude oil has jumped 32 percent to $55.50 from its Christmas Eve low of $42.50. An argument can be made that the market needs to rest at these levels after such a strong run, and it sounds like this: The S&P 500 has risen 27 of the past 36 days. Sentiment has moved from extremely bearish to a far more optimistic stance with the Fed now on the market's side. Stocks trading above their 50-day moving average have moved from an extremely low 1 percent level to 91 percent during that time. Relative strength of the S&P 500 is now in overbought territory. Earnings season is now mostly complete, so there will be little good news or positive commentary from large companies for six weeks. News from the U.S./China trade war issue has been positive lately, but a signed deal may already be priced into stocks at this point. The Brexit situation is not improving, and this uncertain crisis has a March 31 deadline, so the resolution and the possible economic and political calamity could dominate the news for the next month. As always, while the equity market may be overbought, as long-term investors we would not trade or make asset allocation decisions based on these short-term market conditions.

- The potential evil nature of corporate share buybacks and their effect on wage growth and capital expenditures that would boost the economy is a hot topic these days. Strategas Research chief Jason Trennert notes that the political debate over buybacks lacks any real substance. The belief is that the U.S. government cut taxes for corporations last year, and companies then used nearly all that money for share buybacks. Trennert noted strongly, "This is ridiculous. Last year was an exceptional year for the U.S. economy. Employment accelerated, average hourly earnings grew at their fastest rate since 2005, S&P 500 capex produced its fourth largest annual increase on record (despite a trade war), and the bottom 10 percent of income earners had their strongest wage growth since 2000. This economic progress occurred despite the Fed raising interest rates, the dollar strengthening and the rest of the world economy slowing down." Buybacks did increase last year, but that was due to the large $700 billion inflow of repatriated cash drawn from overseas holdings. Through the first three quarters of 2018, just one-third of repatriated funds was used for buyback increases. That leaves over $400bn for other uses like capex, bonuses, M&A and paying down debt.

Three Things

- While a high-speed rail system may seem like a prudent and green idea for travel in the U.S., many realities of both geography and regulation may cause the idea to remain a dream. In 2008, voters in California approved a $9 billion bond issue to begin the very ambitious plan to build a bullet train connecting San Francisco and Los Angeles, at a total cost of $33 billion. Over the past decade, the estimated total costs have rocketed upward to $75 billion. In his State of the State speech last Tuesday, Governor Gavin Newsom called for the state to scale back the project to a less costly route that would only run through the Central Valley, and not connect the state's two largest population areas. High-speed rail in Europe and Japan is the norm, but the cities there are much closer together. The sheer size of the U.S. is an impediment to high-speed rail, as are two very important factors: First, track must be laid in a straight line, as a train cannot take a curve at 300 miles per hour. Connecting one large U.S. city to another in a straight line is very difficult, as there are structures, infrastructure and expensive private property all around large metro areas that cannot be destroyed. Second, legal regulation is a large hindrance. Different from Europe, the U.S. legal system offers citizens many veto points at which they can attempt to block government projects. Building complicated projects such as high-speed rail involves decades of planning, consulting, approvals and courting local governments and unions in order to even begin construction. Many experts now opine that if high-speed rail can't be built in California, where the idea had broad support and funding, it can't be built anywhere.
- Are investors usually too cautious on their five-year equity market forecasts? Ask any market strategist, pundit or consulting firm what their guess is for equity market returns over the next five years, and you will invariably hear the answer, "Returns over the next five years will be more muted than the last five years." Everyone wants to be cautious in their fortune-telling, as pessimism always seems more reasoned and responsible than outright optimism does. However, looking at the last 75 data points of S&P 500 trailing five-year returns (the five years trailing 1949, the five years trailing 1976, etc.), the numbers show very strong performance over most five-year periods. In 75 percent of trailing five-year performance periods, the annualized return was higher than 7.5 percent. Only 25 percent of the periods showed annualized performance lower than 7.5 percent a year. Although it may feel informed and intelligent to predict forward five-year equity returns of less than 7.5 percent a year, annualized returns this low are rare and not often achieved.

- Google plans to spend $13 billion on data centers and offices across the U.S. in 2019, saying the large investments will create thousands of new construction jobs in states outside its home state of California. By the end of 2019, Google will have operations in 24 states. A large presence in many states will increase Google's political influence at a time when lawmakers and regulators are asking tougher questions about tech company business models and internet privacy.

Did You Know — Big Things and Small Things

Many personal financial advice columnists give a similar example: Cutting out your morning coffee habit can be very financially rewarding in the long term. A morning Starbucks, at $4 a day, every workday, costs $1,000 a year. Save that much every year and you will be well on your way to a comfortable retirement. This may seem like a good idea, and it is a very good habit to consider everyday costs as part of overall spending. However, focusing on small things can crowd out a much more important focus on large things. Very simply, focus on the big things, and you won't have to worry about the small things.

Big Things: Consistently contributing as much as possible to a 401(k) or 403(b) plan. Receiving the full company match for your 401(k) account. Investing these funds for the long term in stocks, mutual funds or index funds, and not trading the account on every news event. Paying off credit cards in full every month. Buying a house that you can afford and paying down some of the principal ahead of time. Contributing to an IRA or 529 education plan if you are able. Driving a sensible car and keeping it for a few years after it is paid off.

Small Things: Cutting out your morning Starbucks habit. Clipping coupons. Carrying less house or car insurance than is prudent. Reusing plastic bags. Making your own Christmas gifts. Driving instead of flying on your yearly vacation. Struggling with the service on your low-cost cell phone plan. Canceling your television service. Hiding under a blanket to avoid turning on the heat, and so forth.

Focusing on big things can also foster a positive relationship with money. A negative relationship with money can develop from constantly worrying about the small stuff, and consistently denying anything positive resulting from hard work. After striving to excel in school, getting a good education and working hard on a career, a person should be able to enjoy a daily Starbucks run, a Netflix binge-watch or whatever a simple pleasure happens to be. Take care of the big things first, and you will sleep well knowing you are creating a happy and secure tomorrow.

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