

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

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SECOND QUARTER LETTER

Adam Smith, a pseudonym, in his classic book from the late 1960s titled *The Money Game* introduced the concept of a “kid’s market.” He used the phrase to refer to an investment environment where the traders that are too young to remember the last bear market are making the most money. This condition may be the case today, as the 2008 credit crisis and bear market are now more than a decade in the past. Many of today’s market participants have little or no direct experience in navigating a severe bear market. Their attitudes towards downside risk are different from those who lived through the 2008 crisis, as well as the bursting of the internet bubble and other historical bear markets.

These “kids” are making the most money in the stock market right now. Stocks favored by the “kids” naturally include the mandatory growth stocks like Netflix (+40% year-to-date), Facebook (+48%) and Amazon (+27%)... But the “kids” also really love pot stocks. In Gallup’s October 2018 survey on marijuana, the national pollster found that 66% of Americans favored the idea of broad-based legalization, but millennials’ support stood at 78%. According to data from Robinhood, an investing app of six million users whose average age is thirty-two, four of the top twenty holdings of its users are cannabis stocks. Courtesy of a top-twenty holdings list provided by Robinhood to *Investor’s Business Daily*, these cannabis stocks include Aurora Cannabis (+46%), Cronos Group (+48%), Canopy Growth (+46%) and HEXO (+57%).¹

To illustrate how memory can get in the way of making money in a kid’s markets, Adam Smith described a character he called The Great Winfield, who exploited a kids’ markets by only hiring investment managers who were under thirty years old. *“The strength of my kids is that they are too young to remember anything bad, and they are making so much money that they feel invincible,”* said Winfield. *“Now, you know, and I know, that one day the orchestra will stop playing and the wind will rattle through the broken windowpanes, and the anticipation of this freezes the rest of us who are old enough to remember.”*

To be sure, a kids’ markets can remain euphoric for some time. Eventually, the kids will encounter a bear market and, in the process, become older and wiser. Until then, they no doubt will continue to dominate the performance tables. If the future rhymes with the past, the older and wiser veterans will eventually enjoy the last laugh. In the interim, one listens to the kids rationalize the irrational. Or as Warren Buffett summed it up: *“Nothing sedates rationality like large doses of effortless money.”* And so, it is with the irrepressible bulls, who declare that investors should ignore valuations in the 95% decile because a synchronized global expansion will grow corporate earnings above these extended valuation metrics. This display of overconfidence rationalizes the irrational, which we find puzzling but not necessarily unexpected.

Channeling Mark Twain’s quote that *“history doesn’t repeat itself, but it often rhymes,”* legendary investor Jim Rogers noted during an interview with RealVision that *“When things are going right, we all need a 26-year-old. There’s nothing better than a 26-year-old in a great bull market especially in a bubble. They’re fearless. They don’t know. It will never end. They will tell you why it will never end. They know that it cannot end and will never end. So, in the bull market, you’ve got to have a 26-year-old. But when they end you don’t want the 26-*

¹ Aparna Narayanan, "This Marijuana Stock Toppled Apple as No. 1 Among Millennial Investors," *Investor’s Business Daily*, June 11, 2019.
(footnote continued)
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year-old around... they make a lot of money. They don't know why they made money. So, they don't know why they lose money."²

The risk to the contrarian value-based investor is that, over the short term, the crowd typically outsmarts the patient. But as the time cycle extends, history reasserts its dominance. Although history provides lessons about investing, the application of those lessons is difficult to determine. "Find value" is a logical starting point, but value is subjective and its definition changes throughout a market's cycle. In highly speculative markets, value might simply mean to most people that "the price is going up." In bull markets there is rarely a clear divide between the rationale and imaginary. As the current bull market in complacency progresses, the investor should recognize the market's limited upside and growing potential market downside.

Central bank liquidity, low interest rates and passive investing have pulled forward future investment returns. One should not be surprised if investment returns over the next five years prove lackluster at best. The nature of Wall Street and the players in the investment business constantly change, but the great game remains the same—money. It was Lord Keynes who first saw that the handling of money is a game. Most discussions of money and investing focus on economics and statistics, but that is only part of the game. The other key component is people, individually and collectively, who constitute both the emotional investor and the irrational crowd. Investors today see the market through the eyes of a kid, or perhaps like an older investor at the end of every bull market cycle who behaves like a kid. As the late Morgan Stanley strategist Barton Biggs said, "*A bull market is like sex. It feels best just before it ends.*"

The current economy depends on the growth of ever increasing amounts of debt. This growing pile of debt reveals itself in price bubbles across the world in various asset classes. Examples range from U.S. equities and bonds, U.S. corporate debt, venture capital and technology startups, shale energy development, China's leveraged banking system, cryptocurrencies and all the way to Australian and Canadian property prices. The actual driver of these percolating asset price bubbles links directly back to the aggressive central bank policies of record low interest rates and quantitative easing since the global financial crisis.

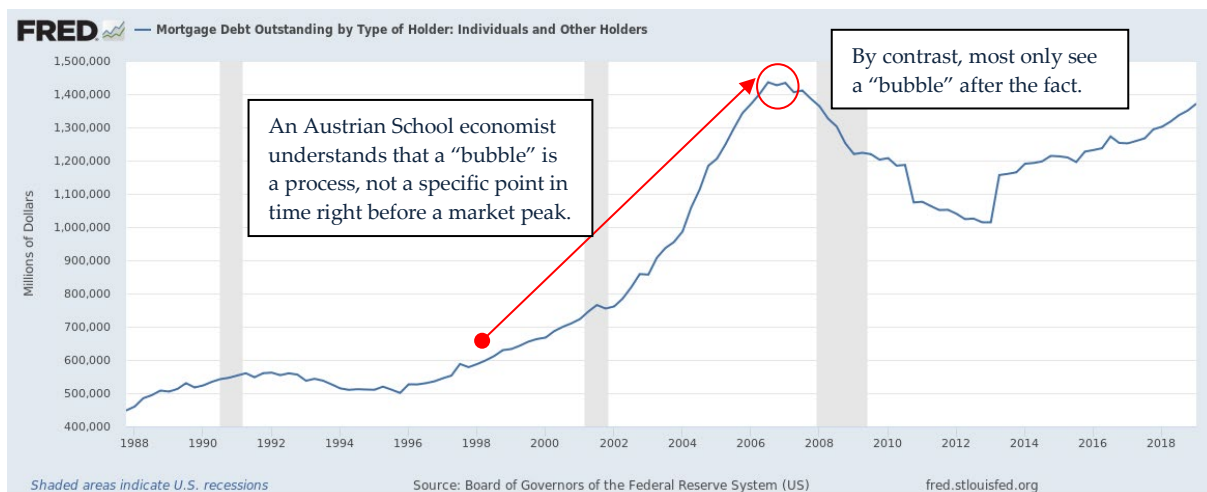
In an economy powered by central bank policies, a major portion of the economic "growth" is really an unsustainable illusion, just as it was in the technology bubble, the housing bubble, and the current bubble in many financial assets. A group known as Austrian School economists display an uncanny ability to spot the development of these bubbles years before they collapse. One practitioner of this school of thought is analyst Doug Noland, who chronicled the development of the dotcom and housing bubbles and continues to warn about the current bubble, in detail, in his weekly *Credit Bubble Bulletin*. Reviewing the publication's archives from the technology bubble period, one notices similarities between that period and today. Noland warned about the development of the housing bubble starting in the year 2000:

February 18, 2000: Eventually, markets always punish egregious excess – always. Actually, this unhealthy bubble was in the process of being pierced back in the autumn of 1998. It should be recognized today that it would have been much better for the system to have taken the medicine back then. Instead, the Federal Reserve cuts rates sharply, while Fannie Mae, Freddie Mac and the Federal Home Loan Bank System moved aggressively as buyers of last resort for the leveraged speculators. In the process, hundreds of billions of new credit was created by the GSEs that gave a dangerously maladjusted credit system another lease on life – and what a life it became.

² Jim Rogers, "Global Risks and Untapped Prospects," *RealVision*, September 20, 2017.

Noland saw the housing bubble developing from the beginning. Had anyone listened to him and others sounding the alarm, one could have avoided the 2008 financial crisis and all the damage it inflicted upon our economy and society. Paradoxically, the financial media ridiculed anyone who continuously warned about the growing distortions in the housing market for the seven long years before recognizing the obvious bubble. In fact, our economy still suffers from the effects of the 2008 financial crisis – the current economy is so weak that the U.S. Federal Reserve Bank cannot raise the federal funds interest rate above a mere 2.25% without causing a stock market panic. History repeats itself. A handful of astute analysts like Noland are once again warning us about the distortions created by loose monetary policies and too much debt. Naturally, most investors ignore these warnings, because “*the road goes on forever and the party never ends.*”³

The reason why most people misunderstand the warnings of Austrian School economists is directly rooted in the dramatically different beliefs markets hold regarding how and why bubbles form. Austrian School economists believe that bubbles can develop over a long period of time, while the mainstream financial community believes that a bubble only becomes a “bubble” near the very peak, shortly before it implodes. Because of their skepticism for central bank-driven economic booms, Austrian School economists view such booms as bubbles from the day they begin inflating until the day they burst. By contrast, the mainstream Wall Street community believes that central bank-driven economic booms are legitimate, sustainable and only considered a “bubble” when market sentiment becomes outright euphoric. Even at the extremes, most mainstream economists will only admit the existence of a bubble after the crisis when hindsight is 20/20.



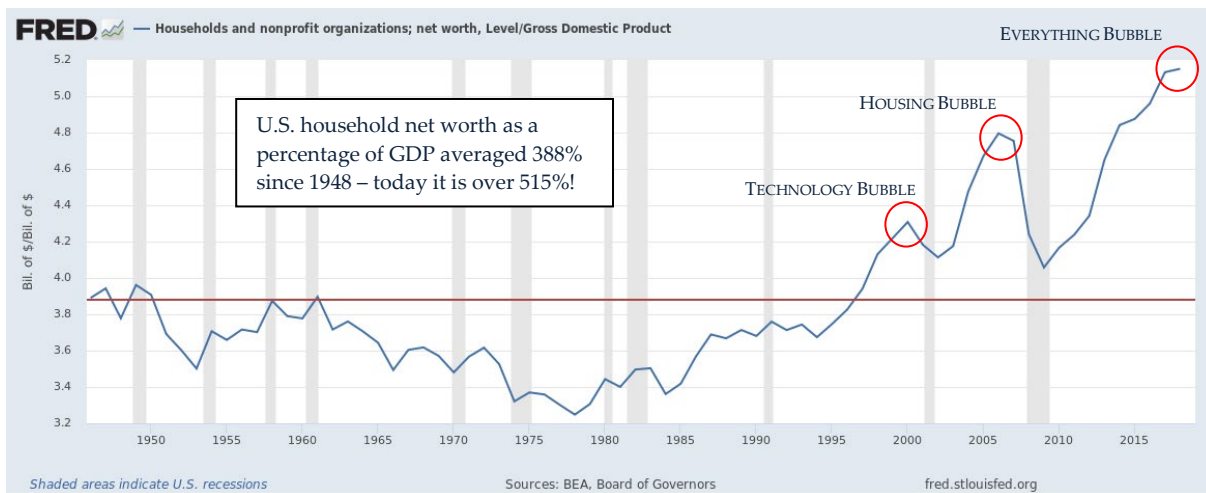
To illustrate this point, note the chart above of total outstanding mortgage debt during the housing bubble.⁴ Though the bubble finally burst in 2007, it reached those levels by inflating over a long period of time. Bubbles are a process – not a specific point in time. Mainstream economists see U.S. housing prices surge from 1998 until approximately 2005 as a boom that helped the economy recover after the technology bust and September 11th attacks. In their opinion, the U.S. housing market only became a “bubble” at the very end of the boom in 2006 and 2007—a fact they only acknowledged after the housing market already imploded. This is both wrong and dangerous. According to Austrian Economics, risk accumulates and malinvestment starts at the very beginning of central bank-driven economies. Because

³ Robert Earl Keen, “The Road Goes on Forever,” *West Textures*, 1989.

⁴ Jesse Colombo, “Why Warning About a Bubble is Completely Rational,” *Real Investment Advice*, April 25, 2019. *St. James Investment Company, Page 4*

the buildup of risk and malinvestment starts so early in a bubble, the market punishes the prudent investor who recognizes the growing distortions and is increasingly reluctant to participate.

As global central bank policies continue to distort markets, we now have the “Everything Bubble,” a term first coined by Jesse Felder in 2015.⁵ The S&P 500 stock index’s 311% rise from its 2009 low is a bubble that speculators will eventually acknowledge, but only in hindsight. Although the U.S. stock market has been surging for a decade, the bubble began forming much earlier. Organic economic growth did not drive the S&P 500 higher, but rather cheap and easy access to credit. The early years of the current “Everything Bubble” resemble the start of the housing bubble. The chart of U.S. household wealth as a percent of gross domestic product (GDP), shows just how inflated asset prices have become relative to the underlying economy. Household wealth surged during the technology and housing bubbles, only to come crashing down again. The current bubble easily exceeds the last two and the coming bust will be proportional to the surge.



The primary reason why the U.S. and global economy continue to grow after the 2008 credit crisis is because new debt piles up on top of old debt. Markets are basically on the same path as they were before 2008. Anyone concerned about another economic crisis appreciates the warnings about the surge in U.S. credit, even though these warnings will not immediately result in a crisis. People with long investment time horizons worry about trends that are likely to cause severe problems in the future. Those with shorter time orientations do not think about the long-term implications of trends – they operate under a one dimensional framework: *“I’m making money now and you’re losing money by worrying.”*

It’s not hard to connect the dots and determine that markets are following an unsustainable track. The quoted value of negative-yielding debt around the world recently touched \$13 trillion. That is a remarkable statistic considering that lenders are in fact paying a borrower for the privilege of extending a loan. According to data from Bloomberg, that \$13 trillion figure represents 26% of global sovereign debt supply and 15% of the global economy for 2018. Negative yields reinforce our belief that loose monetary policies only beget more radical monetary policies. Prudent investors inherently suspect that something is wrong and wonder who is buying all this negative yielding debt.

Peter Chiappinelli, a portfolio strategist at money management firm GMO in Boston, believes that part of the blame rests with the Bloomberg Barclays Global Aggregate Bond Index. The mystery buyer, says Chiappinelli, *“is anybody who owns a passive mutual fund tied to the Global Bond Aggregate Index. Or anyone*

⁵ Jesse Felder, “Welcome to the Everything Bubble,” *The Felder Report*, May 13, 2015.

who might now own a passive exchange-traded fund (ETF) tied to a global bond index. Or anyone who owns a popular target-date fund that has passive exposure to global bond indexes. In other words, millions of Americans.” Ten-year U.S. Treasuries may only yield an interest rate of 2%, but German bonds yield negative -0.4% while Switzerland yields -0.6%. Interestingly, gold bullion, once ridiculed as a pet rock, now yields more than \$13 trillion of global government bonds that currently yield less than nothing.⁶

Central bank policies have led to the surging popularity of passive index investing, which in turn creates the conditions that allow negative yielding bonds to exist. One dot connects to another dot. In a *New York Times* opinion piece, Ruchir Sharma, chief global strategist at Morgan Stanley, discussed another consequence of low interest rates—zombie companies.⁷ Sharma cited a report from the Bank for International Settlements, which found that 12% of publicly listed companies around the world are now “zombie firms”; meaning, these companies do not earn enough profit to even cover the interest payments on their debt outstanding. Sharma concluded that “Once the crisis hit, governments erected barriers to protect domestic companies. Central banks aggressively printed money to restore high growth. Instead, growth came back in a sluggish new form, as easy money propped up inefficient companies and gave big companies favorable access to cheap credit, encouraging them to grow even bigger.”

Connecting more recent dots, one finds that corporate profit growth is struggling. United Parcel Service (UPS) reported first quarter results that missed profit estimates by a wide margin, no surprise given that the Cass Freight Index showed similar weakness recently and global trade volumes are now falling at their fastest rate since 2008. 3M reported disturbing results that sent its shares down to its largest one-day drop since the 1987 crash. 3M is a bellwether for the U.S. economy. In fact, 3M is a great proxy for the economy because they sell “stuff.” Intel disappointed investors when it cut its revenue guidance. The company’s inventories continue to surge, an indicator of weaker future production numbers. This is not just an Intel problem—the entire economy is witnessing a surge in inventories that normally one sees during a recession. Because stocks are not anticipating an earnings recession, the downside risk is significant.

One anonymous trader commented that the stock market has morphed into a video game where all the children run around in the playground without any real idea of what game they are playing. He believes that the “kids” replaced the “adults” who left the game years ago. The kids, devoid of critical thinking skills, but armed with “technology” that substitutes for “brains”, have congealed into a trend following mass. The only rational way to play their “game” is to simply ignore the fundamentals in favor of the trend. If more buyers than sellers emerge, the market will go up and define a rising trend that the professional herd, armed with their technology, will slavishly follow. The reverse is true when more sellers than buyers emerge, leading to a declining trend.

The price action in 3M after their quarterly earnings announcement highlights how trend following now surpasses humans analyzing fundamentals. The year-to-date price action in MMM illustrates the new game. On January 1, 2019, MMM stock traded at \$190. MMM is also a major component of the Dow Jones Industrial Average (DJIA), a stock market index that indicates the value of thirty large, publicly owned companies based in the United States. 3M’s business is clearly under pressure, a simple piece of information conveyed months earlier on several occasions. However, fundamentals matter little in a one dimensional kid’s market. Far more important is the fear of missing out (“FOMO”) and trailing one of the world’s major benchmarks, by which consultants judge professional investors. The “kids” bought MMM blindly, following the trend straight up from \$190 to \$220 over the first four months of the year.

⁶ Jason Zweig, “Let’s Be Honest About Gold: It’s a Pet Rock,” *The Wall Street Journal*, July 17, 2015.

⁷ Ruchir Sharma, “When Dead Companies Don’t Die,” *The New York Times*, June 15, 2019.

However, when 3M reported their earnings on April 25, reality reappeared—the entire four month trend chasing uptrend evaporated in a single day.

The "kid's market" turned surreal on June 26. Stocks surged just after 5am EDT because of a CNBC news headline which quoted the U.S. Treasury Secretary that a US-China trade deal "is" 90% complete: a clear indication that a trade deal with China is once again a possibility.⁸ The headline triggered a flurry of computer algorithm buying in the stock futures market. However, there was one simple problem: CNBC made a grammatical mistake. Instead of reporting "is", the U.S. Treasury Secretary was using the past tense, and what he really said is that 'we *were* about 90% of the way' on the China trade deal. Therefore, the news headline only regurgitated information that was already known. No matter—computer algorithms immediately bid the market higher by 1% on the incorrect headline. Once CNBC corrected the headline, the market gave back most of the gain. Price action continues to outweigh fundamentals.

A veteran investor recently noted that the only time he had seen such disregard of company fundamentals was 1989 in Tokyo, a scene he was sure that he would never see again. Back then, to understand the Japanese market, one needed to be a "shinseiji" or literally a newborn human, because if you had prior experience you could not make any sense of the market or profit from it. Like the nearly religious belief in the technology bubble, the housing bubble, and now the "Everything Bubble," people believe what they believe until reality reappears in the most unpleasant way. Those convinced that this time is different can ignore the warnings and continue to follow the price trend higher. By contrast, prudent investors who believe that history has lessons to teach should connect the dots and invest accordingly.

With kind regards,

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke extending to the right.

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⁸ Tyler Durden, "In Absurd Fiasco, Entire Market Spike Due to a CNBC Mistake," Zero Hedge, June 26, 2019.

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The St. James Investment Company is an independent, fee-only, SEC-Registered Investment Advisory firm, providing customized portfolio management to individuals, retirement plans and private companies.



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