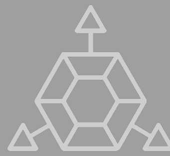
The Type 2 Investor

January 15, 2019

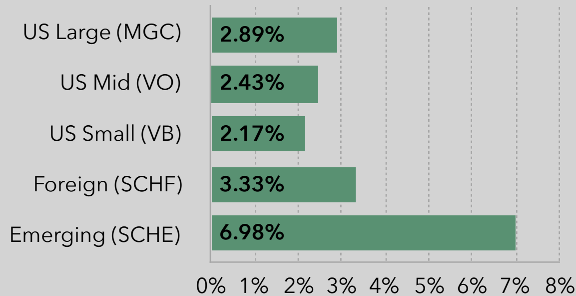


December 2019

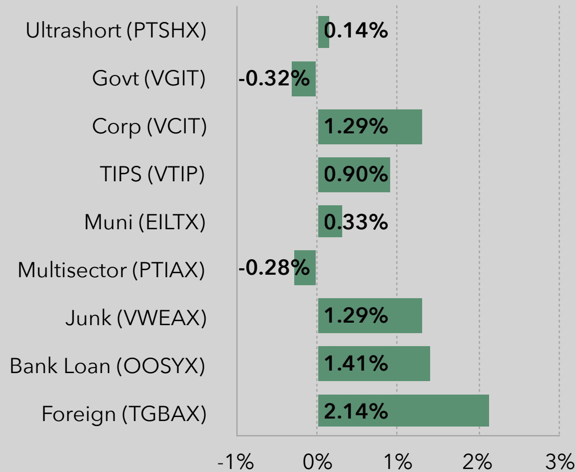
Economic Data

- US payrolls came in below expectations with only 145,000 jobs added, capping off a year that saw the lowest number of job gains since 2011; unemployment was unchanged at 3.5%
- Retail sales were up 0.2% in November
- Y/y inflation (CPI) rose three-tenths to 2.1% in November
- Existing home sales fell 1.7% in November
- The Conference Board Leading Economic Index (LEI) was unchanged in November

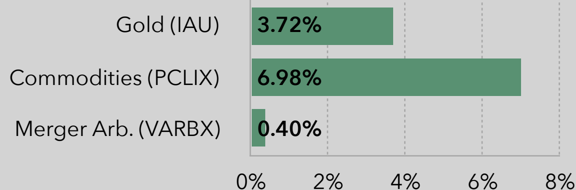
Stocks



Bonds



Alternatives



Performance data provided by Morningstar.

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system – type 2 – that we want in control of our investment portfolios.

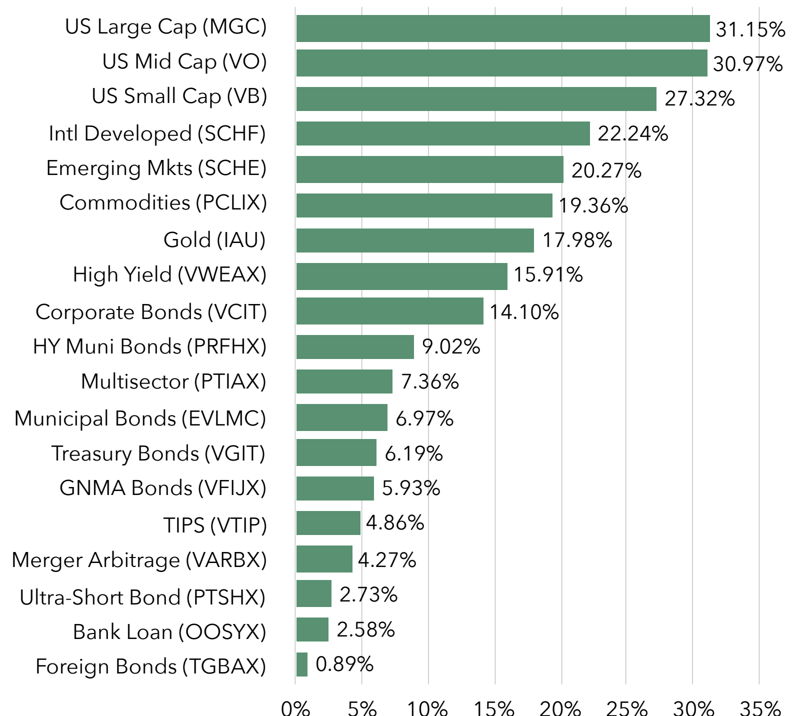
The End of the Twenty-Tens

We're finally in the Twenties, so I no longer have to stumble in search of the appropriate term to identify the decade anymore. No more aughts. No more… teens, was it? I doubt these Twenties will be as "roaring" as the last set, but the last decade certainly wasn't bad. It was a decade without a single month of economic decline that saw the S&P 500 triple in value. And 2019 was exceptionally good, as the index bounced back from a loss in 2018 to return 31.49%, making US Large Cap stocks the best performing asset class we track. Mid and small-cap domestic stocks weren't far behind, while international and emerging lagged but still posted returns north of 20%.

Overall bonds did pretty well last year, too, buoyed by falling interest rates and a yield curve that went inverted. Riskier bonds did particularly well, with spreads on junk bonds tightening 1.75% and investment-grade corporate spreads tightening 0.59%. Bank loans had a tougher go of it due to their floating nature, and concerns about weak covenants sent some investors towards the exits.

On the alternative side of things gold and broader commodities posted excellent returns, coming in just behind the equity categories. Gold was helped by lower interest rates, which reduce the opportunity cost of holding an asset that doesn't yield anything, as well as serving as a safety asset for those with concerns about a recession, or war with Iran, or any number of other things. Oil also had a good year, largely driven by geopolitical tensions in the middle east. Finally, good old reliable merger arbitrage did what it was supposed to do, and gave us a positive mid-single digit return for the year.

2019 Investment Vehicle Performance



Guess Again

This is the time of year where I review all my predictions from the previous year, because despite knowing full well humans are bad at predicting the future, I keep doing it anyway. Most predictions are soon forgotten after they are made, and only remembered later if the original prognosticator obnoxiously reminds you of them if he was right. I think it is a worthwhile exercise to also talk about what we get wrong, which helps keep overconfidence in check.

- First up, I predicted the Detroit Lions will make it to the playoffs. With a record of 3-12-1, the Honolulu Blue and Silver were once again at the bottom of the division. Woof. My reality team didn't do well, but at least one of my fantasy teams won the championship . **-1**

- I predicted the December 2018 - January 2019 government shutdown revolving around border security would be the longest shutdown of the federal government in US history. This wasn't really a bold call, as I made it on day 19 of the partial government shutdown, and the longest at the time was the 21-day shutdown in 1995-96 during the Clinton administration that was most remembered for the Monica Lewinsky scandal. This one ended up lasting a record-setting 35 days, and reminded me again how little I need the federal government in my daily life. **+1**

- *"Rate hikes are so 2018. I believe no further rate hikes will happen this year, and the next move is more likely to be a cut in either late 2019 or early 2020…The Fed can't ignore the yield curve much longer. St. Louis Fed President James Bullard says a rate cut 'may be warranted soon' to counter trade-war risks. I would be mildly surprised if that happens at the next Fed meeting here in June, but I think they will adjust language to telegraph the move for the following meeting at the end of July. As it stands now, at least two quarter-point rate cuts are needed to normalize the yield curve."* We got a rate cut in July and two more after that. **+1**

- *"The messed up looking yield curve is a harbinger for recession. As mentioned before I think this will be in late 2019 or early 2020, but we won't officially know until long after that."* The clock is still running on this one, although the rate cuts have reduced the risk of recession. **Zero**

- *"The UK is due to leave the European Union on 29 March, 2019 and still doesn't have a deal in place. I don't have any particular expertise on the issue, so your guess is as good as mine as to whether they reach a deal, or get an Article 50 extension, or just change the law and unilaterally decide to stay in the EU under the old terms. So for fun I'll take the nuclear option and predict that the UK leaves the EU with no deal in place and we see where the chips fall."* With Boris Johnson in power now and his Conservative Party with a comfortable majority, the Withdrawal Agreement Bill passed on Thursday, clearing the way for a January 31 Brexit. Not a hard Brexit. **-1**

- On the S&P 500: *"Analysts are expecting earnings to grow 16.1% (3Q y/y), which would amount to $151.43. Per usual, I think that's overly optimistic, but let's go with it. If we apply a 17.8 trailing P/E multiple – halfway between the current 19.9 and historical average of 15.7 – we get 2695. That's only about a 4% gain, which I would be happy with considering the way 2018 ended. As good a guess as any, I suppose."* Reported earnings for the S&P 500 were up only 1.9% (3Q y/y), and we are currently in an earnings recession, so I was right about analysts' expectations being too high. But in the end it didn't matter, and the S&P 500 ended the year at 3230. **-1**

- *"Mortgage rates should stay low for a while." -July 2019.* Okay, so six months isn't that long, but mortgage rates were at 3.75% then and have stayed in a low, stable range since then and sit at 3.64% now. **+1**

- *"Emerging markets have been lagging so far this year, but a rate cut in the US could give emerging market central banks some wiggle room to ease policy without risking capital flight." -July 2019.* Emerging markets stocks ceased to lag US stocks in the final five months of the year, and actually slightly outperformed the S&P 500 over that time. **+1**

- *"Perhaps Clover is just an isolated incident, and not just the first sign of worse things to come in the leveraged loan market. I'm inclined to believe we'll see more of these, though, but only time will tell." -August 2019.* Bank loans significantly lagged in 2019 relative to high yield bonds, and the total dollar value of defaults

Tactical Asset Allocation					
Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income			●		
Ultrashort					●
US Govt.		●			
TIPS			●		
Multisector			●		
Bank Loans	●				
Foreign Bonds				●	
Equities		●			
Large Cap	●				
Mid Cap		●			
Small Cap	●				
Developed Intl.			●		
Emerging			●		
Alternatives				●	
Commodities				●	
Hedging					●

Binge Box

The Witcher (Netflix)

The Witcher is meant to be Netflix's answer to HBO's *Game of Thrones*. Henry Cavill stars as Geralt of Rivia, the titular Witcher, who roams The Continent in search of monsters to kill for coin. The show's timeline isn't linear, which isn't clear in the beginning and can be a bit confusing. I also found it a little more difficult to get into without having read any of the books or played any of the video games that would have given me a better understanding of the lore and politics of this world. Despite its flaws, however, it's still an excellent binge. And with Season 2 green lighted before season 1 was even released, and with eight books and three games in the series to draw story from, it seems safe to get invested in this show.

increased over the previous year. Furthermore, the rate accelerated in the October to November 22 period, which saw 11 defaults totaling $7.8 billion, which represented a third of the defaults so far last year, according to Fitch Ratings. **+1**

Add it all up, and I was +2 for the year. Right more than I was wrong, but not great. So I'm going to try to make fewer predictions for 2020, and avoid altogether making any about the Detroit Lions.

- Y/y leading economic indicators are at 0%. If this goes negative, the risk of a recession increases. Consumer expectations for the future, which are negative relative to their views on the present, are also flashing a recession. However, wage growth is getting to the point the Fed would usually raise interest rates in order to combat inflation, however the Fed has done just the opposite so this has eased concerns about a recession. So what's the call here? I think the odds of recession in 2020, while still a legitimate risk, have fallen below 50% and is no longer the base case.

- Federal Reserve Chairman, Jay Powell, who commented: "I think we would need to see a really significant move up in inflation that's persistent before we would even consider raising rates to address inflation concerns." This tells me rate hikes aren't coming this year, and there is even the potential for further cuts if conditions warrant.

- The US will not go to war with Iran. The assassination of top Iranian general Qasem Soleimani was met with a measured response by Iran, who launched over a dozen missiles at two US bases in Iraq that resulted in no loss of American lives. President Trump doesn't want war, and neither does Iran, particularly after the tragic mistake of shooting down Ukraine International Airlines Flight 752, which has led to protests calling for the Supreme Leader Ayatollah Ali Khamenei to step down. Furthermore, according to a poll of registered voters conducted by Morning Consult, only 23% of registered US voters could identify Iran on a map of the world. I feel like there should be a law that if at least half of US citizens can't identify a country on a map, we shouldn't be allowed to go to war with them.

- Repo market funding by the Fed, which is not quantitative easing according to the Fed, but let's call a spade a spade, should continue to put pressure on the yield curve to steepen, which is bearish for the dollar. Twin deficits (government deficit plus trade deficit) should lead to a weaker dollar, as well, which makes gold and foreign investments, particularly emerging markets, more attractive.

- And finally, it's time yet again to engage in that ludicrous exercise of guessing the S&P 500. According to Yahoo! Finance, the average prediction of 23 Wall Street firms is only 3,333—just over 1% higher than today. Piper Jaffray is the most bullish, expecting 3,600 by year-end—a modest 9% gain from here—while Francois Trahan at UBS is the most bearish, expecting a 9% drop to 3,000. I tend to agree more with Francois. As always, analysts are overly-optimistic with earnings expectations, projecting 17.4% growth (3Q y/y), which would amount to $156.01. I don't think it will be that high, but if we apply a 20.25 trailing P/E multiple — halfway between the current 24.8 and historical average of 15.7 — we get 3159. That's about a 4% loss.

Thanks for reading and have a happy New Year.

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About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide personalized financial planning and fiduciary investment management services to select clients. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.

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