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In Pursuit of Value

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Quarterly Outlook

Unanimity is rarely found on market issues, but perhaps the single exception is the statement that, "It's a Difficult Market". To disagree is a secular form of blasphemy, and is sure to invite the Market Gods to quickly disabuse the offender of any notion of control of his P&L. It is therefore the least controversial thing one can say, and one of the most reliable opening gambits in the bonding of traders with one another.

So it is that 2016 has been a difficult market, although on a color scale from neutral green (easy) to deep red, blood-curdling, acidic, bubbling crimson this year has been yellow (never green – see first paragraph). Last year, for MLP investors anyway, was at the end of the Ph scale.

Surprises are what usually cause trouble, and forecasting them is by definition difficult. Fortunately the Federal Reserve hasn't provided any, at least for those who rely on them raising rates only when they've run out of reasons not to. The U.S. economy is complex with countless measures of its health, and like a patient undergoing every imaginable test there's always some cause for concern. The UK's Brexit vote (more on this below) was one of many reasons to delay an otherwise planned rate hike in June, and equity markets shuddered before resuming their ascent while economic growth was unaffected.

Pity the CFO or CIO who has funded liabilities or invested assets based on the Federal Open Market Committee's (FOMC) "forward guidance" of where they expect rates to be. Such trusting faith in the FOMC's forecasting ability (after all, they're trying to forecast their own actions) has been poorly rewarded. As the developed world has sought more strenuously to stoke inflation, the explanation of equity valuations has to include the actions of the Bond Refugee.

Fed Chair Janet Yellen -- so far, not that hawkish

One conjures images of huddled bond investors drifting hopefully on boats to more welcoming environs. Their business suits are ragged, and each carries a sack of money seeking a home, albeit a sack with holes as negative real returns slowly leak away what they've brought. They are fleeing financial repression imposed by the world's central banks, and equities represent more fertile ground. Of the forecastable surprises that might cause a downward revaluation of stocks, one is an abrupt end to monetary policy as we know it. Fortunately, the trend is clearly for continued lethargy by the Fed. Given the ample warnings that have preceded no change in policy, one must assume that when they do reach a "This time I really mean it" emotional state they will be even more vociferous.

Relative valuations between bonds and stocks continue to strongly favor the latter in our view (see September's newsletter, How Expensive Are Stocks?). Absent a wholly uncharacteristic shift to a hawkish stance by the FOMC, the bear case for stocks relies on

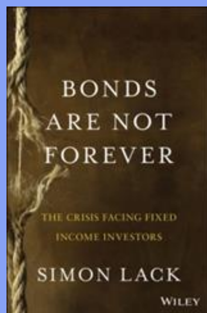
surprises we can't see. As weeks pass without a shock, cash is inexorably put to work.

Today's seller of stocks must presumably hold cash while awaiting a better re-entry point. Apart perhaps from London property which has enjoyed a relentless multi-generation bull market, there are few attractive choices (see The Shrinking Pool of Cheap Assets). It's certainly not an easy market, because a surprise could expose inadequate valuations. But based on what we see today, a combination of stocks and cash depending on risk appetite still looks to be the best choice available. Avoid bonds. MLPs remain the cheapest sector in the equity market.

The Phony War

Three months ago the UK chose Brexit, to the great surprise of most pundits and many UK friends of mine. The political and market turmoil that followed were brief, and most of us await further developments. Some have dubbed this relative inactivity the "phony war," evoking 1939 following war's formal declaration but before the 1940 bombing raids of Britain by Germany's Luftwaffe made it decidedly real. As I found on a recent trip back to London, the extended uncertainty and weak UK negotiating position are a source of great concern – Londoners voted overwhelmingly to Remain in the EU. For citizens in a global financial center it creates very real issues around job security, possible employment-dictated relocation to other EU countries, and questions about owning property. Whereas for a transplanted Brit safely in the U.S. and therefore largely immune to the consequences, the upcoming negotiations will be simply fascinating. But I most certainly share their concerns.

SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.



Start with Article 50, the section of the Treaty of Lisbon which governs a country's exit from the EU. It prescribes a two year period for negotiation which as a practical matter won't be extended. The EU has generally refused to engage in "pre-negotiation" negotiations. Since triggering Article 50 appears to lead inexorably to Brexit two years later, it's unclear how much negotiating leverage the UK will have during this period. Optimistically, there may be a general desire on both sides to maintain goodwill but there's no guarantee of this. Prime Minister Theresa May has evidently concluded that the benefits of continued delay in commencing negotiations are limited, having announced their start within six months.

The Best Alternative To a Negotiated Agreement (BATNA) for the UK is to rely on World Trade Organization (WTO) terms of access to the EU. Which is to say, the UK is in a weak position to reject the terms of almost any conceivable post-Brexit EU relationship. Added to which, Brexit promoters promised controls on EU immigration to the UK combined with continued access to EU markets, whereas the EU seems adamant that people must move as freely as goods and services. These fundamentally different visions of life outside the EU seem totally irreconcilable.

However the UK decides to trigger negotiations, and whatever they ultimately deliver, it's a good bet that the core promise of Brexiteers will not be deliverable. At which point there will be a crisis. Will the UK be forced to accept a Brexit on terms that were clearly not the basis on which the referendum result was achieved? Or will there be an opportunity to reconsider? Put another way, if the EU's logical negotiating strategy is to insist on unattractive terms so as to dissuade others from leaving, what could be a better endorsement of the beleaguered European project than a country changing its mind once faced with the reality of being outside?

Combine the high likelihood of eventual Brexit terms that don't match what was promised with the fact that current Prime Minister Theresa May was not elected in a general election and was even a (quiet) campaigner to Remain. It makes a second referendum, or an early general election, once the terms of Brexit are known highly likely. Among my London friends this is not a widely held view – and yet from 3,500 miles away albeit not as engaged in the issues as they are, it seems to this observer to be unavoidable. Brexit is not yet a certainty.

To Our Clients

At SL Advisors it’s important to us that your investments with us are aligned with your financial situation and objectives. If there have been any relevant changes from your perspective or any reasonable restrictions you wish to impose, please let us know and we'll be happy to discuss appropriate modifications. Of course, anytime you have any questions or concerns don’t hesitate to contact us. We value your business, and never forget the faith you have placed in us as stewards of your capital.