FED COMES TO THE RESCUE

The Federal Reserve started taking the drugs in 2008. The drugs in this case were lowering the Fed Funds rate and Quantitative Easing (QE) when it was buying U.S. bonds in its balance sheet. Ben Bernanke, Chair of the Fed, and Henry Paulsen, Secretary of the Treasury hatched the plan to do these things which at the time seemed like the best thing to do in the middle of the "mortgage crisis". They also bailed out banks, automobile companies and others. It worked at the time. The problem is that the Fed continues to be addicted to these drugs in an effort to continue supporting the U.S. economy. With the unemployment rate at an all-time low of 3.7%, the U.S. economy the strongest in the world with GDP growing at 2.1% per year, inflation low at around 1.5-1.8%, wages going up slowly, real interest rates positive and the dollar strong, with a corporate tax cut in 2018 and a record high stock market, why would the Fed lower interest rates in July by 25 basis points? We are the best economy on the planet. We are not in crisis mode and not in a recession. It seems that the Fed is determined to extend the economic recovery at all costs.

Economic cycles and stock market cycles are normal in economic history. We had a bubble in the stock market led by dotcom stocks and it burst in 2001-2002. We had a bubble in 2007 and it burst in 2008. The Fed is creating another bubble as will the tax cut of 2018. The current trailing Price/Earnings Ratio (P/E) of the S&P 500 is 23.15x versus a historical norm of 14.5x. One of the reasons is that interest rates are so low that investors are taking on more risk by buying more stocks, emerging market debt, high-yield debt, etc. The higher the stock market goes, the bigger the bubble and the bigger the burst when it happens. The yield curve is slightly inverted (short rates higher than long rates). Maybe the expected cut is justified.

FactSet

FactSet Earnings Insight reports that second quarter earnings declined by 2.6% and revenues grew by 4.0% for the S&P 500 versus the second quarter one year ago. It projects earnings to decline 1.9% in the third quarter and revenue growth to be 3.2% in the third quarter. It projects the earnings to grow by 4.9% in the fourth quarter and revenue to grow by 4.0%. For all of 2019 it projects earnings growth to be 1.7% and revenue growth to be 4.4%.

The increase in the value of the S&P 500 so far this year has primarily been because of P/E expansion rather than earnings growth. There is more speculation in the market rather than investing in the market. The move by many investors to go passive or invest in index funds or ETFs has caused zombie stocks to rise along with high quality stocks. This is what happened in 2000. When companies like Uber and Lyft can go public while losing billions each year, history tells us something is wrong.

Hoisington

The following commentary is from the Hoisington Investment Management Company "Quarterly Review and Outlook Second Quarter 2019":

> With the current global experience of more than two decades of subnormal economic growth in the face of extreme over-indebtedness, numerous cases of sustained historically low levels of real yields have come into focus and the following analysis indicates this recent pattern is likely

to persist. If debt levels as percentage of total output continue higher, then investors will likely face even lower future real yields. Additionally, as inflation recedes in response to softening economic conditions, which the Fed acknowledged again in its June meeting, then both determinants of long government bond yields – the real yield and inflationary expectations - point toward noticeably lower nominal yields.

Diminished Returns On Capital

In a normal cyclical setting, we might assume that lower real yields could boost economic growth, but under current conditions lower real yields may, in fact, merely reflect that returns on capital have declined significantly. When real yields are low or negative, investors and entrepreneurs will not earn returns in real terms commensurate with the risk. Accordingly, the funds for physical investment will fall, and productivity gains will continue to erode as will growth prospects.

On average, over the past ten years, real ten-year government bond yields have been slightly negative in the UK and Japan and positive by a mere 10 basis points in Germany. In the past five years, when nominal interest rates were slightly negative in Japan and Germany, real yields were even more negative since modest inflation continued. In each of these cases, negative real rates have been no panacea for the growth problems. Indeed, the span of sustained poor economic performance has increased. Now, evidence has emerged that the U.S. real rate, while still positive, is declining and that investors here are being forced to accept lower real yields similar to investors in foreign markets. The implication: decreased capital returns will prolong the period of poor economic growth in the United States, as has been the case in Japan and Europe. If the solution to the subnormal growth is an even faster acceleration in debt, then this cycle will continue to repeat.

When investors believe that certain government policies will reduce economic growth and can verify such a pattern, they are inclined to cut their expectations for economic growth while also downshifting their inflationary expectations. With growth and inflation expectations in a constant process of influencing each other as well as determining the level of nominal bond yields, both independent variables support two interest rate theorems: (1) Federal debt accelerations ultimately lead to lower, not higher interest rates; and (2) monetary decelerations ultimately lead to lower, not higher interest rates. Strong evidence is emerging that these two theorems are developing.

Cyclical Deterioration

Fundamental economic indicators suggest that recessionary forces may be advancing faster than is generally recognized inside and outside the Fed:

(1) Real gross domestic income (GDI) gained at a very meager 0.76% annual rate in Q4 2018 and Q1 2019, well below the 2.65% growth in real GDP (Chart 2). Over the past year, real GDP growth was 3.2%, versus 1.7% for GDI, hardly ebullient growth. Normally, GDI and GDP have moved together going into recessions but prior to the severe recession in 2008, GDI led GDP, just as presently, a clear warning sign.

(2) Net national saving as a percent of gross national income was just 2.4% in the first quarter of 2019, well down from the post 1929 average of 6.4%. Based on net national saving for this year's first quarter, the economy is just as ill-prepared for recession as in 2007, the year before the Great Recession.
(3) Real disposable income in the latest month was below the level attained in December 2018, the potential cyclical peak.
(4) Manufacturing, which is the high value added sector, has also declined since the end of 2018 and shows the most definitive sign of already being in a recession.
(5) The transportation sector, rail, truck and air freight, have all declined this year.
(6) The Economic Cycle Research Institute's weekly leading economic indicator in late June was more than 2% below the cyclical peak reached about two years ago.

In the December 2018 meeting, the FOMC projected three increases in the policy rate would occur this year. Subsequently, the FOMC abandoned those plans and recently has indicated they are open to a cut in the policy rate. Such guidance, however, is not equivalent to a more expansionary monetary policy even though there has been a significant downward shift in market rates. The nine increases in the policy rate as well as other monetary changes are still a noticeable drag on growth.

Accordingly, monetary restraint is continuing to weigh on economic growth. Inflation, which fell below the Fed's targets and most Wall Street forecasts, will remain on a downward path. These cyclical forces suggest that inflationary expectations should continue to fall this year and next as the economic growth rate weakens further. This means that a mild recession would push the real rate into negative territory. Thus, both determinants of the nominal long risk-free rate (i.e. the real rate and inflationary expectations) are directionally favorable for further interest rate declines, although the path will continue to remain volatile.

Conflicts of Interest

The following commentary is from "Paying to Gain Access – Investors lose when 'revenue sharing' keeps some great-but small-mutual funds off the platforms of big wealth managers and online brokers" by Daren Fonda, published in the July 8, 2019 issue of *Barron's*:

> Revenue-sharing deals—known less charitably as "pay to play" arrangements—between fund companies and brokerages have long been legal. Brokers that are dual-registered as registered investment advisors (as most are) must disclose the payments to investors. But revenue-sharing deals are controversial, and are now at the heart of a sweeping new set of regulations that the Securities and Exchange Commission recently adopted. On the surface, these changes sound good: Brokers will soon have to abide by a "best interest" standard when recommending funds; brokerage firm and client disclosures are being revised; and firms will have to show that they have instituted procedures to mitigate or eliminate conflicts of interest.
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> Critics argue that disclosures don't eliminate conflicts of interest, and that large fund complexes will still have an edge over smaller firms. "We have an industry where brokerage firms are telling the public they have an open architecture, but that's only for the fund

companies willing to pay to play," says Phil Shaffer, a former managing director at Morgan Stanley and one of its top advisors, who handled more than $5 billion in client assets before leaving the firm in 2017 to become an independent advisor. "Small fund companies have no chance," he says, because they can't afford the payments it may take get on a platform and make it to the ultimate prize—getting into a popular model portfolio.

Given the hurdles, many small fund shops don't even bother trying to get into the big brokerages.

Large fund complexes have a clear edge in their ability to pay for distribution and marketing. While asset-based fees may be standard, fund complexes devote substantial resources to getting exposure on brokerage platforms. Payments may come in a variety of guises: sponsoring conferences, paying for a brokerage firm's training program for advisors, or purchasing "data analytics" packages.

These payments may be perfectly legitimate arrangements between fund companies and brokerages that supply the venues to connect with clients and advisors. But boutique asset managers don't have $300,000 to, say, sponsor an industry conference, or another $200,000 for a data package on funds used by advisors or brokers. Critics assert that the payments create a stacked playing field—with large firms paying for access while smaller firms get shut out.

On Wall Street, Morgan Stanley for years published prices outlining financial commitments that fund companies could make. According to the disclosures for 2015, fund companies were granted opportunities to be "Emerging Partners" for $250,000 a year, or $550,000 to be "Global Partners." They also paid for mutual fund sales-data packages at $300,000 each for Global Partners and $150,000 for Emerging. All told, those fees amounted to at least $28.6 million for Morgan that year.

Morgan Stanley scrapped its Global and Emerging Partners program. But its 2019 disclosures state that some fund families still committed up to $600,000 a year for conferences, $125,000 for advisor training, and up to $600,000 for data analytics.

What did the money buy? Morgan Stanley says the $600,000 in conference payments are purely to reimburse expenses. According to former executives with Morgan Stanley, however, the payments were made for shelf space on the platform and access to advisors at conferences and branches.

"If you wanted to get on their platform, you didn't just have to pass their due diligence, you'd have to write a big check," says Shaffer, the former Morgan Stanley advisor. He says fund companies routinely covered costs for conferences so that they could make presentations and pitch advisors directly.

One such conference, he says, took place at the Phoenician Resort in Scottsdale, Ariz., in May 2017. A morning session included a talk from a chief economist of a large asset manager. Advisors and their spouses could pick a leisure activity in the afternoon, such as fishing, rafting, or skeet shooting. More than 40 companies sponsored the conference, he says, with investment managers or sales people seated at virtually every table for dinner with Morgan advisors. The evening's headline entertainment was the Beach Boys.

According to another former Morgan executive, fund companies paid a minimum $250,000 to be on the platform and would need to raise at least $156 million with Morgan clients to break even. They would pay an additional $350,000 to $600,000 for opportunities to sponsor events, with additional charges of $100,000 for national events and $50,000 for regionals. "Unless they were willing to pay," he says, "they didn't get full access to the advisors." Morgan Stanley denies that exposure to its platform and advisors was based on fund company payments.

Much of this has gone on for years. But the payments and price lists have been formalized in recent years, and they are being disclosed due to regulatory pressure for more transparency. Morgan Stanley's 2019 disclosures, for instance, list 61 fund companies that contributed at least $250,000 each to the firm in 2017, including Legg Mason, Franklin Templeton, American Funds, BlackRock, First Eagle, PIMCO, and Invesco. Contributions from these "revenue-sharing fund families" added up to at least $15 million in revenue for Morgan Stanley, not including revenue from other sources such as data and asset-based fees.

"Who loses out? It's the small asset manager that can't afford to pay, and the clients who don't have access to the best managers," Shaffer says. One fund manager had a superb track record but couldn't get on Morgan's platform, he said, because it would have cost $400,000 in annual fees—equivalent to the cost of two research analysts that the manager couldn't afford to lose.

Morgan Stanley says it eliminated the $250,000 minimum to be on its platform in 2017, and it introduced a sliding scale for asset-based fees, starting at 0.16% down to 0.01%. The new revenue-sharing program "reduced the potential for conflicts by requiring level and consistent economics across all money managers on the platform," said a spokesperson. Payments for conferences are optional, she added, and they go to reimbursing expenses. Conferences are "focused on training and education" and are now open to any fund companies, not just the largest.

One former Morgan executive said the firm was well within its rights to sell access to advisors, and that data packages have become a key revenue stream. Fund companies could subscribe to seven data-package levels, including total assets managed by the advisor and team, fund categories, product sales, and conferences attended. For $400,000 or more, for instance, fund companies or wholesalers could buy data that included the percentage of their products that the advisor used. According to former executives, fund companies could also buy data at the individual fund level. Subscribers who left the program were subject to a $100,000 reinstatement fee when resubscribing.

Morgan Stanley flatly denies this practice: "Data packages do not include any information about individual funds or holdings," said a spokesperson for the firm.

However, sources at multiple brokerages say this practice is common. "If an asset manager wants to sell more product, they want to know as much as possible about each advisor," the former executive says. "Morgan says, 'We're not going to give you that information, we'll sell it to you.' It's a revenue stream for them, and the asset managers are willing to pay for it."

None of these practices are likely to go away with pending regulatory requirements; additional disclosures won't level the playing field. And the price of admission to the wirehouses is likely to remain high.

Conclusion

The Fed is expected to lower the Funds rate by 25 basis points on July 31 and again by 25 basis points in September. Both of these should help the stock market temporarily, but as Hoisington says, there are indications that our economy is slowing. Similar monetary policy has not worked well in Japan or Europe. FactSet reports that the Wall Street consensus is that 2019 will not be a good year for earnings growth. The S&P 500 Price/Earnings Ratio is back where it was last year before the fourth quarter. It is overpriced by all historic norms but can go higher temporarily.

We still recommend a neutral asset allocation of 40%-50% stocks and 50%-60% bonds/alternative investments based on the information in this letter.

We have added a Conflicts of Interest section this quarter and plan to do so in the future. We will be explaining how wealth management and consulting firms have conflicts of interest that are not in their clients' best interest.

Jamison Monroe
Chairman & CEO
Director of Consulting

Monroe Vos has over $5 billion under advisement for 97 clients. Recent rankings are as follows:

- The 2nd largest independent registered investment advisor ("RIA") in Texas according to *Financial Advisor* magazine in July 2019
- 54th largest independent RIA in the United States as reported by *Financial Advisor* magazine in July 2019