ROCKEFELLER
CAPITAL MANAGEMENT

Greed, Fear, and a Truce

Bloom off the Crypto Rose; Sleepless in Beijing

It was quite an eventful November bookended by market moving events. At the start of the month, the Iranian oil sanction turned out to be less restrictive than expected as eight countries were allowed to continue buying Iranian crude, thus triggering a sharp decline in oil prices. Investors initially cheered the outcome of the U.S. mid-term elections – a split Congress but a bigger Republican senate majority that should reduce the odds of a Democratic sweep in 2020. However, the optimism faded as it became clear that the GOP was haemorrhage suburban and women votes, and the incoming House Financial Services Committee chair, Maxine Waters, threatened to roll back financial services deregulation. Equities and U.S. Treasury yields then drifted lower off a string of softer-than-expected economic data and reports of weak demand for the new iPhones. Corporate bond spreads also hit two year highs, a sign of growing unease about the sustainability of the business cycle. However, some emerging markets – India and Indonesia in particular – rallied sharply as they would benefit from lower yields and falling crude prices. On November 28th, Fed Chair Jerome Powell sparked a rally with a somewhat dovish speech, and U.S. Treasury yields slid even lower, with the 10-year rate dipping below 3% at month end. Interestingly, major currencies such as the greenback, the euro, and pound sterling were roughly flat for the month in spite of falling U.S. Treasury yields. Investors may be waiting for more clarity on the Brexit and Italian budget impasses. They will, however, get a reprieve on the trade front – the most consequential Sino-U.S. meeting in recent years ended with Trump agreeing to halt further escalation in tariffs for now, thereby giving more time to work out a settlement. With the Fed seemingly turning dovish and the trade war hitting the pause button for now, investors may get a Santa rally rather than a lump of coal this December. Lastly, we bid farewell to former President George H. W. Bush, a real gentleman whose life exemplified a thousand points of light, from his WWII heroism, distinguished public service, to many charitable endeavors.

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EQUITY MARKET INDICES[1]	10.31.18 Price	11.30.18 Price	MTD Change	YTD Change
MSCI All Country World	485	491	1.3%	-4.3%
S&P 500	2712	2760	1.8%	3.2%
MSCI EAFE	1815	1810	-0.3%	-11.8%
Russell 2000®[2]	1511	1533	1.4%	-0.1%
NASDAQ	7306	7331	0.3%	6.2%
TOPIX	1646	1667	1.3%	-8.3%
KOSPI	2030	2097	3.3%	-15.0%
Emerging Markets	956	995	4.1%	-14.1%
FIXED INCOME				
2-Year US Treasury Note	2.87%	2.79%	-8	90
10-Year US Treasury Note	3.14%	2.99%	-16	58
BarCap US Agg Corp Sprd	1.18%	1.37%	19	44
BarCap US Corp HY Sprd	3.71%	4.18%	47	75
CURRENCIES				
Australian *(AUD/$)*	1.41	1.37	3.4%	-6.3%
Brazilian Real *(Real)*	3.72	3.87	-3.7%	-14.3%
British Pound *($/GBP)*	1.28	1.27	-0.1%	-5.7%
Euro *($/Euro)*	1.13	1.13	0.0%	-5.7%
Japanese Yen *(Yen/$)*	113	114	-0.6%	-0.8%
Korean Won *(KRW/$)*	1140	1121	1.7%	-4.8%
U.S. Dollar Index *(DXY)*	97.13	97.27	0.1%	5.6%
COMMODITIES				
Gold	1215	1223	0.6%	-6.2%
Oil	65.3	50.9	-22.0%	-15.7%
Natural Gas, Henry Hub	3.26	4.61	41.4%	56.2%
Copper *(cents/lb)*	266	278	4.5%	-15.8%
CRB Index	191	182	-4.8%	-6.3%
Baltic Dry Index	1490	1231	-17.4%	-9.9%

Source: Bloomberg

The truce signals that President Trump does not endorse a new cold war with China, as advocated by the über-hawks. Diminishing the odds of the worst possible outcome should help steady market sentiment as well as the renminbi.

BITCOIN REVISITED

A year ago, my article about a Thanksgiving dinner conversation with my college-aged daughter regarding her interest in cryptocurrency investment elicited much response, though I doubt it changed anyone's mind. Cryptocurrency proponents, mostly younger investors, thanked me for highlighting blockchain's ingenious design and not dismissing Bitcoin as a fraud. Traditionalists supported my view that it was a bubble due to a lack of intrinsic value. Bitcoin then soared 80% over the ensuing few weeks to nearly $20,000. Lately, however, the bloom may be finally off the crypto rose as Bitcoin price dropped below $4,000. Google Trends showed that Google search for "bitcoin" peaked in mid-December 2017, which coincided with its parabolic price surge; at the end of November 2018, the search volume has declined to 14% of the December 2017 peak.

This year, my Thanksgiving dinner conversation was pleasantly devoid of cryptocurrency and even politics. Instead, I learned something about the gig economy. My daughter, having graduated last May, now writes a column for an online culture and fashion site while working with a number of start-ups on their social media marketing strategy. Instagram has become the dominant social media platform and companies large and small need to curate and refresh their content to cultivate an Instagram persona. Some millennial companies have even built their business out of Instagram, using the app as their main platform to interface with customers. This has created an ecosystem of creative strategists, videographers, actors, and models to meet the growing demand for on-line content and commercials. Venmo is the preferred payment method among them. Personal branding can be highly rewarding – those with a considerable Instagram following can get paid to be product influencers. One can even turn hobbies into money making ventures – one of my daughter's friends was signed up by Facebook to live stream herself playing video games. It's hard for me to comprehend how video games have become a big spectator sport, but perhaps parents no longer need to worry that their kids spend way too much time playing video games – they could pursue a lucrative career as eSports stars. As virtual reality matures into mainstream games, I suspect more people will get hooked. One can always find fulfilment in the virtual world when the real world seems troubled on so many fronts.

IN SEARCH OF THE NEXT BIG THING

Markets are driven by two primal emotions – greed and fear. When greed is in vogue, investors tend to extend their time horizon and pay up for secular investment opportunities. The cryptocurrency frenzy reflected high risk taking appetite to satiate investors' greed. Interestingly, around the time that the bitcoin frenzy peaked in mid-December 2017, investors and speculators started looking at marijuana as the next big thing, as confirmed by the soaring volume of Google search for "cannabis stocks". Investors appeared to be focused on potential catalysts such as the legalization of recreational use of marijuana in Canada and several states in the U.S. On October 17, 2018, Canada became the first major world economy to legalize recreational cannabis.

As investors and speculators piled into a handful of formerly small or micro-cap cannabis-related stocks, their share prices soared. Canopy Growth Corporation, formerly Tweed Marijuana, saw its share price surge from $6.8 at the end of 2016 to $23.7 by the end of 2017, and a high of $56.9 by mid-October 2018. Its peak market capitalization of $10 billion was 133 times its annual sales run rate. In July 2018, Tilray, a Canadian cannabis and cannabinoids company, went public at $17 a share and subsequently rocketed up as high as $214 by mid-September, giving it a market capitalization of nearly $20 billion against an annual sales run rate of $40 million. That was a valuation of 500 times sales, which may appear reasonable only under the influence of drugs.

While cannabis stocks offered get-rich-quick pipe dreams to some, their limited volumes and liquidity precluded larger funds from purchasing them. The so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, Google), on the other hand, were the real deals as they offered exposure to promising secular trends and plenty of liquidity. During the first three quarters of 2018, these stocks accounted for much of the S&P 500 Index's appreciation. Netflix had more than doubled its share price over the first six months of 2018. Apple became America's first trillion-dollar company in early August, followed by Amazon a month later. Jeff Bezos, Amazon's founder and CEO, also became the world's richest man in modern times on an inflation-adjusted basis, although he still trailed John D. Rockefeller's record when personal wealth is measured as a percentage of the American economy.

FROM GREED TO FEAR

How things have changed over the last two months. Led by a rout among technology and Internet stocks, the S&P 500 Index has pulled back as much as 10% from its peak. As fear took over from greed, investors have shortened their time horizon and

shifted their focus from growth opportunities to risk minimization; that is, looking at the glass as half empty rather than half full.

At the depth of the recent sell-off, more than half of the S&P 500 stocks were in the bear market territory, a decline of more than 20% from the peak. They included the five FAANG stocks, which collectively lost more than $1 trillion in market capitalization. Facebook was the worst performer among the fab five after the company guided lower margins due to higher operating expenses as well as stepped up research and development. During periods of ebullient market sentiment, investors would typically have a favorable view of increased R&D as an investment for future growth, especially given Facebook's dominance of social media with Instagram and the company's strong presence in virtual reality. Now, however, it seems that the company can do no right and is caught in the crossfire between the political left and right. Facebook has long been accused by the conservatives for being liberally biased and it has lately incurred the wrath of the left over data privacy and Russia's election meddling scandals. Various foreign governments have also started the witch hunt against the company with Mark Zuckerberg's image being changed from a tech wunderkind to an evil tech overlord, or as one Canadian politician called, "frat boy billionaires from California." Lost in the brouhaha was the fact that Facebook's price-to-earnings ratio has declined to just a slight premium over the market.

Semiconductor maker Nvidia, a one-time investor darling as a way to play the Bitcoin frenzy, lost nearly half of its market value from its October 1st peak after demand for cryptocurrency mining equipment collapsed. It was estimated that bitcoin miners cannot break even until the price has recovered to roughly $8,600. The market sell-off has also brought down the once smoking hot cannabis stocks by 40% to 50% from their peaks, though we suspect the weed craze is not yet washed out.

From a contrarian vantage point, the rising bearishness is a positive development as the market goes through the bottoming process, which usually culminates in so-called market capitulation. The American Association of Individual Investors (AAII) Sentiment Survey has lately shown far more bears than bulls. However, the Investors Intelligence Advisors Sentiment Survey still has bulls outnumbering bears by 1.8 to 1. While this bull/bear ratio of 1.8 was already below levels reached at market lows in February and April of this year, we have seen lower readings in past market bottoms. In short, it does not appear that we have reached capitulation, but the linkage between sentiment and market performance is not an exact science. Ultimately, fundamentals will prevail, and they are currently healthy but softening. In short, everything is data dependent.

A GAME OF CONFIDENCE

I made a trip to China in mid-November to get an on-the-ground view of the economy. To my surprise, there was a profound shift in sentiment. On my prior China trip in April, business people had mostly exuded confidence in the government's ability to manage the economy. Seven months later, that confidence has dissipated into doubt and uncertainty, and the sense of caution, or even pessimism, was widespread. This was quite untimely, as 2018 marked the 40th anniversary of China's reform and opening-up, and the country has been holding various commemorative events to showcase China's breath-taking development, the scale and pace of which were unprecedented in human history.

China's deleveraging effort that started in 2017 certainly had an effect on credit availability, but the bigger issue to business owners was a perceived leftward shift in policy and ideology (dubbed public in, private out in Chinese parlance). This perception was created by reading the tea leaves from policy initiatives, editorials, official speeches, etc. It has a potentially chilling effect of snuffing out the animal spirit that has been the hallmark of Chinese entrepreneurship.

Sensing the unease among private business owners, policymakers have started a concerted effort to restore confidence. In early November, President Xi held a symposium with dozens of entrepreneurs to reassure them of property rights protection and additional stimulus in the form of tax cuts, bank credit, and even bailout funds. Judging by the cautious views expressed to me, business owners were not yet fully on board. However, one contact did acknowledge that the strength of the Chinese government lies in mobilization and execution, and this time it appeared determined to reflate the economy.

The truce in the Sino-U.S. trade war should serve as a near-term confidence booster in China, even though difficult negotiations still lie ahead. Chinese media has described the Trump-Xi meeting as "the 150 minutes that changed the world" and proclaimed that the Sino-U.S. relationship will get back on the right track. We are not as sanguine, knowing how unpredictable Trump can be. However, the truce signals that President Trump does not endorse a new cold war with China, as advocated by the über-hawks. Diminishing the odds of the worst possible outcome should help steady market sentiment as well as the renminbi. That could create a relief rally, especially in the much maligned emerging markets. In a nutshell, a little more confidence can go a long way, but it ain't over till it's over.

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