ALAMAR
CAPITAL MANAGEMENT

January 28, 2020

Last year was a stark contrast to the prior year. While all asset classes declined in 2018, investors enjoyed a bounty of riches in 2019 - every asset class produced positive returns. Corporate profits, on the other hand, exhibited the converse phenomenon. In 2018, S&P500 profits were up 21.7% largely due to tax cuts, while in 2019, profits are expected to barely grow.

Since Alamar's inception 10 years ago, we have matched the S&P500 performance of 13.6%. In 2019, the S&P500 returned 31.5% while our equity strategy was up 22.5%. It's important to realize that we have accomplished this performance while taking less risk. We have held roughly 10% cash on average during the entire 10-year duration. Moreover, as we have written several times in the past, a large portion of the market performance has been driven by just a few stocks: FaceBook, Apple, Alphabet, Microsoft and Amazon (FAAMA). For instance, these 5 stocks were responsible for 24% of the performance of the S&P500 last year. FAAMA now makes up 21% of the index. We have never owned these stocks in our equity portfolio since we prefer to avoid crowded, fashionable investments.

We are optimistic about the US economy in this election year as it seems a number of uncertainties overhanging the market have been or will be resolved. One of the largest has been the restrictive monetary policy of the US Federal Reserve at the end of 2018. The Federal Reserve has now switched from a restrictive to an accommodative stance. We will explore these subjects in this note.

IS THE FEDERAL RESERVE JUICING THE MARKET?

One of the criticisms we hear is that money printing by the Federal Reserve is finding its way into the stock market. To put it more bluntly, the Federal Reserve is pumping up stock prices; if the Federal Reserve stopped expanding the balance sheet, stock prices would decline.

We went back and looked at money flows into the domestic stock market to see if there is any evidence to back this claim. If the money printed by the Fed was pushing stock prices up, we would expect to see large inflows of cash into the market. **Table 1** depicts flows into mutual funds in the major asset classes over the last 10 years. In fact though, money has been flowing **out** of domestic equity funds with relative consistency over the last decade and **into** bond funds instead. One possible explanation could be that Fed influence is transmitted through passive vehicles such as ETFs instead of mutual funds. **Table 2** depicts flows into ETFs over the same time period. While ETFs have attracted funds away from active vehicles, the amounts involved are too small to meaningfully impact a stock market worth over $30 Trillion. Moreover, the combined impact of mutual funds and ETFs last year was an **outflow** from equities of almost $200 Billion. Investors have been allocating funds away from equities into income producing assets such as bonds.

Table 1: Mutual Fund Flows

YEAR	EQUITY FUNDS ($ Billion)	HYBRID FUNDS ($ Billion)	BOND FUNDS ($ Billion)	TOTAL FUNDS ($ Billion)
2010	$ (24)	$ 36	$ 232	$ 244
2011	$ (129)	$ 40	$ 118	$ 29
2012	$ (153)	$ 46	$ 306	$ 199
2013	$ 159	$ 75	$ (71)	$ 163
2014	$ 25	$ 30	$ 44	$ 100
2015	$ (76)	$ (19)	$ (25)	$ (120)
2016	$ (258)	$ (42)	$ 107	$ (193)
2017	$ (159)	$ (28)	$ 260	$ 73
2018	$ (261)	$ (91)	$ 2	$ (350)
2019*	$ (360)	$ (50)	$ 314	$ (96)
TOTAL:	**$ (1,235)**	**$ (3)**	**$ 1,287**	**$ 49**

** Estimates for 2019* *Source: ICI*

Table 2: ETF Flows

YEAR	EQUITY FUNDS ($ Billion)	HYBRID FUNDS ($ Billion)	BOND FUNDS ($ Billion)	TOTAL FUNDS ($ Billion)
2010	$ 80	$ 0	$ 30	$ 118
2011	$ 69	$ 0	$ 46	$ 118
2012	$ 124	$ 0	$ 52	$ 186
2013	$ 197	$ 1	$ 12	$ 180
2014	$ 190	$ 2	$ 51	$ 241
2015	$ 173	$ 1	$ 55	$ 231
2016	$ 188	$ 1	$ 83	$ 284
2017	$ 346	$ 3	$ 121	$ 471
2018	$ 209	$ 2	$ 98	$ 311
2019*	$ 166	$ 6	$ 148	$ 320
TOTAL:	**$ 1,742**	**$ 14**	**$ 697**	**$ 2,459**

** Estimates for 2019* *Source: ICI*

In addition, the relationship between the size of the Fed balance sheet and the level of the US stock market is very weak. ***In our opinion, equity prices are moving higher because investors perceive economic fundamentals will improve going forward.*** We will elaborate on what we see in the earnings landscape in the next section.

HAS THE CYCLE BEEN EXTENDED?

From the time Alamar began operations in 2010 economic prognosticators have been forecasting the end of this economic cycle. The reasons have been manifold, including:

- This cycle will be short because the consumer is overleveraged (2010 and 2011)
- Too much debt in the economy will place a damper on growth (all along)
- Standard & Poor's downgrades US credit rating
- Government shutdown because Congress would not pass the budget
- Fed money printing will create inflation leading to stagflation
- Fed raising rates will lead to recession
- Fed quantitative tightening will drain liquidity from the economy
- Yield curve inversion is predicting a downturn (2019)
- Revoking NAFTA and placing tariffs on Chinese imports will thwart the economy
- Brexit will weaken the UK and Europe in general

Now here we are, a decade later, and the economy is still chugging along, the longest economic expansion in history! In fact, from our surveys, economic growth looks to be accelerating. The month of December was very strong in a number of areas – retail sales, credit card spending, airline traffic, existing home sales and new home sales. Unfortunately, the political landscape hinders our ability to perceive the improving backdrop.

Many of the headwinds mentioned above have abated. The consumer is in excellent shape – the unemployment rate is at a 50-year low, income is rising, savings rates are up and consumer leverage is heading lower. There is no sign of inflation in the economy. Indeed, money velocity has collapsed and deposits are piling up on bank balance sheets. We will discuss this in more depth in a future note. The Fed has stopped raising rates and has reversed the last few hikes. Quantitative tightening has ceased with the Fed now pumping liquidity into the banking system. The yield curve is no longer inverted. NAFTA has been replaced by the USMCA and will soon be in effect after Senate ratification and Presidential signature. China and the US have agreed to a phase 1 deal where China will import an additional $200 Billion of goods and services from the US over the next 2 years. This will undoubtedly reduce the trade deficit and increase US economic growth. After 3 long years, Brexit will now go into effect at the end of the month. Uncertainty of Brexit has now been finally removed and businesses can be more certain of their investments.

Besides removing the headwinds, there are tailwinds building up strength that will, in our view, push the economy further. This year is an election year and there are an unprecedented 3 billionaires running to become President. All will spend hundreds of millions of dollars on their campaigns – staffing, advertising and travel. This will likely be the most expensive election in history – very good news for the economy. The Olympics in Japan this summer will add to the spending binge.

The deployment of the 5th generation of wireless networks is just beginning. New infrastructure, handsets and applications to harness the power of 5G will spur growth for years to come. At Alamar we have already begun investing to capitalize on this theme and are on the lookout to add more investments in the next few years. Entire industries will be disrupted if they do not embrace this technology.

The entire automotive installed base worldwide will switch to electric or hybrid over the next 2 to 3 decades. Governments will be forced to mandate this switch as the repercussions of global warming become evident. Similarly, the utility industry will have to switch from burning fossil fuels to renewables to generate electricity. All these transitions require large outlays by companies, individuals and governments. These outlays will produce enormous opportunities for investors which we hope to capitalize upon in the next decade of Alamar's existence.

CONCLUDING THOUGHTS

The stock market continues to hit new highs but without investors full participation. Fed money printing is not percolating into the stock market; instead, cash is piling into money market funds, bank deposits and bond funds. Investors are spending much time listening to prognosticators preaching doom and gloom and missing out on a spectacular investment environment.

When investors do decide to allocate to equities, they are more likely to go with what's popular and fashionable. 2019 displayed a recurrence of an investing trend we identified many years ago - investors piling into a few select names (FAAMA) which in turn drive index returns. Five companies now represent 21% of the market and capture 21% of new investment dollars. While detrimental for us in the short-term, this trend is very beneficial for us in the long run. It is far more difficult to double the value of a company from $1 Trillion to $2 Trillion than from $1 Billion to $2 Billion. We look for opportunities where we can invest at the $1 Billion to $10 Billion stage and go along for the ride as the value rises to $50 Billion and beyond. As our clients who have been with us a long time know, we have been very successful in identifying many such opportunities over the last 10 years. Given the unprecedented opportunities in front of us, we are confident the best is yet to come.

Thank you for your continued trust and confidence in Alamar Capital Management.

Sincerely,

George Tharakan, CFA
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Disclosures

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