WHITE PINE CAPITAL®

July 2019

Where's Waldo?

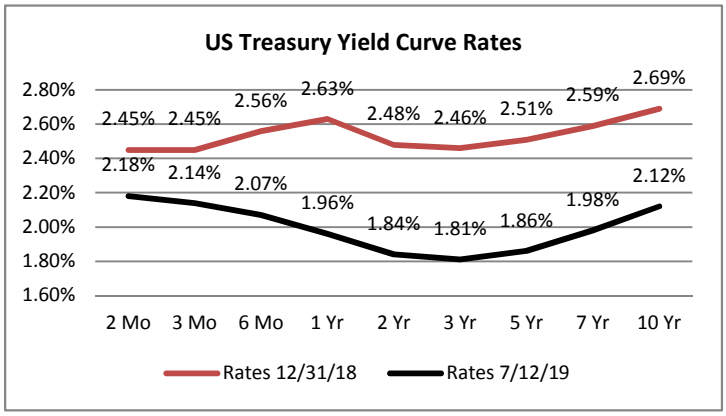
Good Bank, Bad Bank

Wealth Management and Small Cap Equities

It's been quite the ride over the past 9 months. Since late December when the FED clarified rate policy, equity markets recovered strongly from their sharp 4th quarter decline.

U.S. Equity	**Q4 2018**	**2018**	**12/31/18 to 6/30/19**
S&P 500	-13.5%	-4.6%	18.5%
Russell Mid Cap	-15.3%	-9.1%	21.4%
Russell 2000	-20.3%	- 11.1%	17.0%
Russell 2000 Growth	-21.7%	-9.4%	20.4%
Global Equities			
MSCI EAFE	-13.0%	-14.1%	13.8%
MSCI Emerging Markets	-7.3%	-14.9%	10.2%

After raising rates throughout 2018, on January 30th the FED further clarified their rate posture by announcing movement towards a neutral/accommodative stance. The announcement added fuel to the equity rally. It also fueled a strong bond rally with yields dropping by 55-65bp in the longer maturities, resulting in an inverted yield curve. At mid-year, markets now anticipate 25-50bp of rate cuts in the second half of the year. Quite a change from a short while ago when markets expected a 25-50bp increase during 2019.



Source: U.S. Department of the Treasury as of July 12, 2019

What's changed? Slowing global growth along with the lack of tariffs and strong wage growth filtering into inflation is giving the FED room to change their view. Although U.S. rates are low on a historical basis, zero to negative rates in Europe and Japan also provide room for the FED to become dovish in order to keep the U.S. economy growing. As former Chairman Ben Bernanke reminded us in an October meeting: "Expansions don't die, they're murdered. The most common causes include (1) inflation acceleration; (2) financial stress; (3) geopolitical issues; (4) current policy tools are not at levels to dampen a downturn". We wonder if the FED sees something others haven't found…yet.

Where's Waldo?

Our base case investment thesis continues to assume the economy does not enter a recession in 2019. However, as we look into 2020 without resolution on the trade front, the possibility of slower global economic growth and rising prices do concern us. In addition to discussing current holdings and portfolio strategies, our Investment Committee meeting discussions are including more thoughts on where risks might be hiding. It's unusual to have ten years of economic growth, tightening labor markets and rising wages without seeing inflationary pressures.

Our discussion reminds us of the illustrated children's book, Where's Waldo? It's based upon a simple concept: find the illusive Waldo, who is always wearing his trademark red and white stripped sweater and glasses, amongst the oceans of people, spiraling buildings, and mythical beasts. As you begin searching each page, you quickly discover he is not easy to find, but he's in there. Once spotted, it seems so obvious.

Finding real market risk is a bit like finding Waldo. It's buried amongst all the oceans of information, noise and opinion. Where you find him on one page is always different from where you find him on another. Real risk emanates from a source not expected and is often found after-the-fact, the magnitude of which is often underestimated.

Central bank intervention into both the bond and equity markets around the globe has been longer and larger than at any time in history. Market participants have been conditioned to central banks supporting asset prices and growing economies across the board. Have these policies injected unknown hidden risks into the market? It's hard to know for sure, but we do know it is not normal for investors to lend money to central banks and knowingly accept negative rates of return.

We're in uncharted territory. And just like finding the illusive Waldo, the real market risk is hidden. And once spotted, it will seem so obvious.

Low rates and central bank accommodation will likely support asset prices in the short to medium term. Longer term and assuming inflation remains low, trade issues are resolved, labor participation improves, investment spending offsets rising wages, and improved growth across Europe and Asia, we may enter a period of stable global growth with low rates lasting longer. Hence the caveat that the starting point for U.S. rate cuts is low from a historical perspective, meaning less effectiveness as the zero-bound is closer.

Good Bank, Bad Bank

As we finish writing this mid-year update, we're encouraged about Deutsche Bank's restructuring announcement over the July 4th holiday. This looks like a similar playbook on how several U.S. banks were recapitalized post the Great Recession. No doubt there will be more details and likely changes, but suffice it to say that European banks have been slower to recognize bad assets. In addition to cutting the dividend, Deutsche Bank announced that €74B

of risk-weighted assets will become part of a new non-core “Bad Bank” unit that will be unwound over time. This helps unlock capital the bank was holding against these assets that can be used to help restructure and improve the remaining “Good Bank”.

A healthy, well capitalized banking system is important for economic growth. Perhaps the U.S. approach is a good play book for others to follow?

Wealth Management and Small Capitalization Equities:

Our year-end letter discussed the importance of knowing and understanding your heuristics and bias in order to minimize illogical investment decisions. Systematically following a fundamentally based investment process helps to minimize heuristic and bias creep into investment decisions. Repeatedly following the investment process, along with periodic, honest assessment and feedback, minimizes illogical choices and provides the opportunity to exploit market inefficiencies on a security level (especially in smaller stocks) and irrationality on a broader level.

U.S. equities remain attractive relative to Fixed Income, Preferred and International asset classes. Generally, large and medium value/dividend stocks offer attractive total returns with more moderate risk relative to growth stocks. We also like the tilt towards smaller stocks as they have significantly underperformed larger stocks over the past year. This remains one of the most inefficiently priced areas of the U.S. equity markets, and a segment where behavioral economics repeatedly finds abnormalities. Our process has a long history of exploiting these inefficiencies and abnormalities.

With the rally in rates, we are emphasizing shorter duration investment grade bonds and those with adjustable rate structures. Although the lower rates have reduced portfolio yields towards floor rates in the High Yield market, floor yields are still attractive relative to alternatives. Preferred securities offering fixed and/or floating structures are also sources of yield in a low rate environment. Given the uncertainty in global markets, we believe a position in gold is reasonable.

Assuming global growth improves, a core investment in the Europe, Australasia and Far East (EAFE) countries can be enhanced with a tilt towards Emerging Markets as valuations are attractive and growth improves.

Feel free to give us a call if you have questions or would like to discuss further.

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