November 2019 Commentary

The Dipsea Capital Fund returned 0.68% to partners for the month of November, 6.90% year-to-date, and 7.96% for the previous twelve months.

The U.S. equity markets were positive for the third consecutive month and for the ninth month this year. Dipsea Capital posted its 16th consecutive positive month in November. Implied volatility on the S&P 500, as referenced by the VIX index, maintained a subdued profile as the market rose steadily. Single-name option volatility also remained low, despite the active industry sector rotation that took place in the market.

Market Landscape

The tailwinds supporting higher stock prices remain largely the same:

1. Economic growth remains positive in the U.S. Consumer spending has been strong through the initial holiday period.
2. Although soft data (sentiment based) remains muted, hard data continues to support an expanding U.S. economy. Employment growth remains strong and real wages are rising.
3. Interest rates remain at historically low levels.
4. The Federal Reserve has arguably embarked again on Quantitative Easing by resuming purchases of Treasury bonds.

Headwinds to higher stock prices appear to be gaining strength:

1. Earnings growth is negative. For Q3, 85 S&P 500 companies issued negative EPS guidance - tying the third highest figure since 2006 (FactSet). For Q4, the estimated earnings decline for the S&P 500 is -1.5%. If reported earnings at the end of the quarter are negative, it would be the fourth consecutive quarter of year-over-year earnings declines.
2. Global economic data remains tepid as evidenced by recent industrial production figures in China, South Korea, and Japan and continued stagnation in Germany, Europe’s largest economy.
3. The U.S. stock market is expensive at a P/E 10 (or CAPE ratio, cyclically adjusted over 10 years) of 29.9, approximately two standard deviations, or 80%, above its historical mean of 16.6.
4. In a marked contrast to this year’s strong stock market gains, the ISM survey of

purchasing managers continues to hover near its lowest level in years. This divergence is atypical.
5. The November asset allocation survey from the American Association of Individual Investors shows that investors hold 67% of their portfolios in stocks, while having less than 14.5% in cash, among the lowest cash balances in 30 years. This combination suggests that investors will be susceptible to sell if the rally stumbles.

Thoughts on the Year Ahead

As Heraclitus wrote, “The only constant in life is change”. At Dipsea, we feel the best method to harness the outcomes of newly emerging scenarios is through the persistent cultivation of mental flexibility, self-improvement, and the active development and testing of our models.

In that context, the following observations are top of mind for us as we look forward to 2020.

1. Persistently low U.S. interest rates and a flat yield curve in the midst of an expanding economy may be pointing to weakness ahead.
2. The price divergence between the lowest-rated corporate debt and higher-rated issues has expanded to its widest spread in years. In the past this has signaled the end of the credit cycle and rising defaults.
3. While near-term options traders aren’t pricing in much of a chance of a big move, longer-term traders are. The skew on 1-year options on the S&P 500 shows that traders are willing to pay up significantly for downside protection.

Tumultuous markets have been beneficial to Dipsea’s strategy in the past and we will aim, as always, to deliver attractive returns with no market correlation to our investors in 2020.

We wish our partners and friends a warm holiday season and look forward to contributing towards our mutual success in 2020.

With gratitude,

Chris Antonio
Chief Investment Officer and Founder

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Dipsea Capital, LLC
350 Bon Air Center, Suite 230
Greenbrae, CA 94904
(office) 415-925-1349
www.dipseacapital.com