Are you Conflicted? I sure Am.

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If you had to come up with one word to describe the state of things these days, what would it be?

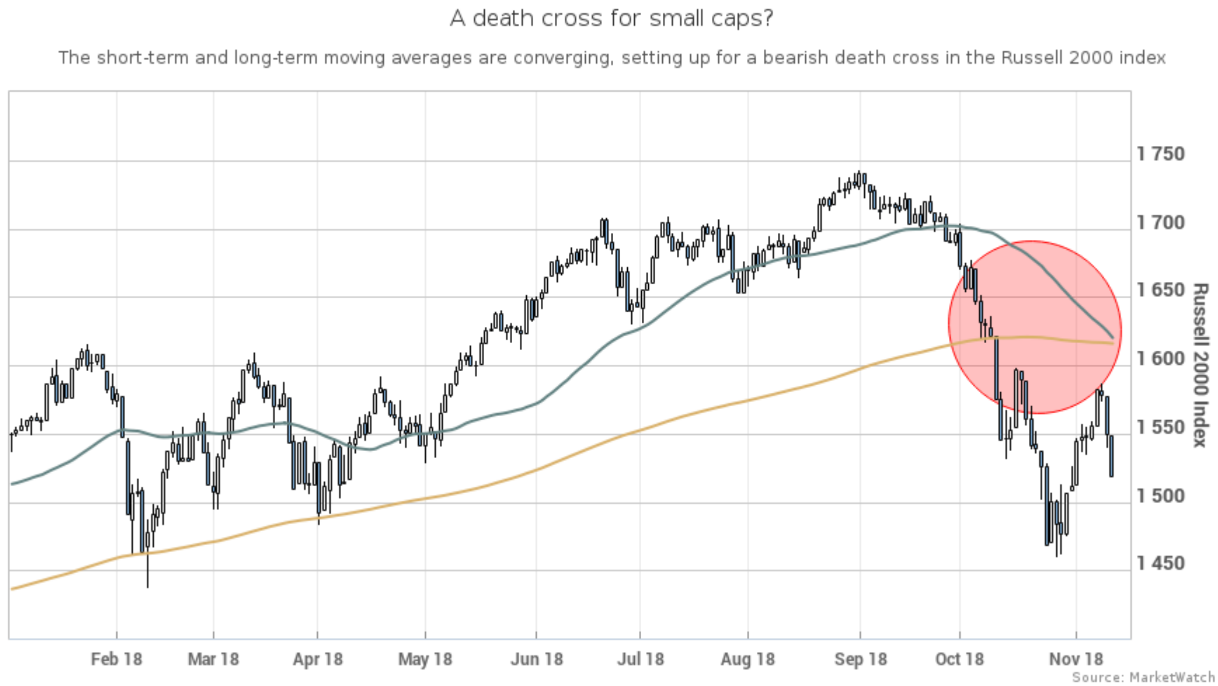
Personally, I can come up with several words to describe how I feel about that and some of those would be more pronounced one day versus. For instance, I love baseball but when it became clear that the Red Sox would be playing the Dodgers in the World Series my word for *that* day was "indifferent". By the way, that might seem benign, but as I tell my kids every so often, for me, indifferent is one of the worst ways for me to feel about something because it means I no longer care what happens with respect to the given person, situation or outcome etc. That is actually worse than me being mad, because if I am mad about something, I may spend some time rethinking what made me mad in the first place and conclude that perhaps I played some role in my own "madness", or I may proactively work to mitigate whatever made me mad to start with, or I may just let enough time go by that it doesn't make me mad any longer. So, if something happens to make me mad, chances are I will eventually get back to the place I was before I got mad and it will all be good again. However, if I am (or become) indifferent, it means I was never really "good" to begin with or, whatever has occurred has tipped me over and I don't really care to ever be "good" again. I think the response "whatever" has become an expression of indifference, which I also think is the reason it makes people so mad when they hear it. Its also why if someone hears it enough, they stop being mad and they become…indifferent. But I digress…back to my question.

If I took a survey and I asked 500 people what word they would use to describe the environment we live in, I think some of them would say "conflicted". To my point, I think our recent elections suggest that might be a good word. On the face, the root of conflicted (conflict) is certainly apropos to the current political environment. However specifically, if one is *conflicted* it suggests that they sit in the middle of the opposing sides of a conflict and don't know which side to choose. From that perspective, in my view the outcome of the elections drives home my point about many people feeling conflicted. I think there were clearly a fair number of folks who went to the polls and voted their confliction, which meant spreading their votes around in a way that they didn't have to pick sides. That seemed especially clear to me in some of the ballot initiatives around the country where for instance, people elected particular candidates but rejected initiatives that were in lock-step with the platforms of some of those same candidates.

As further proof of my "conflicted" theory, stock market investors seem to be displaying some of that same attitude. As the chart below of the CBOE Volatility Index (VIX) denotes, we went through some volatility early in the summer, but from mid-summer up through the first part of October, the markets experienced relatively low volatility. Since that time, we have seen large swings both up and down and the narrative in the market seems to include the same division. I think a lot of investors these days are conflicted. As an analyst, I must admit I am conflicted as well.

As a generalist microcap analyst, I am essentially a stock picker. While the term stock picker seems simple enough to understand on the face, it involves some important investment inferences. I won't belabor the point, but stock picking stands in contrast to some heavy investment theories and strategies: indexing, diversification, Random Walk and Efficient Markets etc. More times than not, being a stock picker, especially a microcap stock picker, is a contrary place to be. I think that is especially true in environments that (I think) we are in right now.

One of the reasons (but not the only reason) many people pick stocks, is the idea that individual stocks can possess specific attributes that allow them to outperform the general market regardless of where the general market is headed. For instance, if a small biotech company gets an FDA approval for a new cancer drug in the middle of a bear market, its probably still going up, regardless of how much the general market is going down. The idea that stocks can trade on their own unique merits regardless of the prevailing investment sentiment is what drives stock pickers. The problem is, while it is obviously true that individual stocks can trade in their own direction regardless of the direction of the broader market, that doesn't mean the direction of the broader market, and in conjunction the underlying economic conditions that drive it, don't matter. They most certainly do. That may be especially true for microcap stocks that in the aggregate are particularly sensitive to things like general market liquidity for example. In fact, I would argue that when it comes to things like the rising tide of liquidity lifting all boats (or all stocks in this analogy) smaller stocks are typically the last ones to rise, and the first ones to sink when the music finally stops. That is why the chart below from a recent Marketwatch.com article regarding the state of the Russell 2000 has me "conflicted" :



https://www.marketwatch.com/story/small-cap-index-perilously-close-to-death-cross-and-thats-bad-news-for-the-broader-stock-market-2018-11-13

I have been suggesting form many months now that central bank policy worldwide has created an abundance of liquidity that in my view, has created some stark inflation in financial assets. The simple implication to that is that as the Fed continues to raise rates, that tide of liquidity will subside and asset valuations (the stock market) will subside with it. Moreover, theoretically, that scenario should prove the most detrimental to those assets that are the most overpriced, and I think that will be true. From that perspective, there are many small companies that are trading at better relative valuations than many much larger counterparts, which would suggest that those lower valuation companies should "weather the storm" better than those with more extended relative valuations. That may ultimately prove true, but I assure you, while we identify many microcap issues that we think are trading at good relative valuations perhaps even to their own intrinsic values, if the S&P 500 heads for 2200 they are probably all going with it, at least initially. THAT is the basis of my current confliction.

As I said, I have been arguing for some time now that the Fed's unprecedented liquidity experiment of the **past decade** has created a debt addiction. I don't see how that ends well, and in any case, markets will have to *eventually* be weaned off that debt. Of course, the challenge there is figuring out the "eventually" part of that equation. One thing Keynes did have right, was that in assessing the merits of classical economic theories regarding the "long run", he surmised that in the long run we are all dead. That is, we may all recognize that the world's mass of liquidity must be reconciled somewhere out there, but in the meantime those who have sat on the sidelines, or worse yet made contrary bets, believing that reconciliation was imminent have missed an extraordinary financial opportunity.

I submit, each day that passes without a market crash makes me think we are one day closer to that eventuality. However, in the meantime I continue to see compelling stories in the microcap space that I think have opportunities that could lead them to extraordinary returns even in the face of difficult equity market environments. I submit, poor equity environments, especially those driven by illiquidity, will not on the face be good for any stock. While that “conflicted” notion certainly impacts my approach to new coverage, it won’t keep me from continuing to search for companies that I think hold extraordinary opportunities perhaps even despite or at least beyond the prevailing equity headwinds. Even with Halloween/October behind us, it’s still plenty scary out there.