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Forging Your Path

GLOBAL UPDATE

The Market Strikes a Different Tone

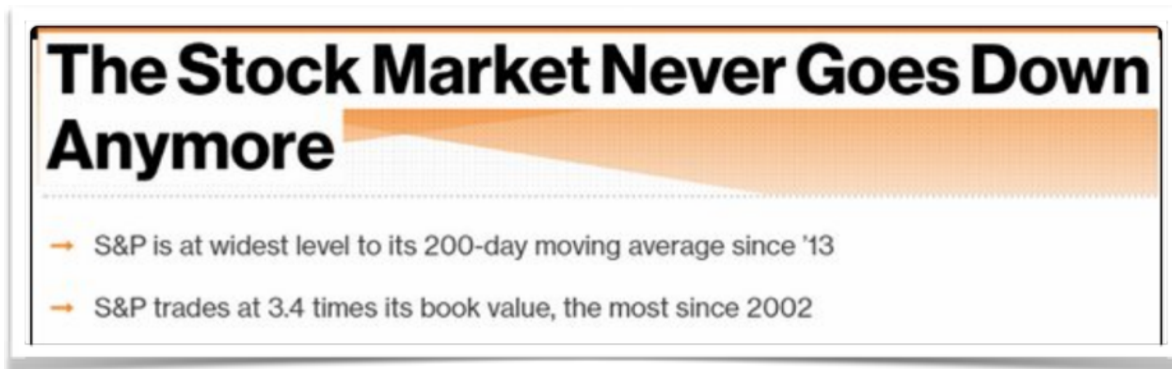
After a year of record complacency, volatility returned to the markets with exuberance beginning January 26th. For this newsletter, I'll cover the following topics and discuss briefly how we believe each is having an effect in changing long-term sentiment from the most positive it had been in decades to a more realistic tone today.

•Market Action & Tactical Summary
•Key Drivers of Change
1. Valuation
2. Interest Rates / Central Bank Policy
3. Trade Wars / Protectionism
4. European Financial Stress / Deutsche Bank / Populism
5. China De-levering

Market Action and Tactical Summary:

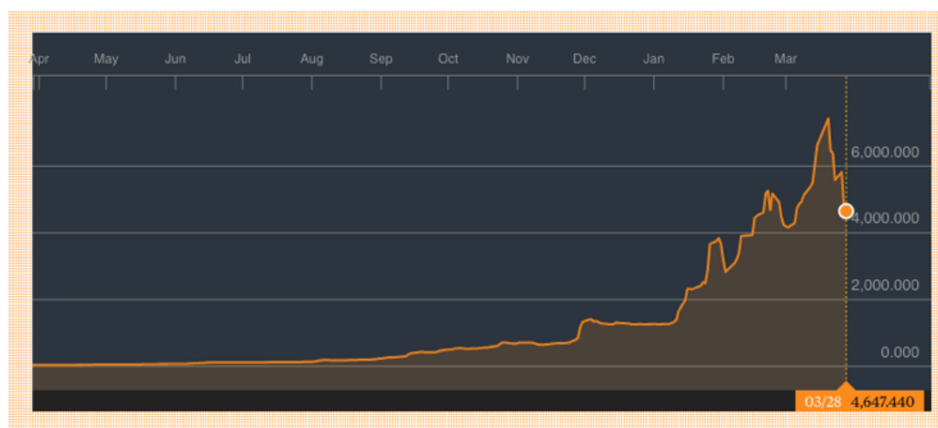
As stated in my newsletter at the end of January, the first bout of volatility likely started with the markets getting spooked by the rate of change in interest rates which caused the beginning of an unwind in some volatility related and leveraged securities. This caused a considerable amount of pain for those who had been banking on a continuation of the 2017 status quo, as the inverse volatility product imploded in a matter of days. The first downturn lasted until February 8th, and after reaching oversold readings, the market began to bounce as "buy the dippers" returned and

helped the market recover about 60% of its losses from the fall. Volatility returned again the week of March 19th, and the market retested its low on Friday the 23rd. As I write this, after the market close on Monday, March 26th, the market rallied strongly off of its low this morning. If this path follows many past long-term tops, buyers will soon be exhausted, and the downward trend may commence soon.

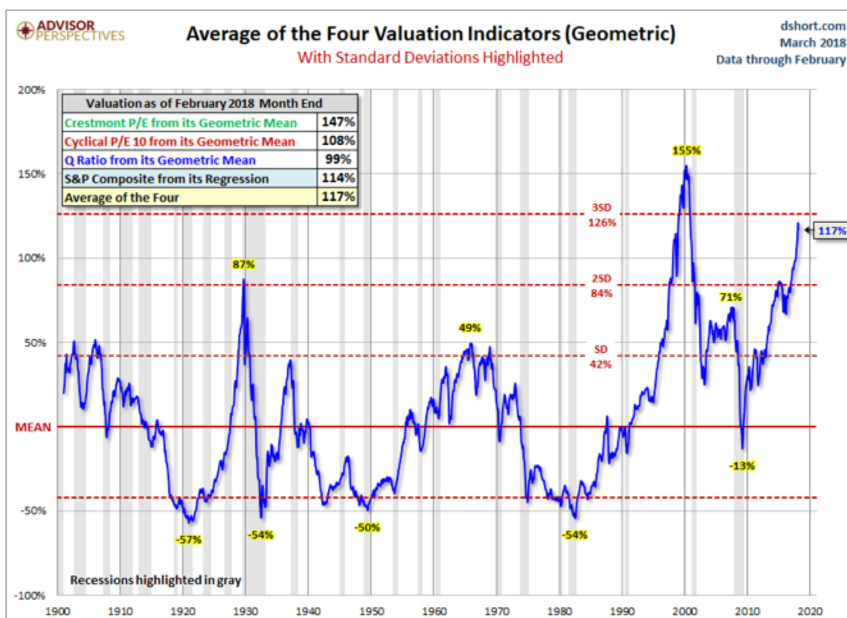


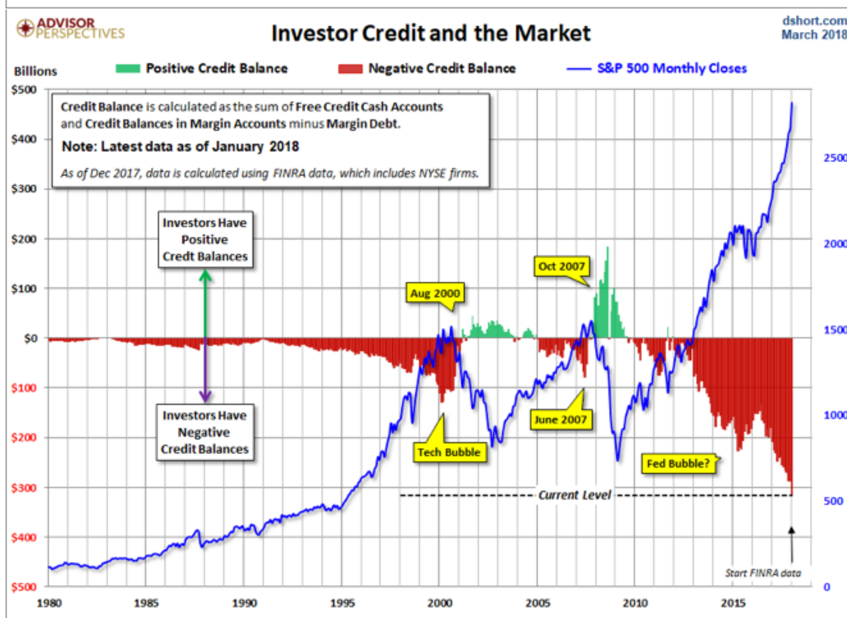
Bloomberg headline on Jan 16, 2018, about two weeks before the first round of volatility.

As we see the current situation, there is one way that markets could resume their long-term uptrend, and it relies on currency valuations and Central Bank policy. I've discussed how falling currencies can be a huge force in stock markets increasing in value. In fact, over the past year, the Caracas Stock Exchange has been one of the best performers globally! (chart, Bloomberg, 1 yr trailing as of 3/28/18). However, one has had to endure crushing inflation in the local currency and the market's performance has only partially offset the devaluation of their currency. The US Dollar index fell vs. a basket of foreign currencies by roughly 11% last year. If the U.S. Fed reverses course (yet again), and goes back to a money printing regime, and back pedals on future interest rate hikes, we believe it could begin a cycle of stock market appreciation, coupled with more significant U.S. dollar declines, ultimately leading to significant inflation. Significant longer-term weakness in the equity market may in fact force the Fed to take this action. A change in Fed direction likely would not be a one-day turnaround. It would probably occur over a longer period of gradually walking back recent rhetoric around interest rate "normalization" to a "wait and see" approach, and then returning to loosening monetary policy and more money printing. Our new Fed chief, Jerome Powell, is not a believer in Q.E. however, and it would likely take more significant market pain to occur before a policy reversal is implemented.



Key Drivers of Recent Volatility:





1. Valuation:

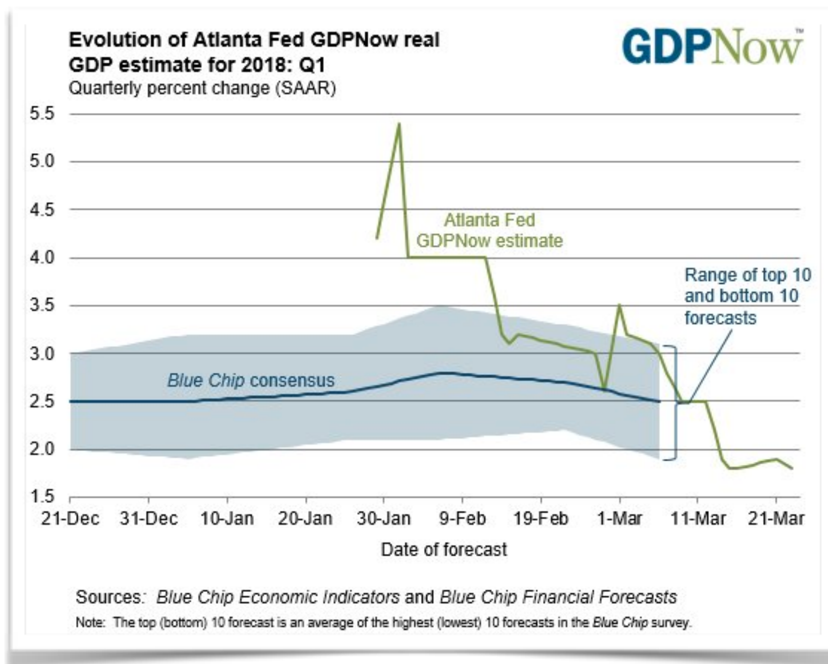
In the past, I've referred to the valuation chart (attached), which currently shows equity market valuations approaching 3 standard deviations from the mean, an occurrence that should statistically happen once every 2000 years. In addition, NYSE Margin Debt has reached an all time high in March (lower chart). We've discussed repeatedly during newsletters that our belief is that central banks have yet again been the root cause of blowing a bubble in all assets due to prolonged policies of excessive money printing and artificial suppression of interest rates. We believe there will be ample opportunity to benefit from equity valuations falling back to historic norms as central banks seek to "normalize" policies. While valuation can be very predictive of future return potential in markets, it is a notoriously poor tool for timing, as investor sentiment tends to push markets far in excess (on both the up and down sides) in the shorter term, until a reason becomes apparent to change that sentiment.

2. Interest Rates & Central Bank Policy: The new US Federal Reserve Chairman, Jerome Powell, recently announced the first of 3 or 4 expected interest rate hikes in 2018. In addition to increasing rates, the U.S. Fed is supposed to be reducing their balance sheet by not reinvesting in bonds that mature (purchased with money they had "printed"), gradually starting at $10 billion/month and increasing to $50 billion/month by October of 2018. This "normalization" was scheduled to begin late last year. The Fed has been promising to unwind their "Quantitative Easing" programs since 2010 (after the initial round of QE 1 in the wake of the financial crisis). It APPEARS that they are finally serious, only $4 Trillion printed dollars later.

The net effect is that by not reinvesting in bonds, other buyers must come into the market to absorb supply. In the absence of that, rates will rise until they attract new buyers. In addition, with increasing budget deficits, new bond supply also increases. The Fed has just begun the process of

normalization, and has barely reduced their balance sheet to date. However, the bond index is down over 2% YTD in anticipation of the excess supply.

In our October 2017 newsletter, we highlighted the case a market in which both stocks and bonds could fall in tandem due to excessive valuations in both. This would be an event many market participants are not prepared for, and the attached chart shows that so far, in 2018, this is exactly what is beginning to play out. We shall see how this resolves itself over time.



The Atlanta Federal Reserve Bank came out with a Q1 GDP forecast early in the year for over 5% growth! As noted by the chart below, it's been reduced and is currently back under 2%. Central Banks and economists have been consistently missing and adjusting GDP targets down for many years, expecting that the economy can and will return to 3-4% growth. I've discussed in the past that due to many factors, including excessive debt and demographics, why that is simply not probable, and is a near mathematical impossibility (for any prolonged period). Such growth is, however, necessary if we're ever going to solve the debt problems we've managed to accumulate through the years, with Social Security and Medicare consuming an ever larger portion of the government's budget, and having just passed $21 Trillion in U.S. government debt. It is understandable why the hope for optimistic growth assumptions exists. At this point, however, we need more than hope. It was time for action a decade or more ago. Unfortunately, it doesn't seem that any measures are currently being undertaken that would demonstrate fiscal restraint. The likely way this plays out globally is a fall in the status of the U.S. dollar as the sole global reserve currency and there are measures underway currently by the IMF and by China to move in that direction.

3. Trade Wars/Protectionism:

The recently announced tariffs have been largely promoted by the media as the cause of volatility. In fact, as shown before, the cause of volatility is significantly overvalued and over leveraged markets. However, one of the catalysts could be the potential for trade wars. Interestingly, much of the data we use to gauge trade trade deficits is severely flawed. For example, when China assembles an iPhone, it adds roughly $6 in value per phone. Parts are manufactured all over the world, shipped to China, and assembled. When China exports the iPhone back to the U.S., the entire value of the phone is counted as an export, leading to a massive misrepresentation in the actual value that was added via the small part China actually played in assembling that phone. The same is true for many products worldwide, including autos and other big ticket items. While I do not claim to know the right answer, I am well aware that many countries (including our own), but particularly the Chinese, have been using unfair trade practices. China has been a significant violator of intellectual property rights, and they have been dumping steel and aluminum on global markets for many years to avoid shuttering manufacturing plants and causing unemployment to rise. While the metrics for measuring trade imbalances are significantly flawed, and the issue of unfair trade practices are readily apparent to the most casual observer, an actual trade war is seen as a threat to the volume of global trade, and thus a threat to current assumptions of global market growth.

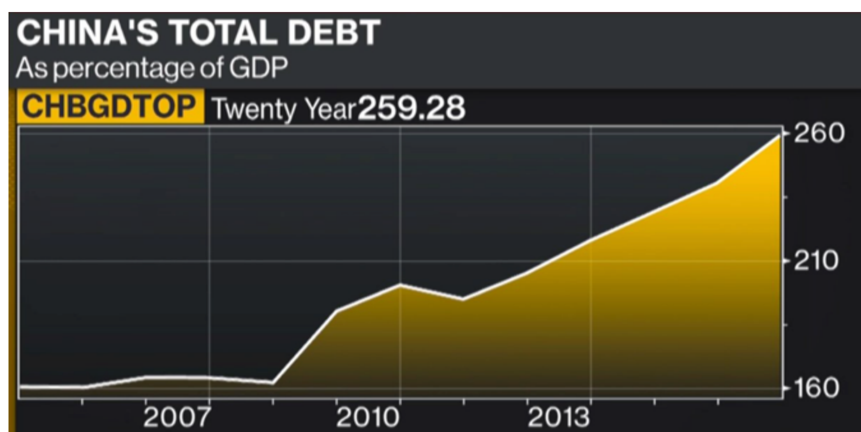
4. European Financial Stress / Deutsche Bank / Populism

There are a couple of issues that have led to the resurgent stress in the European financial system. The first being that Italian election in early March was won by two anti-establishment parties, the Five Star Movement and the League. The primary risk is that if the new Italian government decides to reject EU policies which limit budget deficits and impose controls on the sovereign rights of the Italian government, things could truly become dire quite quickly among Italian financial institutions. Their banks are largely recognized as "zombie" banks, being kept alive by the European Central Bank and their bond buying program. Italy has one of the largest bond markets globally, and an unraveling of their financial institutions would certainly have global consequences.

The second issue is that LIBOR (London Interbank Overnight Rate - the rate that banks charge each other to borrow and provide liquidity overnight) rates are rising quickly (chart - Bloomberg, March 23rd). This signals stress among European financials. Note the last time rates were at these levels was in 2011, which sparked a brief crisis in which Mario Draghi (head of the European Central Bank) gave a speech that the bank would do whatever it takes (meaning print more money and buy bonds of troubled institutions) in order to calm markets. Now - fully seven years after that time, European banks by and large are still in dire straights. It appears that Deutsche Bank is "on the ropes" and their stock price is down 88% since Jan of 2007. For one of the large, respected financial firms in Europe, with roughly $70

Trillion in derivatives exposure (yes - Trillion - with a “T”), this is less than opportune, especially coupled with waning support for the ECB’s money printing programs.

5. China De-Leveraging:



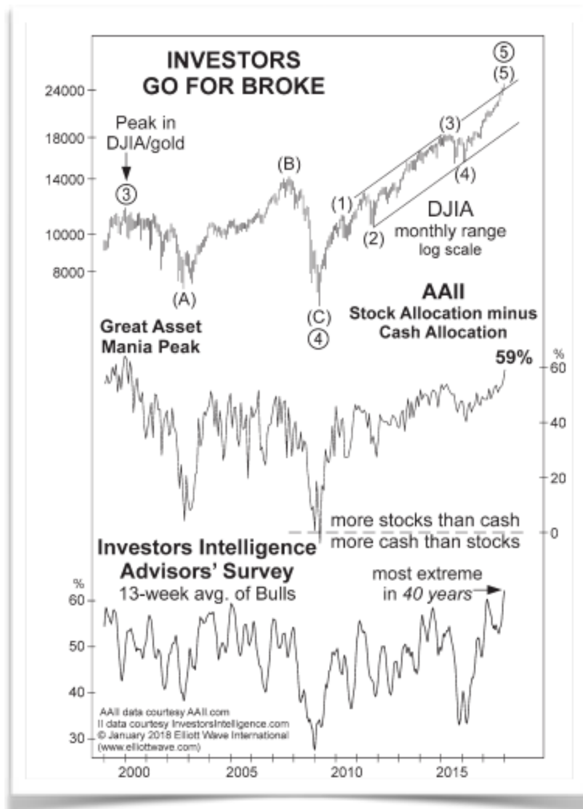
Lastly, the Chinese Congress was recently concluded and Xi consolidated power. It was largely believed that China would intervene in any significant market downturns or turbulence to maintain stability during their meetings.

The U.S. and Western Europe were not the only governments levering up after the financial crisis. China’s total debt (chart source Bloomberg) has also exploded in the past seven years. Now that the Congress meeting has passed, we’ve seen reports making the argument that China would like to attempt to deflate the bubble sooner rather than later so that a crisis does not hit close to its next Congress, which occurs every five years. China has been guiding growth estimates lower recently, leading to uncertainty about global growth assumptions, especially since China has been a major driver in global growth over the past five years. However, since much of that growth came with massively expanding debt/leverage, there will likely be significantly more pain felt than would have been the case without the effect of leverage unwinding.

Summary:

It is truly amazing that just three months ago, Advisor sentiment reached a 40 year extreme level of optimism. Private investor sentiment had also broken out to the highest levels ever. Allocation to stocks peaked in January as well (see chart to the left). For me, the most interesting thing to observe when being involved with the markets is how as a collective, people continue to make the same mistakes time and time again. When presented with data showing the equity market has reached valuations that should occur once very 2000 years, many people simply ignore the information due to “fear of missing out”.

The issues that have caused the recent bout of volatility are not new within the last three months. They have existed and have been getting worse for years. Investors have simply chosen to ignore



the issues of valuation, leverage and so on, because humans tend to project future outcomes in linear terms. When problems do occur, the catalysts that change sentiment are often viewed as the cause of the problems, when the true causes require a deeper understanding than most are willing to take the time to explore. This means that the solutions also require a deeper understanding. For these issues to be addressed on a public level, its not just an understanding, but an honesty with the public at large regarding the depth of the problems at hand, and the collective pain that we need to go through to achieve a sustainable fix. Our institutions, starting with the Central Bank and its leaders (Greenspan, Bernanke, Yellen) have failed us, and have chosen to pursue the same unsustainable solutions as they have in the past. Solving a debt crisis with more debt wouldn't make sense to most sixth graders!

Currently, the European Central Bank (ECB) and Bank of Japan are still printing money, and the emergency stimulus is still being added to "the system". However, with the U.S. having begun to reverse course, and the ECB reducing their program, the rate of change, and thus support to the markets, is decreasing significantly. It is not a coincidence that the market has chosen this period of time for volatility to reemerge. We have been fooled by the central banks multiple times over the years as they have promised to withdraw stimulus and then changed course to start yet another round of Quantitative Easing. With the new leader in charge of the U.S. Fed, it seems that this time might in fact be the real deal.

As discussed at the beginning of this update, we are continuing to make portfolio adjustments that we feel will benefit our clients and ourselves through the next phase of the market cycle. We very sincerely appreciate your trust and confidence as we all navigate this unique environment we find ourselves in.

Our warmest wishes for a very happy Spring season!

Brian Prichard and the Team at 44 North Financial Partners

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