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Forging Your Path

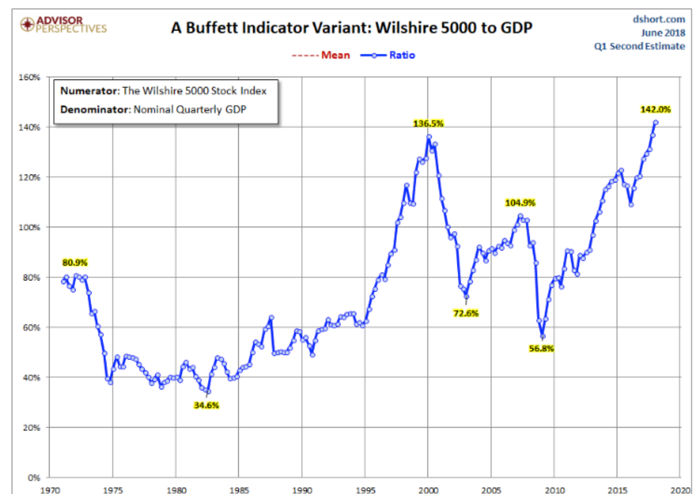
GLOBAL UPDATE

The Long Wait

As I begin this newsletter update on the afternoon of June 15th, President Trump has just announced China tariffs and representatives from China immediately responded stating that it will impose a similar level of tariffs on U.S. goods.

It has been quite a busy week on the economic front. The U.S. Federal Reserve chair announced another interest rate hike, the European Central Bank pledged to end their money printing program by the end of 2018, but stated that they wouldn't raise interest rates from 0% for one year. The Bank of Japan has left their interest rate at negative 0.1% and promised to keep "printing" money and buying their 10 year government bonds to keep the interest rate around zero percent because they could not hit their growth or inflation targets. This is perhaps the best place to begin our newsletter.

It was almost 30 years ago, in December of 1989, when the Japanese stock market (the Nikkei 225) posted a high of roughly 39,000. After a massive bull market, their bubble burst, and they've been unable to reclaim that high, with the Nikkei currently trading a bit below 22,851, still 40% lower than their prior peak. At the height of their market, the common view globally was that the Japanese tech stocks such as Sony, Panasonic and Canon were going to take over the global technology market. There would be no end to their growth, and valuations were sky high. At the time, the value of the Japanese stock market was about 130% of Japan's annual GDP. As can be seen on the cart (right), the U.S. stock market is currently at 142% of



our annual Gross Domestic Product, after bottoming at 56% in 2009. Our market has even surpassed the value/GDP that it had attained during the 2000 "dot.com" tech bubble. What particularly resonates with me right now is the very narrow leadership of the U.S. stock market by those technology firms that it is believed will grow to infinity, such as Amazon, Facebook, Google, etc.

I put out a brief newsletter last November that quoted an interview after the "dot.com" bust with the former CEO of Sun Microsystems in which he chastised investors for buying his stock at 10x sales, and concluded the interview with "What were you thinking?" November 2017 Valuation Brief For reference, Facebook is currently trading at 13x sales.

Back to our title, "The Long Wait". In the past, I've discussed, perhaps ad nauseam, my concerns regarding the market's valuation and the Central Bank intervention that was designed to artificially boost asset prices. This has truly been a grand and historic global experiment, with Trillions of dollars being printed globally, and government debt to GDP ratios spiking to levels not seen since they were required to fund the military during the epoch fight for survival that was WW II. The fact that, nine years after the "financial crisis" has supposedly ended, global markets are still receiving trillions in annual support through emergency measures (primarily now through the European and Japanese central banks) is alarming, and it should tell us how dire the situation is perceived to be by those in charge of the global banking system.

FT Breaking News

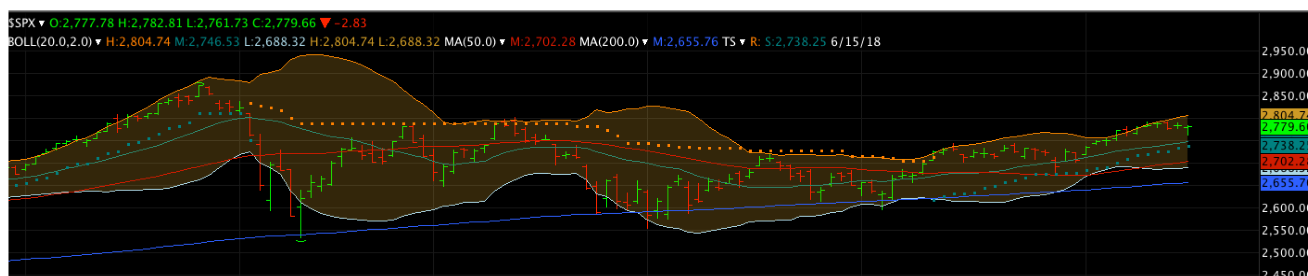
ECB signals plan to end bond-buying programme by end of 2018

The European Central Bank has signalled plans to end its €2.4tn bond-buying programme by the end of this year.

The bank said on Thursday that "the monthly pace of the net asset purchases will be reduced to €15bn until the end of December 2018 and that net purchases will then end".

The U.S. has, however, reversed its course and our central bank under Jerome Powell (Janet Yellen's successor) has stopped the presses and begun increasing interest rates. I've readied portfolios for the likely effects of a reversal of policy each time Powell's predecessors promised to end money printing, and have been burned each time. However, Jerome seems committed to this path, and based on prior speeches that he's given from as far back as 2012, he has consistently been against the printing of debt to solve a debt problem. Refreshing! This however says nothing about the U.S. budget deficit, which continues to mount at an ever increasing pace. The European Central Bank has recently committed to ending their bond buying/money printing program by the end of 2018 as well. This takes out two legs of the three legged stool that had been pushing liquidity into markets, leaving only poor Japan to support the weight of the entire system through the paltry (ha!) roughly trillion dollars per year that it is printing.

Not surprisingly, to me at least, the market has begun to take notice. The chart below (source, QUODD, as of June 16, 2018) shows the S&P 500 market action since the beginning of 2018. The trend has been sideways for about half a year now, with the first round of volatility occurring between the late January and mid-March timeframe. Central Banks will now test their theories to see if they can ever "normalize" interest rates without causing havoc via unintended consequences of their past actions. Unfortunately for us, we are all part of this grand monetary experiment that barely receives

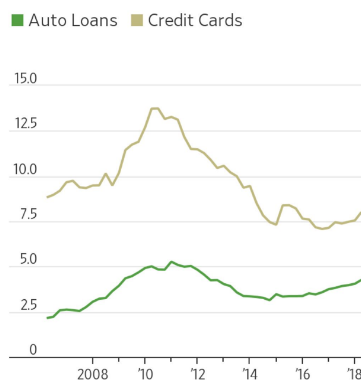


press in the mainstream media any more. To me, this is the most dangerous time in the investment cycle. The market has spent the better part of six months in a volatile, sideways holding pattern, and investors have become accustomed to markets moving up. By this time in the cycle, everyone has been trained to “buy the dip”. They hear in the media that all is well, and for sure:

- Unemployment is at the lowest rate it has achieved in decades;
- Corporate earnings are quite good;
- U.S. GDP growth seems firm; and
- Corporate tax cuts and repatriation of overseas money should provide a tailwind for the markets.
  - Some of that money has been used by companies to repurchase their own stock, and provide further support for the markets.

Quite frankly, I never thought we would see this point during this cycle precisely because the central banks had promised to remove the monetary stimulus punchbowl at least four times since 2010. While none of the above positive points should be dismissed, we are now beginning to witness typical signs of a top in the market. They are as follow:

- Household savings rates are down to the lowest level since just prior to the last peak, indicating that consumers are re-leveraged and have little “gas in the tank”;
- Both personal and corporate defaults/bankruptcies are ticking up, which is a late cycle sign, whereas early in investing cycles defaults have peaked and are trending down (see chart below);
- The equity market is being led by a more and more narrow group of stocks, primarily technology, that investors are piling into because they seem to be the only ones “working”, and they are no longer concerned about valuation;
- Consumer and Financial Advisor sentiment is at or beyond that of prior peaks;
- Corporate earnings may be as good as they get this cycle because costs are on the rise, specifically:
  - Input costs (oil is up significantly year over year)
  - Payroll costs (wages are up, which squeezes corporate margins)
  - Interest rates are on the rise, which will impact companies as they have to roll over debt;
- Global GDP is slowing, particularly in China and Europe, which will likely have spillover effects on our multinational companies.



It would be quite easy to dismiss the above items and maintain a “bullish” view, but when you think back to the other market peaks and consider the factors that were present in both 2000 and 2007, both **felt** quite good! In fact, our cadre of central bankers were cheering on markets in 2007 and had bullish views.

In 2007, Ben Bernanke (Chair of the U.S. central bank) said, ”My recommendation also is to take no action and to maintain a bias toward further tightening," at the first meeting of the year, noting that inflation risk had picked up and the housing market had shown some improvement after slumping in 2006. "The housing market has looked a bit more solid, and the worst outcomes have been made less likely," he said. "The central scenario that housing will stabilize sometime during the middle of the year remains intact," Bernanke said at a meeting in March, adding later, "The effects of the decline in subprime lending may have already been mostly seen, since that has slowed from last fall.” Roughly two months later, Bear Stearns suffered major losses from mortgage debt and the financial crisis kicked off in earnest. (Source: CNN Money, Jan 18, 2013)

I am not including the above to discredit or smear Ben Bernanke's name, but I am trying to make the point that those in charge of the monetary "reflation" policy that got us to this point in the markets sometimes truly have no more accuracy in their forecasts than anyone else. A quick search of 2007 central banker quotes would further prove this point.

<u>Outlook:</u>

We are at an interesting inflection point currently.

The strongest index in the US, the Nasdaq, has surpassed its January high for the year. The broader markets are still trapped in the sideways movement I highlighted at the beginning of this letter. I believe the more time that passes without upward followthrough by the broader markets, the more likely it is that we very well may have reached a high for this cycle in January. Many large foreign markets, such as China, Germany and Japan reached their peaks in January as well. Without other major economies reaching highs, it will be difficult, if not impossible, for the U.S. markets to go it alone.

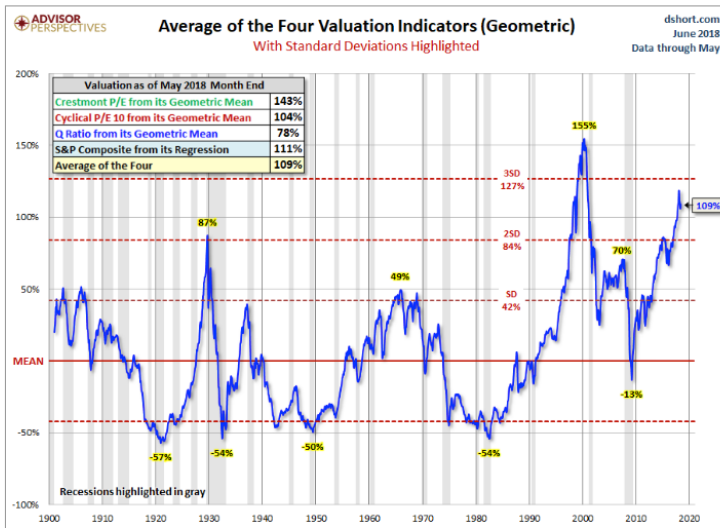
Alternatively, with the US Fed raising interest rates, the dollar has been stronger this year than last, and has appreciated against the "dollar index" (a basket of other developed market currencies). This has put pressure on many Emerging Markets (EM), because both EM countries and companies use U.S. financial markets to raise debt, which is dollar denominated. As the dollar appreciates, it makes it more expensive for those entities to pay the debt back because their currency is depreciating vs. the dollar. The attached chart shows the Argentina stock index since the Forbes headline was printed on February 20th. No, the headline was not a joke, and the author was referring to the strong performance of the Argentine market in 2017, but the 34% drop in just over 3 months shows how much pressure can be exerted by a simple change in direction of the dollar! Examples similar to this can currently be found in Turkey, the Philippines, and to varying degrees in Russia, Malaysia, and Vietnam, among other Emerging Markets. This could force global funds into the U.S. market temporarily, regardless of the valuations, simply because the U.S. could be perceived as a safe haven. This could also lead to a final push for U.S. equities this cycle, particularly into the most overvalued sectors of the market that have had positive momentum. The valuation chart that I frequently reference (next page) shows that the U.S. equity market, by the measures referenced, is still at the second highest level since 1900.

Is Argentina The New Darling Of Emerging Markets?

Forbes Kenneth Rapoza

Forbes February 20, 2018

At this point, I'd put a 70% weight on the first scenario being the most likely outcome. Either way, I believe the markets will succumb to the pressures of rising interest rates and a reduction in global liquidity as we progress through 2018. We all learned the mantra, "Don't fight the Fed!" (frequently used when the Federal Reserve Bank is pushing for looser monetary policy in an effort to inflate markets), but for some reason, people tend to forget that mantra works in reverse when the Fed is



tightening monetary policy. Until the end of this year, markets will still be receiving a significant liquidity boost from the European and Japanese central banks. I believe this is what is causing the current "push-pull" to take so long to play out. However, in the context of prior peaks, it typically does take many months for sentiment and direction to ultimately turn. Assuming we are near or perhaps at the peak for this cycle, it seems to be playing out surprisingly like past peaks.

In my view, the only thing likely to push markets higher from here is a significant and coordinated reversal in the tightening of monetary policy from multiple central banks. I know if feels as if this process has taken forever and a day to play out, and it has! This truly has been a long wait.

Our warmest wishes to you and your family as summer kicks into high gear! We hope you have some great things planned and look forward to speaking with you soon.

Sincerely,

Brian Prichard and the Team at 44 North Financial Partners

Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.

All indices are unmanaged and investors cannot invest directly into an index. Investing in alternative investments may not be suitable for all investors and involves special risks, such as risk associated with leveraging the investment, adverse market forces, regulatory changes, and illiquidity. There is no assurance that the investment objective will be attained. Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than their original value. Some investments are not
suitable for all investors, and there is no guarantee that any investing goal will be met. Talk to your financial advisor before making any investing decisions. Emerging market investments may involve higher risks than investments from developed countries and also involve increased risks due to differences in accounting methods, foreign taxation, political instability, and currency fluctuation. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the
NASDAQ. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common
stocks. The US Aggregate Index covers the dollar-denominated investment-grade fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS passthrough securities, asset-backed securities, and commercial mortgage-based securities. These major sectors are subdivided into more specific subindices that are calculated and published on an ongoing basis. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. This index is rebalanced monthly by market capitalization. Investing in commodities may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of
commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs, and international economic, political, and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time,

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44 North Financial Advisors is located at 2 Cotton Street, Suite 200, Portland, ME 04101. Tel: 207-319-7373