GLOBAL UPDATE

Oct 2017
Keeping it Simple

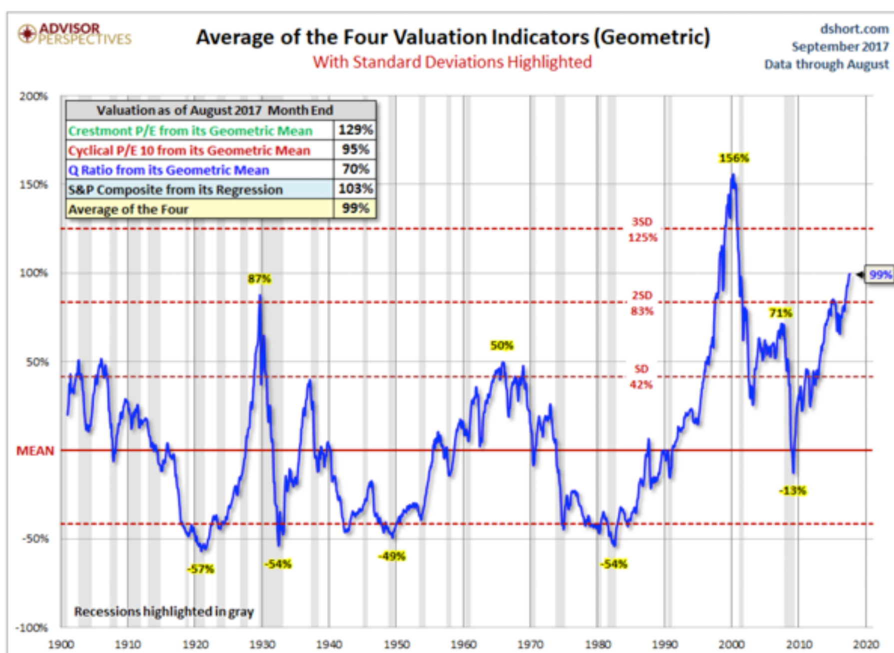
In the beginning of this issue, I will highlight two indicators regarding the markets that I've shared with clients over the past couple of years. Both are very straightforward and serve as a basis for how we view the equity market today. If you spend no more time on this newsletter, please review the two charts as I believe they are the most important long-term indicators to follow and serve as a basis for determining exposure to equities as well as illustrating overall market risk.

In "Section 2", I will highlight strategies that we believe possess the opportunity for good performance in light of the stretched valuations. In addition, I will highlight sectors or themes that we feel are compelling for the longer term.

Finally, I will share some external research from Jim Reid, a lead strategist at Deutsche Bank, regarding their views and expectations for the bond market. I found the charts compelling, and supportive of our views on bonds.

First, however, I'm happy to report that with the exception of the loss of power and some inconvenience, our friends and clients in both Florida and Houston escaped both large disasters relatively unscathed. A small miracle in my mind, and one that we're thankful for. In that vein, I'd like to mention that if you did not read my partner, Chad's, last brief planning letter regarding emergency preparedness, please do so. The links provided will be a good start to making you and your household more resilient in times of an emergency.

Section 1: Valuation and Margin Debt Review (Keeping it Simple)

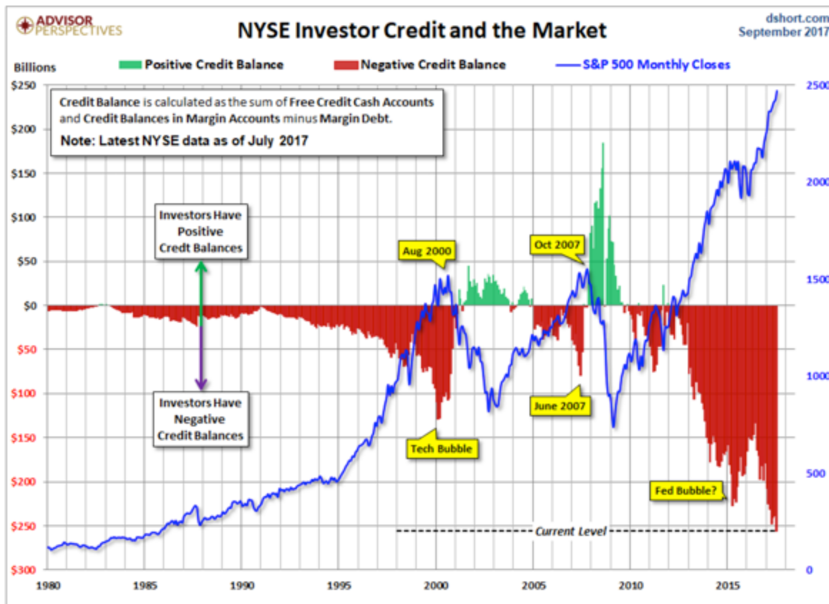


The chart to the left uses an average of four long-term valuation measures for the stock market, beginning in 1900. If the blue line is above the solid horizontal red line (MEAN), stocks are more expensive than their mean value. The dotted red lines above and below the mean represent Standard Deviations. Valuations should fall within +/- 1 standard deviation from the mean 68% of the time, and +/- 2 standard deviations from the mean 96% of the time. U.S. equities are currently over 2 standard deviations above mean valuations, and in fact have only been higher one time in history, which occurred during the “Dot Com” bubble. The other two close extremes occur in 1929 and again in 2007. What we know for a fact is that in 100% of the prior 3 times that valuations became this extended, the market ultimately fell 50% or more from its peak. This could be the one time in history that markets permanently remain at such an extended level, or (as I would assert) this has been caused by the most extreme monetary policy in modern history (zero interest rates and trillions in money printing), which will come to an end as central banks attempt to withdraw stimulus.

There are two ways for valuations to fall to lower levels. The first being if corporate earnings increase faster than the market appreciates. Take for instance the decade of the 70’s. From 1968 - 1982, the S&P 500 was flat from a price perspective (little to no appreciation). However, corporate earnings were improving during this time, making stock valuations retreat from above 1 standard deviation overvalued to 1 standard deviation undervalued during that time (see chart). This scenario could occur if central banks very slowly withdraw stimulus over a decade or more and corporate earnings continue to grow. The market would constantly fight a headwind and likely would make little progress, but valuations could fall to lower levels, at which point forward returns become more attractive.

The second way for this to play out is a significant market downturn. My view is that this is the more likely outcome, which is why we’ve structured portfolios to heavily invest in “alternative” strategies that either 1) play in the equity (stock) space but can go both long or short the market; and 2) are involved in markets other than equities or fixed income, and have flexibility to invest both long and short their respective markets (an example of these markets might be oil, industrial metals,

etc.). We believe that by utilizing managers with a successful long-term track record of producing positive returns when equity markets become challenging, we are setting ourselves and our clients up for a positive experience during a potentially very difficult time.



The second chart that we find vital to understand is the one to the left, which illustrates the level of margin debt that exists across the market. The easiest way to explain this is through a housing analogy, as follows:

Homeowners A own their home outright and have no mortgage, thus no "margin" or leverage to the price of the housing market. If their $1million home appreciates by 10% over 1 year, their return is $100,000, or 10%. Likewise, a decline of 10% is not catastrophic to them, as they will never be forced to sell their home. They may not like the price, but they can continue to enjoy living in it.

Homeowner B is an investor in real estate who puts down 10% ($100,000) on a $1million home. If the market appreciates by 10%, excluding some de minimis mortgage interest, the return is 100% for that same year! (They've used $100,000 to control a $1million house, and they've made $100,000 on that investment). However, if home prices fall by 10%, their home is worth $900,000. They've now lost 100% of their initial investment and will need to quickly look for the exit, or they will have to write a check to get out of that property.

The chart above shows the level of margin (or borrowings) across the New York Stock Exchange. As demonstrated in the above example, leverage works well in an up market, but when facing a down market, a highly leveraged investor needs to sell investments to avoid going bankrupt. The current level of margin debt is concerning (especially in light of the peak in 2007). In the past 30 plus years, the best market returns have been achieved when investing in a market that is near or below its mean valuation, and when leverage is low an building, vs. high and falling.

Section 2: Strategies & Themes We Favor (Short and Long Term)

<u>In the short term</u> (until valuations return to a more favorable level) we favor the following strategies:

- Active management over indexing: While we believe low cost indexes absolutely have a place in a portfolio by giving very efficient exposure to a selected market, with valuation readings at such extremes, their weakness is that there is no "emergency stop" on the downside. Investors will

participate in the full downside of their respective index. Looking for active managers who have a successful track record of reducing risk, and who have participated in multiple full market cycles makes sense to us at this juncture.

- Long-Short or Tactical Funds: Short selling, at a high level, is the opposite of owning stocks “on the long side”. Quite simply, in short selling, investors make money if the underlying asset (a stock or an index) depreciates in value. In our portfolios, we currently include managers who can do the following:

  - Own their favorite stocks or sectors on the long side, while taking short positions in stocks or industries their research shows are fundamentally weak, or have deteriorating business models. Funds that employ this strategy are typically called “Long/Short” funds.

  - Move their entire long stock position to cash, and then, if market momentum becomes significantly negative, into short positions to benefit from a fall back to mean valuation. This style of management can be found in “Tactical” funds.

- We currently also employ Managed Futures funds in our portfolios. Again, we look for managers who have significant track records of offering positive performance through a variety of market cycles. These managers can participate on both the long or short side of many global markets, including stocks & bonds, currencies, interest rates, commodities such as wheat and oil, as well as industrial and precious metals.

- We are currently significantly underweight bonds for reasons that you will read about in the next section.

Longer term, we see the emergence of quite a number of opportunities as the markets become cheaper, and the global economy changes. We participate in some of these themes currently, but in smaller size. We will wait for equity markets to become more attractive to really scale into these ideas as we feel they will present long-term growing trends that we want to benefit from. Some of these trends are:

- Global Healthcare/Biotechnology: While the U.S. still has to fix its healthcare system, there is likely substantial growth globally, and particularly in the emerging markets, as their consumers continue to become wealthier and in certain countries (like China) demographics play in favor of continued increased spending in this sector.

- Global Infrastructure & Power Grid: Quite a bit of the developed economies infrastructure is in need of upgrades, and emerging markets continue to invest, as Asia, South America and Africa all will likely continue to develop their infrastructure needs. As a subset of this we see:

  - Green Energy: both technology and manufacturing are opportunities for the long term, and;

- Clean Water: infrastructure and technology around the delivery of clean drinking water to vast population centers will likely provide opportunity, and is on many governments' agendas, not simply for the humanitarian aspect, but also for political stability.

- Internet & Information Security: As we've recently seen in the Equifax data breach, internet systems are currently vulnerable. We believe the two main areas to experience growth in the future are centered around 1) corporate and personal systems that connect with the internet; and 2) global payment system security and the emergence of blockchain technology (or something else that may come along) which will likely radically change the way money is transferred between parties.

- Agriculture: Yes, boring old agriculture. We believe there will be a move from mass farming for both grains and livestock, to a more natural and localized production of foods. Finding quality companies that can capitalize on this trend is difficult (especially from a "pure play", meaning not a small part of some larger conglomerate), but we are doing our research.

In summary, while valuations in markets are extreme, we don't feel that sitting in cash is a terribly effective option. We are well aware that governments continue to print money, which ultimately devalues currency. In fact, our central bank has a target of "achieving" 2% annual inflation, which cuts the purchasing power of a currency in half over 30 years. If you're 60 years old, can you remember what an average home cost when you were 20?

We feel that our main mission currently is not to expose our clients to excessive market risk, but offer some return to fight inflation until we see that market valuations and leverage get closer to their norms.

Section 3: Notes from Deutsche Bank

Historically, I have to say that I've found little value in "sell-side" research firms' reports, because by nature, their firms need investor participation in both stocks and bonds to keep the lights on. That being said, however, at the end of 2016, Jim Reid, a lead strategist at Deutsche Bank, produced a 91 page report on the state of the markets which I found to be quite interesting and honest.

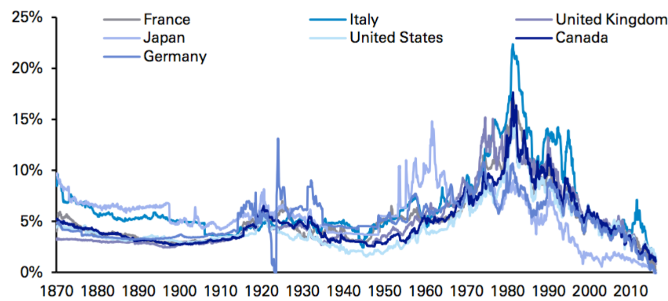
Figure 9: Real Annualised 10yr Govt. Bond Returns by decade since 1940

	1940 -1949	1950 -1959	1960 -1969	1970 -1979	1980 -1989	1990 -1999	2000 -2009	2010 -2016
Australia	-0.20%	-3.10%	1.70%	-2.90%	3.80%	10.40%	3.50%	6.20%
Austria		1.50%	2.70%	2.00%	4.80%	5.90%	3.90%	3.80%
Belgium	-6.90%	2.20%	1.60%	-0.80%	6.90%	8.20%	3.90%	5.00%
Canada	-1.00%	-0.90%	1.00%	-0.70%	6.80%	8.40%	4.60%	3.60%
Denmark	0.30%	0.60%	-1.40%	0.50%	11.70%	9.00%	4.10%	5.00%
France	-22.40%	-0.80%	0.40%	-2.80%	7.50%	8.70%	4.00%	5.30%
Germany		3.60%	3.40%	3.00%	5.30%	4.50%	4.00%	4.70%
Greece							2.00%	8.90%
Ireland	1.80%	-4.10%	-0.90%	-6.70%	8.80%	8.00%	2.50%	9.30%
Italy	-29.80%	-0.60%	1.30%	-5.60%	6.30%	9.90%	3.40%	5.90%
Japan	-32.70%	3.00%	6.40%	-2.00%	6.70%	6.10%	2.10%	1.90%
Netherlands	-3.00%	-3.40%	-1.90%	0.30%	6.70%	6.20%	3.60%	5.00%
Norway	7.80%	-8.20%	1.30%	-3.50%	3.40%	9.00%	3.40%	3.10%
Portugal					2.40%	4.90%	4.10%	5.80%
Spain	-3.30%	-2.80%	-0.90%	-7.60%	5.90%	7.80%	2.60%	6.70%
Sweden	3.40%	-3.00%	-0.20%	-4.20%	4.40%	8.60%	3.70%	3.80%
Switzerland	-0.40%	1.50%	-0.30%	0.80%	0.60%	3.70%	3.30%	4.30%
UK	0.50%	-0.70%	1.30%	-3.20%	6.60%	6.50%	3.40%	1.90%
US	-2.50%	-1.80%	0.20%	-1.20%	7.30%	4.90%	4.00%	3.80%

Source: Deutsche Bank, Global Financial Data. Shaded areas represent negative real return decades.

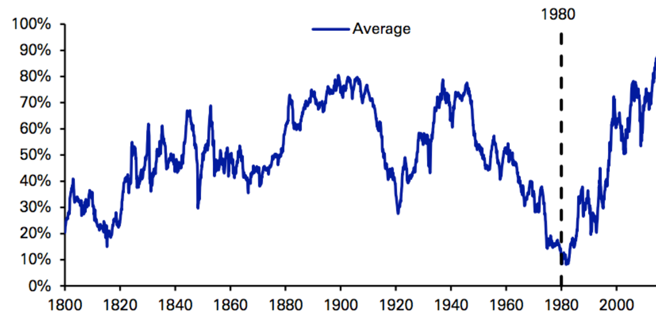
Jim starts by showing historic bond market returns by decade beginning in 1940 for a variety of developed economies (see chart to right). I believe he provides this background so that his current conclusion does not sound too far fetched to readers facing "recency bias", a scenario where people project their recent experience in something and extrapolate that out in their future expectations. As you can see, since the 40's, there have been three decades where annualized returns for U.S. 10 year Government bonds has been negative. However, since the early 1980's,

Figure 20: Long term government bond yields (G7)



Source: Deutsche Bank, Global Financial Data

Figure 23: Aggregated 15 DM country average bond (nominal yields) and equity percentile valuations (100% = most expensive; 0% = cheapest)



Source: Deutsche Bank, Global Financial Data

bond returns have been quite good, which makes sense in light of inflation last having peaked in the late 1970's, and rates having been at historic highs in the U.S (see chart to left). A constant march of lower rates since then has boosted returns. In fact, he shows us that in aggregate, interest rates have never been lower among G-7 countries!

The natural corollary to this is that prices are also at their most expensive level. In fact, Jim states, "In aggregate, valuations across these three asset classes *(stocks, bonds and real estate)* across 15 DM *(developed market)* countries have moved from being near the bottom of their 215 year range at around our key 1980 starting point to being pretty much at record high valuations now."

Jim's conclusion is that "Government bonds will likely see a negative real return from this starting point over the next few decades. For those who think such a long period of consistently bad performance is unlikely, Figure 9 (taken from our data section at the back) shows annualised real bond returns by decade since 1940 for 19 major DM bond markets with negative return decades shaded."

Jim's conclusion is supportive of our current view on bonds. Our view is reflected by a significant underweight to bonds in our model portfolios. Where we do hold bonds, we've employed managers who have the ability to employ tools that can assist in managing the damaging effects that rising rates may have on a fixed-income portfolio.

Conclusion:

Campfire weather is arriving in Maine, with evenings in the low 50's. The colors are beginning to turn and we're settling back into our families school routines. We've prepared well. The firewood is split and stacked, outdoor projects are complete, and the snow blower is tuned and ready for what's next. The seasons are changing, and we wonder if seasons are about to change in the markets as well. If so, we feel well prepared for what may lie ahead.

Our warmest wishes to you and your family,

Brian Prichard & Your 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, creates the possibility for greater loss. Asset allocation programs do not assure a profit or protect against loss in declining markets. No program can guarantee that any objective or goal will be achieved.

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