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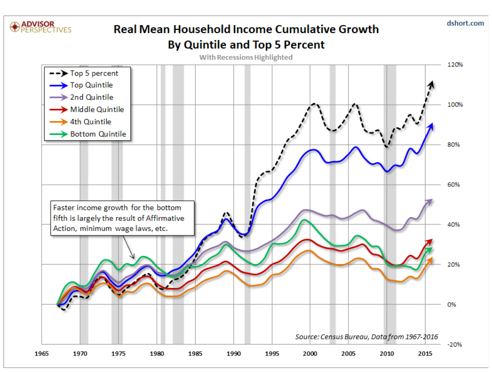
GLOBAL UPDATE

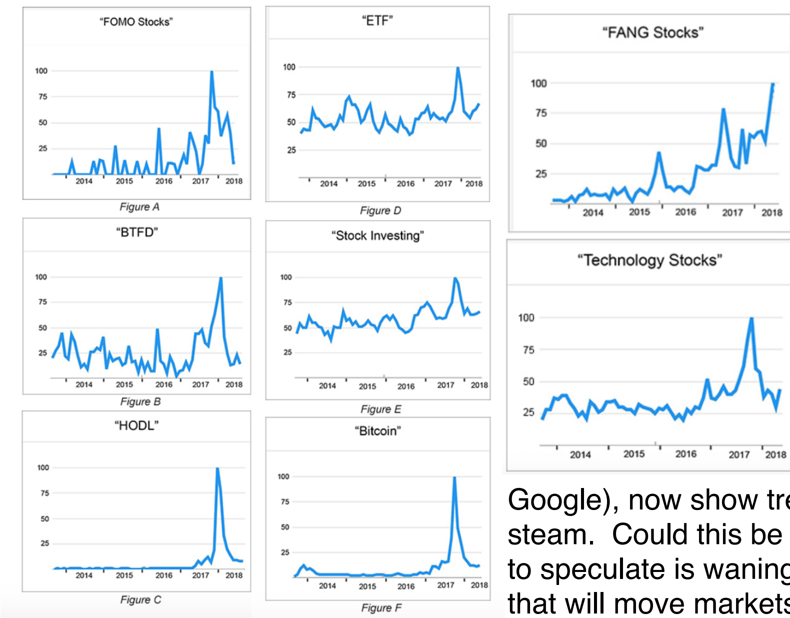
Running With Scissors

We have been living in a the strangest economic time, likely in history, since the government bailouts after the financial crisis. Over the past nine years, some truly positive things have occurred with technology, medicine and manufacturing. Our country's unemployment rate is low, consumer confidence is high, inflation looks to be contained (unless you have to pay for college or medical services) and economic growth seems stable. Interestingly, however, most of the people I speak with don't trust the recovery, and many seem more and more on "edge" than in years past.

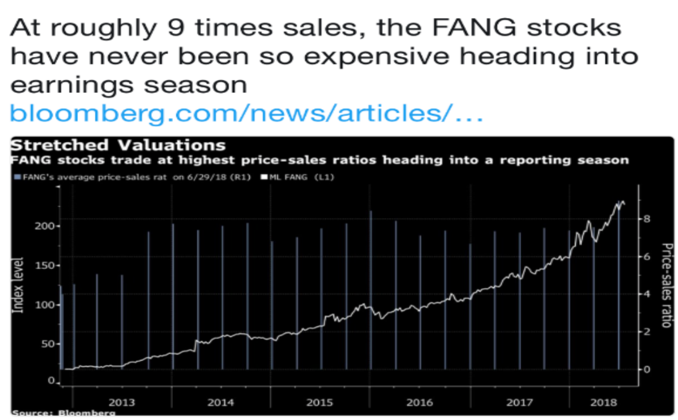
I read about the markets constantly - different approaches to evaluate the business cycle, technical & charting approaches and theories, fundamental valuations, monetary policy and so on. Of the things I've read, the one that seems to hold the most credibility lately is the one that would be considered the least "market" related. The theory focuses on collective social mood as a driver of markets and the generational influences that tend to shape behavior of people en masse for periods of time. An obvious example is that of those who went through the Great Depression. Most of us remember our grandparents approach toward finances, typically being conservative savers with low tolerance for risk and a dislike of debt. Without going too deep into the generational cycles and reasons behind them, it appears that we're at the stage where populism (as defined by the "Free Dictionary": A political philosophy supporting the rights and power of the people in their struggle against the privileged elite.) and protectionism are on the rise in many developed Western economies. It's no wonder, because we live in a country where 60% of the people haven't seen their standard of living rise in roughly 30 years (see chart - left). However, those who own and



control assets, and the banks that finance economic growth through the miracle of globalism, have benefited greatly. According to this brand of theory, these cycles are not short lived (20-30 years typically), thus, we would be at the front end, likely in the first third, of the populist movement. These phases don't typically end until there is real change, and with a good deal of pain during the process.



Along these lines, we now have the ability to track not just social mood, but investors' moods via Google searches, shown by the Google Trend data charts. In looking at some of the commonly searched financial terms (some a bit less orthodox) both in the press and on social media, it seems that much of the speculative fervor peaked in early 2018 after multiple years of growth. All terms, with the exception of the "FANG" stocks (Facebook, Amazon, Netflix, Google), now show trends that seem to have run out of steam. Could this be an indicator that the collective desire to speculate is waning? Granted, there are other factors that will move markets, and this is just a cross section of speculative terms, but it is interesting nonetheless, and it will be more interesting to see how this type of data can be used in the markets in the future.



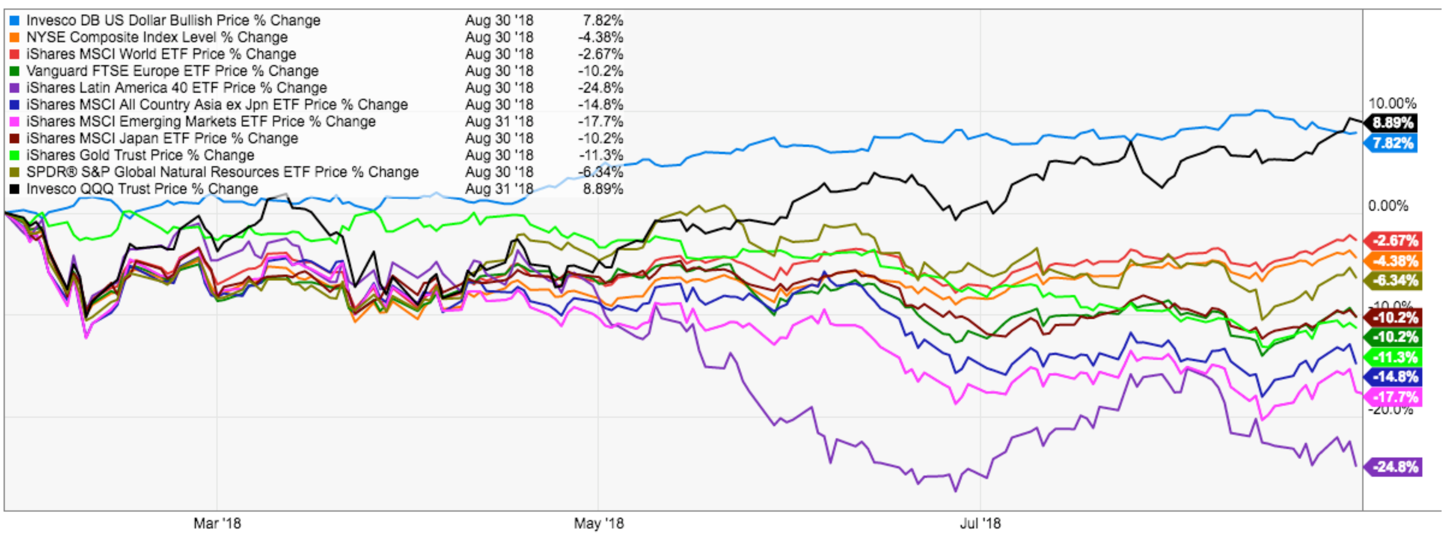
In line with the search data, it has been a narrow basket of technology stocks that has been driving the U.S. market YTD. Some portfolio managers believe there will be a "blow-off top" to this market, while others believe this phenomenon has already occurred, as Amazon took only 165 days to go from a market value of $600 billion to $1 trillion. A "blow off top" is a phenomenon where as fewer and fewer stocks make gains, investors continue to pile into the handful that are making progress, pushing leaders to unsustainable valuations and, because of their weighting in narrower indexes, pushing indexes up so it appears that all is "good". This same Bloomberg article stated that "six stocks, FMAANG (Facebook, Microsoft, Amazon, Apple, Netflix and Google) accounted for 98% of the gain in the S&P 500 through July. This is not a healthy trend, and we've seen it before in 2000.

The S&P 500 and tech heavy Nasdaq indices have gradually reclaimed their January levels through the summer months, while the Dow Jones and NYSE Composite indices (broad measure of U.S. stocks) are still below their January peaks as of this writing. While the U.S.

markets may appear to be untouchable, we are witnessing market tremors around the world that should not go unheeded.

Global Markets:

January 26th marked the peak in equity market prices for much of the world. The chart below, while busy, tells the global story. Our Federal Reserve Bank has been hiking interest rates which has driven the value of the US dollar up almost 8% since the end of January. A broad cross section of global equity markets is pictured below, as well as natural resources and gold since that time. This chart shows that markets in every single area of the world besides the U.S. are feeling pain. Europe is down over 10%, Japan is down 10%, broader Asia almost 15%, broad Emerging Markets almost 18%, Gold is down over 11% and natural resources over 6.5% (chart Y Charts, 1/26/18 - 8/31/18, please note that these values are approximate. Unlike indices do not incur management fees, charges, or expenses.). Even the broad US index, the NYSE Composite, is down 4.3%. This index is one of the broadest measures of U.S. equities (https://www.investopedia.com/terms/n/nysecompositeindex.asp).



While broad U.S. stocks are down and the rest of the world has taken a beating, only the narrower US sectors are higher. The Nasdaq QQQ index is up over 8% during that time, and has a significantly disproportionate weighting to technology stocks, while the S&P 500 has just pushed above its January high by roughly 1%. This begs the question, “why not invest in U.S. technology shares, where the momentum is?” The chart (prior page), taken from a Bloomberg headline at the end of July, shows the “multiple times sales” at which the popular “FANG” stocks (Facebook, Amazon, Netflix and Google) are currently trading. At 9 times sales, we are approaching “dot com” era price peaks. My brief November 2017 “Global Market Interim Update” newsletter quoted the former Sun Microsystems CEO, Scott McNeely, stating how ridiculous it was that investors were buying shares at 10 times sales, and his interview concluded with him asking investors, “What were you thinking?” Sun Micro fell from $64/share to $5/share by the conclusion of the bear market. Who knows what the markets will bring us in the future, and with real earnings in companies like Amazon and Apple, I can’t say that I’d expect such a dramatic downturn, however, would it be possible to see a 50-60% cut in those share values during a bear market? Based on history and valuations, I believe so. What I can definitively say, however, is that earnings are not keeping up with stock prices. The valuation

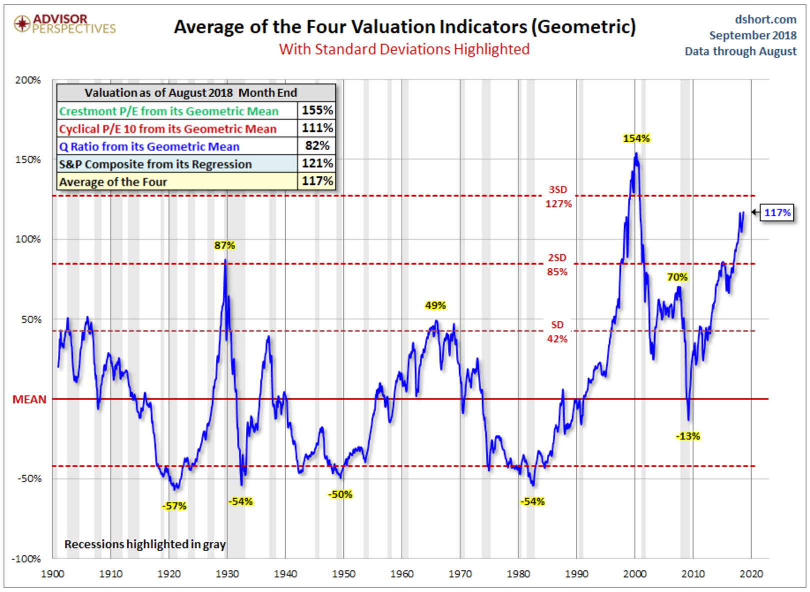
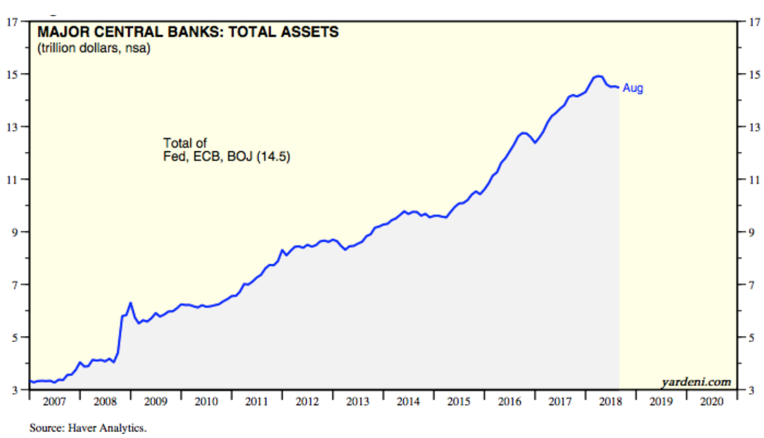


chart shows that we're approaching 3 standard deviations above the long-term mean value since 1900, well above the values of 1929 and 2007, and closing in on those seen in 2000.

When stocks ultimately decide to "revert to their mean", the most overvalued shares tend to do so extremely quickly and without much warning. Take Facebook for example. The stock closed on July 25th at $217.50/share. They reported earnings that evening, which showed margin compression and slowing earnings. The stock opened for trading the next day at $174.89/share, 20% lower, without affording U.S. investors the opportunity to sell. At this writing, Facebook is currently trading a little above $160/share. Similarly, Netflix closed before it's earnings report on July 16th at $400.48/share. It opened the next day at $346.95, over 13% below its prior night close, and investors have since given the stock the benefit of the doubt. Netflix has partially recovered to roughly $368/share currently. I could run through a host of these high tech stocks that we're beginning to see cracks in. It seems that investors, who believe these stocks are like trees that can grow to the sky, may be running with scissors. Interestingly, perhaps as seen earlier in the waning speculative search data from Google Trends, the fervor may be starting to die down.

Central Banks - the most important trend to watch



As I've stated so many times before, I firmly believe that the liquidity provided to the markets by central bank money printing programs is the key metric to watch above all else in trying to determine where markets are headed. The slight dip in aggregate printing in early 2016 caused a brief but vicious 15% correction in the markets. The downturn was so short and sharp, in its recovery as well, that many retail investors didn't really notice it. This downturn caused Europe and Japan to rush in and increase their money printing programs to more than offset the amount that the U.S. had ended. In addition, Great Britain's central bank affirmed a 0% interest rate policy going forward, and China lowered bank reserve requirements to stimulate lending and growth. Central Bankers learned something during that time. They could not simply end support for the markets, even seven years after the crisis, without expecting a bad outcome. Currently, the U.S. is raising rates and reducing the balance of printed money (the reverse of quantitative easing - we are now in quantitative tightening) by $40 billion per month, stepping up to $50 billion per month in October. In addition, the European Central Bank is reducing the amount of money they are printing (they are still in easing mode), and are scheduled to end printing by January 2019. This will leave the Bank of Japan as the sole money printer remaining globally, at roughly $700 billion annually. Will this be enough additional liquidity for global markets to maintain the positive direction? We don't yet know.

In addition, throughout the years, as interest rates were suppressed to zero (or below in the case of Europe and Japan), a massive amount of borrowing has taken place at the corporate and global government level. Now that rates are rising (albeit from the lowest base in history, and very gradually), as that debt needs to be refinanced, it will be at higher rates. This means more interest expense to both entities, and revenue will need to be found from the corporate side to maintain margins, and from the government side, likely via higher taxes (if not in the U.S. currently, at least globally). Deficits will widen as a result.

Is "it" different this time?

Well, yes, no, and we don't know.

<u>The "yes":</u>

Quantitative Easing is a new monetary policy that has been implemented by central banks. They have never before in history intervened in markets in this way. Certain banks, such as Japan, Switzerland, and Norway, have even taken a liking to printing debt for free (because rates are close to zero), and buying stocks. Based on everything I've read from Central Banks, it is very likely that this policy will be with us going forward. Meaning - what started as emergency intervention has likely become a permanent part of our economic system. The Bank of Japan has intervened to such an extent to keep their interest rates low, that they now own over 40% of the Japanese bond market. What was once a vibrant bond market, the 2nd largest in the world, has become a hollowed out farce. Bonds of various maturities don't trade for days. It is no longer a "market", but a nationalized program where certain investors (banks, pensions) are forced to hold a specific amount of this debt. At roughly 250% debt to GDP, I believe it is unlikely that Japan can ever stop the intervention, or interest rates would rise, and due to the cost, it would bankrupt the country.

Mario Draghi, the head of the European Central Bank, has made it clear that this tool will be used going forward. The U.S. Fed, while the inventor of quantitative easing (QE), was also the first to attempt to wean itself off of the program. In various speeches, it is also apparent that we are only temporarily off life support, and that QE will likely be back during our next downturn.

Thus, it is different this time. Money printing programs to actively intervene in global equity markets are a new phenomenon. When taken to extremes, the programs could ultimately lead to the nationalization of equity and bond markets. Ultimately, these policies are anti free-market.

<u>The "no":</u>

All of this money printing and debt purchasing by central banks suppresses interest rates, which spurs global borrowing and debt creation. There are some laws of economics that I still believe in. I don't believe a debt crisis can be solved with more debt. It doesn't work for us as individuals, and ultimately I don't believe it will work for governments. On the corporate side, loans are being made to marginal-at-best borrowers under some of the loosest terms in modern financial history (to find out more, Google "cov-lite loans" - which means covenant lite, or extremely weak collateral requirements pledged to borrow). As debt continues to grow for marginal borrowers, and they ultimately default, the credit cycle will come to an end. Credit is the manna for all modern growth cycles, and the end of easy credit has been the downfall. As bank loans default, and banks are required to increase loan loss reserves, credit becomes tighter and more marginal borrowers default because they can't roll over their debt when it matures. It is a cycle that plays out in capital markets globally, and I believe will continue to do so. Thus, I believe that while printing programs (QE) can greatly extend the cycle, possibly to limits beyond our imagination, they will not extinguish market cycles.

<u>The "we don't know":</u>

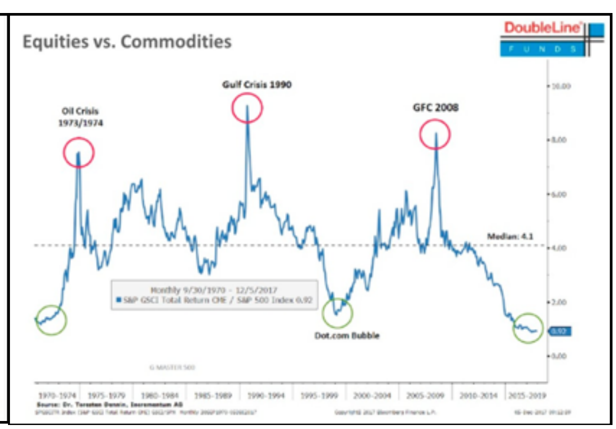
We do not know at what level of decline in the equity markets the Central Banks will decide that these support programs need to be ramped back up. We also don't know whether investors will choose to believe that new rounds of debt printing will work. It likely all depends upon the collective social mood at the time. On the faith that investors and citizens have in "the system" and in central banks. This is one reason I find the timing of the crypto currency market so interesting (this is not an endorsement of crypto currencies). In going along with the social cycles studies mentioned earlier, and the populist movements we see globally, it is not a surprise that a large group of people have decided that they don't trust our financial institutions to protect them (just look at the Wells Fargo headlines over the past couple of years), and that they need to find an alternative. It's also not a surprise that governments will fight back via regulations, as we've started to see implemented globally.

Again - now that QE is considered a tool for central bankers, we don't know when they will increase programs again, but I'm quite confident that they will.

Opportunities:

Core risk managed fund strategies in the portfolios have performed in line with my expectations so far this year. With the dollar strength having crushed emerging markets and natural resources, however, some of the small positions that have allocations in those areas have been a drag to performance. This dollar strength has caused some of the cheapest assets globally to become even cheaper. We (and the market) expect that the Fed, run by new chair Jay Powell, will raise rates on September 26th. What I believe may happen at that meeting however is that due to the dollar appreciation and subsequent emerging market pain felt globally, the Fed may begin to insert language into their press conference regarding future rate hikes, and soften their stance going forward. This would serve to weaken the dollar. At the same time, Europe is set to end their printing program by the end of this year. A currency

Source: Thomson Reuters, Credit Suisse Research



rebalancing where the dollar falls would, in our view, be a catalyst for a large rally in emerging markets, natural resources and precious metals. One of our portfolio fund managers has been increasing their position within the Emerging Markets space. We may increase current, or take additional small positions as well prior to the Fed meeting. Due to valuation discrepancies between these assets and the U.S. market, we feel there is potentially a significant opportunity for price appreciation. If the Fed signals that it will continue on its current rate hiking path, we will likely reverse these positions and move them back into core risk managed funds.

On Tariffs:

I've been asked over the past few months whether tariffs are ultimately good for the United States. The answer, I believe, depends upon if you are a populist or a globalist. Our country's companies have benefitted hugely from outsourcing labor to other parts of the world. This has helped profitability at the expense of our middle class jobs. We've all benefitted from this process however through reduced costs of goods that we've imported, which has kept inflation down. In fact, this has been a major deflationary force to offset those things that have experienced inflation. Think about the cost of a TV or microwave, or even a computer, and what's happened in the past 20 years. Now think of the labor cost to build a new home(labor that can't be outsourced), even when taking materials out of the equation. Big banks love globalism. They've financed factories all over the world and corporations have expanded margins and profitability. Conversely, with tariffs imposed, it will bring some manufacturing jobs back home. It would likely be fine for some sectors, where the labor expense is not that high of a portion of the overall cost of the good. But, where labor costs are a higher percentage of the finished product, that product would likely not be competitive globally.

One thing I do absolutely believe however is that if we embark on a trade war with multiple countries, and end up imposing large tariffs, corporate profitability will fall significantly from current levels, as U.S. companies would have to retool their entire manufacturing and supply chains. So, perhaps a minimal amount of tariffs, used as a negotiating tool, won't hurt the economy badly in the near term. However, I believe a potential black swan for the U.S. market is a larger scale trade war with China, as corporate margins will fall and stocks would likely be revalued quite quickly.

On Midterm Elections:

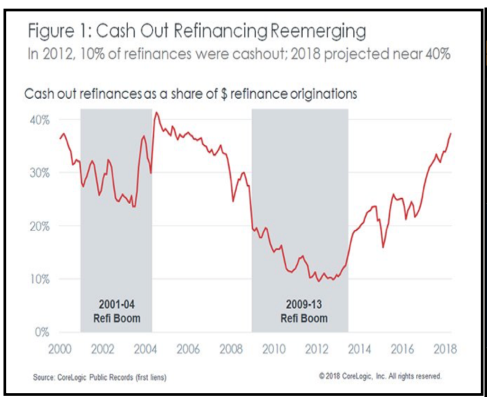
The outcome of midterm elections will likely impact the direction of a potential trade war. If Republicans do well, and retain their majorities, I believe Trump will be emboldened to pursue his fight with China, which I feel could be a catalyst for weakness in the equity markets. If, however, Democrats unseat the Republican majority, a return to gridlock is usually viewed by markets as positive. The Trump administration has already passed tax reform, assisting corporate profitability, and reduced regulations. The remaining agenda items would seem to have less of a positive market impact if Republicans maintain control. However, by the end of November into December, I believe the larger impact on the markets will be the declining "credit impulse" felt as tighter financial conditions as the reduction of QE (money printing) programs begins to have an impact on markets.

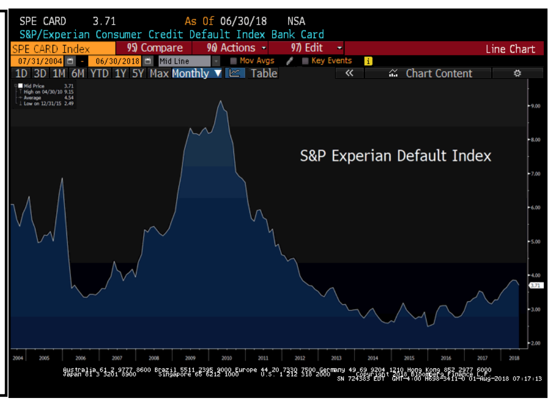
On Index Funds:

I've long said that I am an agnostic investor. At certain points of an economic cycle, I want full exposure to equity markets, and will use index funds in our portfolios. At this point in time, I have no index funds, and prefer strategies that are either not related to equities, or have the ability to help protect from major market moves down (some even benefit from that). Some people may ask if this is an extreme view. As I think about market valuations approaching, yet again, a once in 2000 year figure, and central banks having printed $10 trillion in value over the past 9 years while beginning to remove stimulus, I have to consider that both of those are quite extreme as well. While I appreciate index funds as efficient vehicles to gain access to markets, I feel that owning them now is yet another form of running with scissors.

In closing:

Typically, as summer vacation ends and traders get back to work, the next two months have heightened volatility. A variety of signs are pointing to the end of this market cycle. The housing and auto sectors, both of which are very sensitive to economic turns, have been extremely weak year to date (housing sector down over 12%, General Motors down 16% and Ford down 24% ytd as of 9/14 - Source: Bloomberg) . Defaults are increasing among both consumers and corporations. Cash out refinancing of home mortgages has returned to levels last seen near the peak of the 2007 real estate crisis. Sentiment levels are extremely high setting up a situation where earnings expectations will be difficult to meet. We've patiently awaited both the end of Quantitative Easing and the turning of a market cycle that has been pushed to extremes. We will take small positions in asset classes where valuations become extremely cheap and we feel there is ample opportunity to reward that risk, and intend to stick to our knitting with the core, risk managed portfolio positions.





Our best wishes to you and your families and as always, we welcome any questions. Thank you for your trust and confidence.

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