GVA Newsletter

June 2015

Plan B

"There is no bubble in real estate" Ben Bernanke 2007

"There is no large mispricing in US Securities" Ben Bernanke 2015

"I am mostly concentrated in cash because I think most asset prices have been pushed by central banks to very elevated levels. Central banks look at growth, at employment, at wages. They are too low. They don't have the instruments they need, but they feel obligated to do something; so they artificially lift asset prices. Because they hope that they will trigger what is called the wealth effect, but there is a massive gap right now between asset prices and fundamentals." - Mohamed El Erian on *CNBC* April 7, 2015 (Former Chair of Harvard's Endowment)

These are interesting times to be making financial decisions. Our business is helping our clients make good decisions about the larger scope of their financial plans and the details within them. Decisions like whether to pay down debt when times are good, how much to keep in cash and where, understanding general liabilities and how to address them, managing tax liability and how to invest in different market cycles. These are just some of the discussions we have with clients. We have a process to help our clients clarify objectives, identify roadblocks, choose appropriate resources and ultimately take action. Moreover, when it comes to achieving their goals, we like our clients to have more than one option - not just a Plan A, but a plan B and sometimes even C & D.

There are plenty of things to talk about with our clients and write about in this newsletter. Interesting trends are developing in the world in both the short and long term. Healthcare demand is growing and changing, the way people think about real estate is changing, approaches to energy and water usage are changing. Asia may be slowly becoming the center of the financial world. It really is a fascinating environment.

But when it comes to making decisions about money today, central banks have sucked all of the oxygen out of the room. We know it looks like they lit a fire, but that is what fire does, it consumes oxygen and everything else. The Fed has gasoline which burns hot and sometimes explodes, but it does not have good steady burning fuel that drives economic fundamentals. And unfortunately, for all their academic credentials, central banks have no Plan B. Plan A has to work. Their solution to Plan A not working is just to do more Plan A - more gas. If their goal is to foster a healthy economy that can function on its own, it does not appear to be working. And this has a meaningful impact on every other trend - at least in the short-term.

What we appear to have today is grossly distorted financial markets driven by unsustainable stimulus where, for example, the median stock is more richly valued than ever including the tech bubble of 2000. However, for all the speculation that central banks have inspired, by many measurements we have a deteriorating economy. In the end, as Jim Grant of The Interest Rate Observer says; central banks can make things look better, but they can't make things actually better. They can, however, make things worse than they might otherwise have been. By believing in their ability to manage the emotions of the market they are playing a game that has never been won.

Actions have consequences. It is a fundamental lesson our parents try to teach us and we attempt to pass along to our children to help them avoid unnecessarily painful experiences. Sometimes you can get by doing less homework, getting less sleep, cramming for tests or making a snazzy presentation to mask the fact that you just did not put the work in. But ultimately we are governed generally by the rule of the farm: you reap what you sow.

Current central bank policies have sought to stimulate risk taking with the rational that if people feel better then things will actually get better. Economists have been predicting that we will achieve "escape velocity" for six years but this has yet to be seen. Still we engage in the same thinking and strategies that have not worked in the hope that we can bypass fundamental changes and rely on good feelings to bring about prosperity. The potential consequences are disastrous.

We have been working furiously to uncover and develop strategies to help our clients have more than one option to reach their goals. The question we want to ask is: do you have a Plan B? Please continue reading as we delve more deeply into some of the relevant issues of the day.

Thanks for your time and for reading.

Matt & Tom

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Executive Summary

Economic Numbers - Let's take a look at economic numbers to support our claim that the economy is by some measures deteriorating.

Margin Debt - One measure of speculation – margin debt - is higher than ever.

The Fed Thinks They are Managing Emotion – It is an Illusion- "Don't Fight the Fed" does not end up holding up.

Investing is Supposed to be Boring - Returns are ultimately based on future cash flow. What does investing feel like to you today? A recent CNBC story featured a well-known columnist recommending investors take out auto loans and invest in the stock market. File that under – "From the ridiculous to the sublime."

Solutions - A brief outline of some of the investment themes we are discussing with our clients today

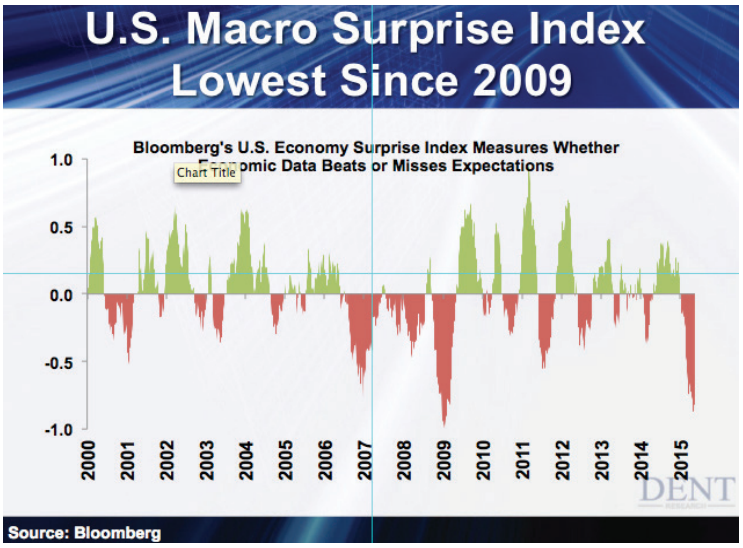
Create your Own Economy Corner - What is Wealth?

Plan B

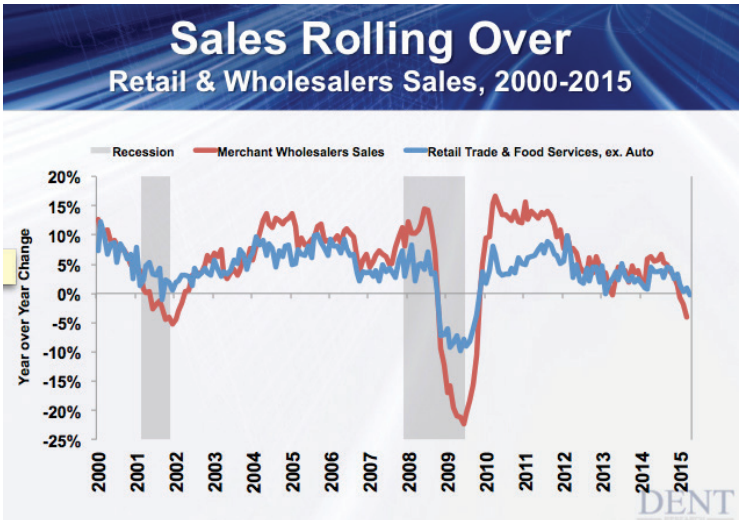
Economic Numbers

One of the primary leading economic indicators has historically been the stock market which turns up before the economy and turns down before the economy. But, due to the Fed's involvement in keeping the stock market elevated, one could argue that the stock market may not be as a reliable leading indicator in the current cycle. We might suggest that the only thing keeping the market up is an expectation of liquidity injections from central banks. Unfortunately this works until it doesn't. Let's take a look at what other indicators are telling us about the economy. We already know that 1st quarter GDP was negative.

U.S. Economic Surprise Index measures whether economic data beats or misses expectations. It is currently the worst showing since 2008/2009:



Retail and wholesale sales are good indicators of the health of the consumer sector which makes up roughly 70% of GDP. It is turnig negative:



The Inventory-to-Sales Ratio is showing acceleration. The last time we saw this was in 2008/2009. Companies keep making things which counts in GDP but if people are not buying, inventory builds and then has to get worked down:

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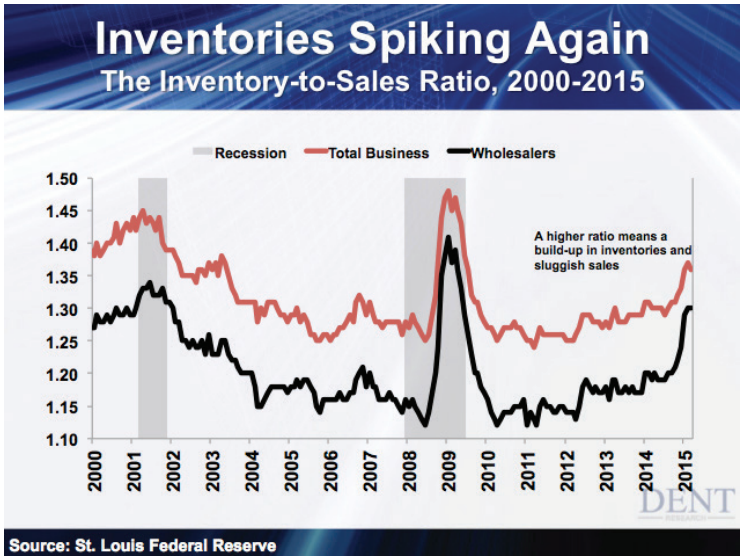
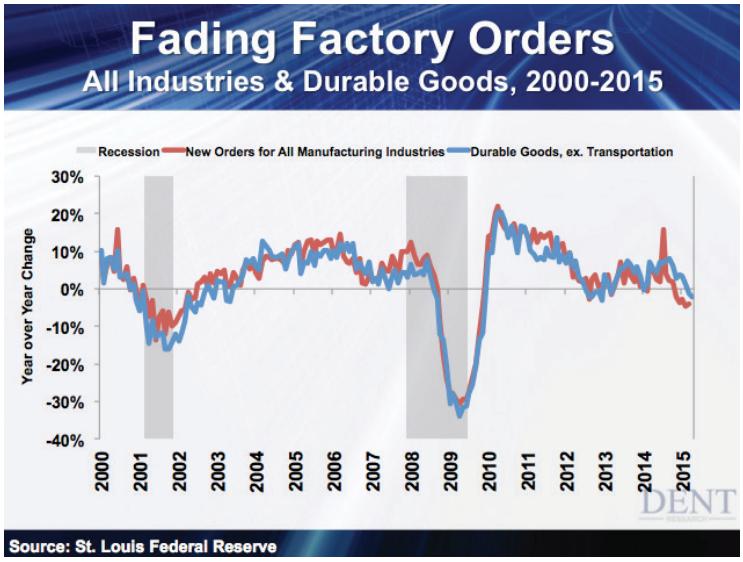
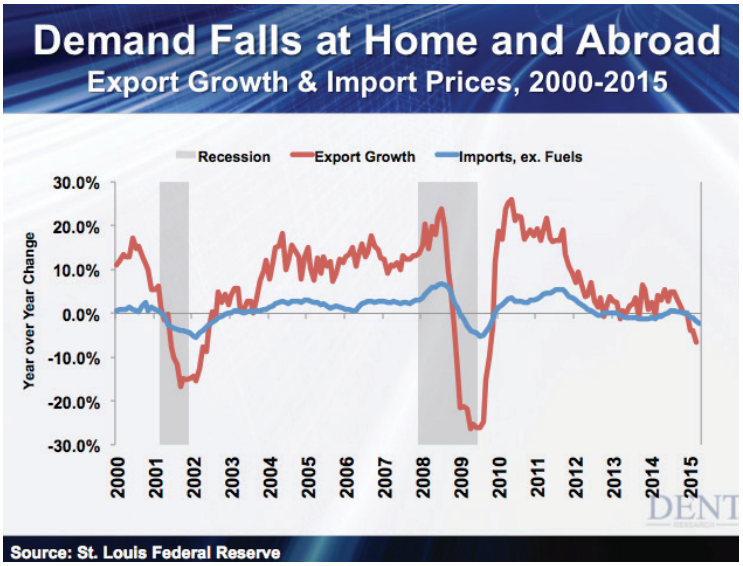


All Industry and Durable Goods Orders: Factory orders declined another .4% on an expectation of a .1% rise this month continuing the decline you see below.



Export Growth and Import Prices: Impacted both by a rising dollar and slowing global demand export growth and import prices are falling.



What is interesting is that all these numbers have been essentially getting worse since 2011. That is why more astute economists like Mohamed El Erian have been saying that there has never been a wider gap between equity prices and economic fundamentals. Our conclusion: what the Fed and other central banks are doing is not working.

The idea that the market is becoming detached from economic fundamentals is becoming a mainstream conversation, just as the idea that the housing market might be in a bubble was a pretty mainstream conversation in 2007. But then as now, most investors did not take action. The market was up, which felt good. People did not want to miss out or pay taxes on their gains.

In the end those who rode the market down and back up have been rewarded for their patience. This is true. But if the Federal Reserve has used all its energy and experimental tools, creating 40% more debt than we had in 2007 in order to drive stock prices higher, what do they have left for the next down-turn if it comes? How will we feel if all they were able to do was create one more massive bubble with no lasting benefit? This is a question we think you should be asking. How fast will it come back next time?

Margin Debt & Corporate Stock Buybacks

Investing is a confidence game. People and companies invest generally to the degree that they feel confident in their future. We have written about corporate stock buybacks in past newsletters. Goldman Sachs recently released a report chronicling the history of corporate buybacks that showed two things:

1. Companies are historically horrible market timers in that they buy the most of their own stock at the tops of markets and the least at the bottoms.
2. We just reached a new record in corporate stock buybacks.

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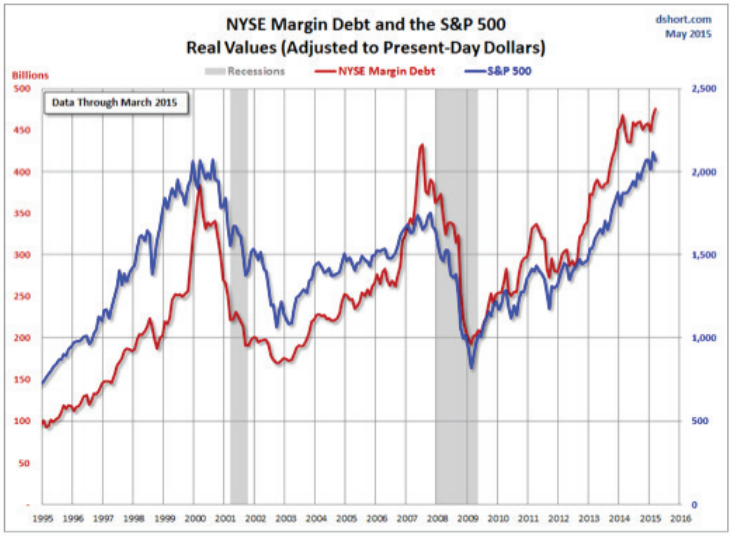
Another measure of sentiment in the investment world is margin debt. Stocks are one of the few things that people want to buy more of when they are more expensive. (Aren't we funny creatures?) When stocks get really expensive we borrow more to buy more generally by taking debt against existing stock holdings called "margin debt". One factor that makes stock markets go down faster than they go up is the need to cover margin. Ratios of debt-to-equity value need to meet certain requirements. As stock values decline investors on margin must sell to meet those requirements. They don't sell because they want to; they sell because they are required to.

Margin debt is now at an all-time high:

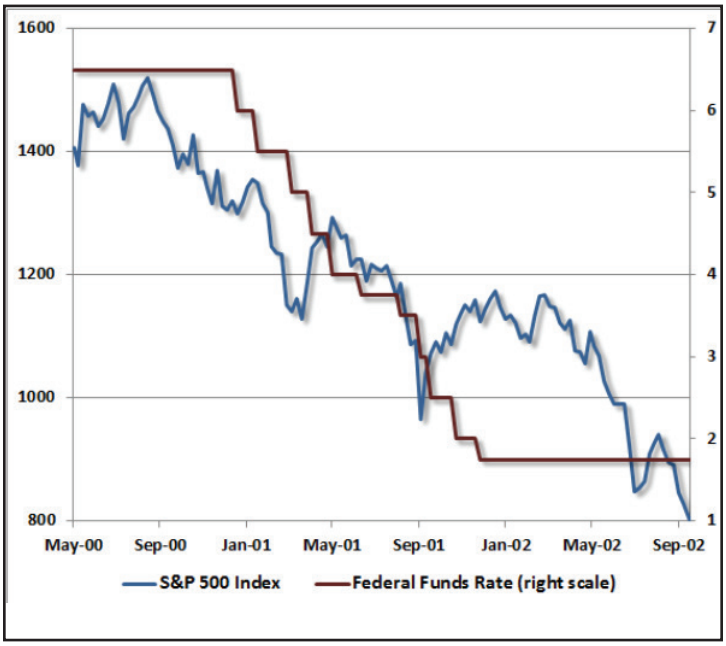


The Fed Thinks They are Managing Emotion - It Is an Illusion Managing Emotion

We have said repeatedly that what the Fed is doing works until it doesn't. That is, no one can predict or control the emotion of the market. After markets crash analysts look back and say it happened because "blank" happened on such and such a day. But we have learned that is ultimately not true. If it were true there might be a way to predict markets and there is not. All we can hope to do is identify conditions that suggest whether asset prices are historically high or low, or whether risks are historically high or low.

The Fed can create conditions that favor risk taking but they cannot control the emotion of the market. A conclusion that we draw from this, right or wrong is up to you to decide, is that if the central banks push things too far beyond what might otherwise exist in terms of leverage and risk taking and create an environment that magnifies the instinct of greed, then they have created the potential for even greater downside. Therefore, when the mood of the market shifts from risk taking to safety and preservation and then the instinct of fear takes over, the consequences are also magnified. These are not just our own conclusions from experience, this has been well chronicled in respected books such as "Extraordinary Delusions and the Madness of Crowds" by Charles MacKay and "The Myth of the Rational Market" by Justin Fox.

During both of the last most recent market declines the Federal Reserve lowered interest rates to stimulate risk taking early in the market's decline. Was there some magic in the fourth interest rate cut that was not in the first? How many does it take? Or was it that the market went down enough and long enough to reach equilibrium on its own? More importantly, if the Fed has done all it can to push financial assets higher with the promise that enriching those with assets will improve the economy and it fails, what tools will the Fed have left to help improve the confidence of the market? Below are graphs illustrating the Fed's rate cuts during the last two market declines or "crashes" to use a less savory term:



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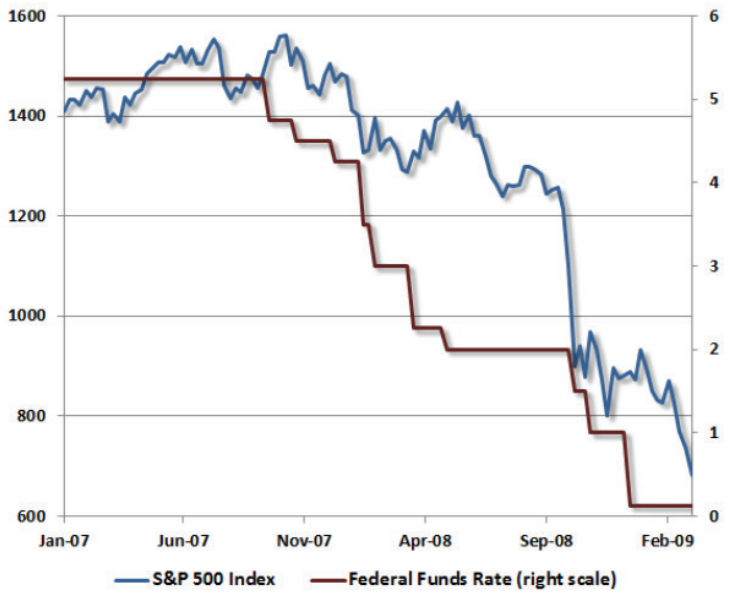

Source: John Hussman Weekly Market Comment May 25, 2015

Investing is Supposed to be Boring

A word that often describes successful accumulators of wealth is patience. But too often Wall St. uses this term to insinuate that one should always buy stocks and have patience during down cycles. However, value investors have used patience another way. They have used patience to wait until the objects of their investment are at a sufficiently low price to justify the cash flow they expect to receive in the future.

This is not as exciting as finding the next internet start-up or biotech stock and hitting it big. Nor is it as exciting as buying a spec home on leverage and making 50% on a quick sale. These have been the darlings of the speculators in the recent cycles. Unfortunately they always end the same way. The music stops and the money is gone for all except those who sold.

Returns are ultimately based on future cash flow. To create any meaningful cash flow from investments in today's zero interest rate environment, market participants are using leverage. This only compounds the problem when the music stops - as we learned in 2008. We will say it again, leverage is 40% higher in the world today than it was in 2007. Yes, it's exiting. Scary exciting.

We think our client's goals are too important to be playing the "exciting" game. We have seen how that plays out. Do we know how things will play out this time? No. Can we reasonably identify risk and overvaluation? We think so. More importantly we believe that alternatives to conventional investing should be sought out and investigated and at minimum investors should have a preference toward cash and safer investments for a larger part of their portfolio than average.

Solutions

When we discuss investment solutions in the context of this newsletter it is never a comprehensive discussion. This is partly a factor of regulatory restrictions. But it is also a matter of practicality. Every investor is different; all of our work is customized.

That said there are some major themes that we continue to highlight. Here are a few:

1. Deflation is the greater risk in the short-term - inflation long-term.
2. The US Dollar stands a good chance of continuing to rise and commodities stand a good chance of continuing to fall.
3. Trend following strategies are often designed to capture both the up and down movements in markets such as interest rates, currencies, commodities and stock markets. These can be a good diversifier to a portfolio - but not all are created equal.
4. Gold is a commodity with no cash flow to support its value. It is often a refuge against the total destruction of currency and one of the oldest forms of money. Why you invest in gold and precious metals and how you invest is as important as whether you invest in this area or not.
5. The center of the financial world may be slowly moving east to Asia. Demographic trends and growth prospects are in many ways better in parts of the world outside the US. But it will not likely be a swift or smooth road anywhere.
6. Demographic trends in most developed countries are creating demand in certain areas that we believe support the value of some investments in those areas. Think boomers getting older.
7. Where you do your banking is, in our opinion, an important consideration. There are things happening within the banking system that are hard to understand. But you can better understand the basic balance sheet of smaller regional or local banks than the large money center institutions.
8. Diversification is still king. If we knew what was going to happen we would not need to diversify, but we don't. We talk about diversification of process and diversification of protection.

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If there is any message we want our clients to hear it is that now is a time to think differently and act defensively. Understand what you need to earn for return to reach your goals. We also think that the one thing you can control is how much you spend and save. Robert Shiller said it best in his recent interview with Goldman Sachs when asked by Allison Nathan the following:

"Allison Nathan: *'What should investors do when so many assets look expensive?'"*

"Robert Shiller: *'I am not an investment advisor. But I would say that the main implication for most people is that they should save more because their portfolio probably won't do as well as they imagined. And if they're saving for some distant goal like retirement, they might get disappointed. People have learned about the power of compound interest. But what they don't understand is that if interest rates are at zero, you don't get any compound interest. I think that there is complacency among investors today. People have seen how well the stock market has done over the past century. But the market might not do as well the next time. So you have to consider whether you are saving enough.'"*

People don't want to hear that they need to save more. They also don't want to hear that their expectations should be lower. They want a snazzy story about upside. Everyone wants growth. We want our clients to reach their goals. We want to understand and share what is real. We are very grateful that our clients appreciate this approach.

Create Your Own Economy Corner

What is Wealth?

Today is a world of leverage, derivatives and high frequency trading. The word "wealth" brings up images of fancy homes, boats, cars, clothes and exotic locations. At Global Vision Advisors we repeatedly and consistently talk about wealth as something that includes how you spend your time, the quality of your health, the quality of your relationships as well as your financial possessions. One of the early teachers of living a truly wealthy life was Benjamin Franklin. We thought that for this issue of Create Your Own Economy we would pass along some of his words of wisdom:

"There are two ways of being happy. We may either diminish our wants or augment our means - either will do - the result is the same; and it is for each man to decide for himself, and do that habit which happens to be the easiest. If you are either sick or poor, however hard it may be to diminish your wants, it will be harder to augment your means. If you are active and prosperous or young or in good health, it may be easier for you to augment your means than diminish your wants. But if you are wise, you will do both at the same time, young or old, rich or poor, sick or well; and if you are very wise you will do both in such a way as to augment the general happiness of society." - Benjamin Franklin

Wishing you a happy 4th of July,
Matt and Tom

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