GVA Newsletter
January 2016

The Switch

"What The Fed did, and I was part of it, was front loaded an enormous market rally in order to create a wealth effect…and an uncomfortable digestive period is likely now."

"The Fed is a giant weapon that has no ammunition left."

"In my tenure at The Fed, every market participant was demanding we do more. It was The Fed, The Fed, The Fed…in my opinion they got lazy and it is time to go back to fundamental analysis… and not just expect the tide to lift all boats. And as the tide recedes we are going to see who is wearing a bathing suit and who is not."
Richard Fisher 01-05-16 on CNBC: (Underlining ours)

Richard Fisher was recently the President of the Dallas Federal Reserve and a voting member of the FOMC – Federal Open Market Committee. His comments matter. They are an admission of the truth that many do not want to see.

2015 was supposed to be the year that the economy really took off. Finally there had been enough time for all the monetary stimulus to work its way into the economy, but instead we saw slowing growth. 2015 has been referred to as one of the hardest years to make money in stocks, the worst year since 2008 and it was a year in which Warren Buffett significantly underperformed the S&P. The beginning of 2016 has been the worst beginning in the stock market ever. As of this writing, the stock market, as measured by the S&P 500, has not made any progress for roughly two years.

If your financial plan is based on assumptions of you making 8% or more over the next ten years by investing in the stock market, you may want to reconsider your plan.

Markets tend to fall faster than they rise but markets do not tend to rise or fall in a straight line. Keep this in mind during the next rally when CNBC is telling viewers that the worst is over. For the six years from March 2009 until May 2015 the U.S. stock market has risen fairly consistently and one of the most successful strategies for investors and traders has been to "buy-the-dips". At some point this is likely to switch to "sell the rallies". The question is, has it?

Every time the market has turned down since 1987 the Federal Reserve has responded in either word or deed. While they were powerless to halt the declines from 2000 to 2002 and from 2007 to 2009, since 2011 their efforts have appeared successful, lulling investors into a false sense of confidence in central banks' omnipotence. Throughout this time, the Fed has tried to convince market participants that the economy has been healing in the "recovery" since the last recession. In December they argued that the economy was healthy enough to raise interest rates to begin the process of normalizing the interest rate environment.

We welcome a normalization of interest rate policy and the effect it may have of unwinding dangerous asset bubbles. But investors should ask this question: what if what we have experienced over the last six years is not a real economic recovery? What if all we have experienced is a debt-fueled rise in asset prices encouraged by central banks through extreme policy experimentation? If this is true, then perhaps there could be something to be concerned about. Is this what the market is trying to tell us?

Market tops are impossible to predict. They are a function of a shift in market sentiment from a dominance of risk taking to risk avoidance and this shift can be subtle. The shift can play out in many facets of the economic system. It can play out in lending and borrowing in a myriad of sub categories, in investing in a myriad of categories, and in decisions about how governments, businesses and consumers spend and save. This is a complex system we are operating in.

JP Morgan has said that the switch is here; that it is time to sell the rallies rather than buy the dips. (*Marketwatch January 11*). RBS has suggested that investors should sell. http://www.theguardian.com/business/2016/jan/12/sell-everything-ahead-of-stock-market-crash-say-rbs-economists

What to do? It has been said that you don't need to know the future, only the present to know how to invest. Are the investments you are considering expensive or cheap? Are risks high or low? These are considerations to be made calmly in a space free of market- induced emotion. We would suggest they are decisions to be made in the context of a personal financial plan and a clear understanding of the facts on the ground.

No one knows what will happen next. What the quote above from Richard Fischer tells us is all we need to know and what we have been telling our clients for years. Markets have been artificially manipulated by central bankers beyond anything we have experienced in our lifetimes. There is no way to know the risks that exist in traditional assets until there is some level of policy normalization or price reset. Asset protection should be investors' first priority and the best questions to ask are, how far down can things go, and where do we look for opportunities?

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We do not pretend to be perfect nor do we have a crystal ball. We are focused on value, sustainable cash flow and on opportunities as well as dangers. Our eyes are open, our minds are aware and receptive and we are working diligently with capable partners to find ways for our clients to navigate these waters. If you have not yet engaged us to help you map out your strategy for the next phase of this market cycle, we would encourage you to do so now.

Happy New Year and here's to a prosperous 2016! Regardless of what may come.

Matt and Tom

"Education is what survives when what has been learned has been forgotten" – B. F. Skinner

The Swtich

Executive Summary

Market Valuation - Price to EBITDA is back to where it was in 2000 – when the market was the most overvalued ever.

Market History and Downside Risk - A look at the market using an equally weighted index that gives a more broad view of stocks tells a very different story of what the last 22 years has looked like. Two analysts we respect put the worst case on the next downturn at roughly 75%.

Create Your Own Economy Corner - Money matters too. Too often people who think "holistically" undervalue the role that money plays in having a fulfilling life. Thoughts on this and Six Pillars of Wealth Building Basics from Casey Research.

In Brief:

Not Just About The Market - Following cycles and trends helps you make decisions about more than just the market. When should you buy your next car or make your next real estate investment? Should you expand your business or cut back? Our research indicates that opportunities for buying real estate and cars could be really good in the next few years.

Three Shocks - We have suggested that there are at least three major potential areas that could cause the move back into a deflationary phase; China imploding, the European experiment failing and US banks weakening due to a real estate relapse. We can add to that, US banks weakening due to a crash in energy markets. It is all the same thing: excess capacity, soft demand, too much debt. When people try to tell you it is unrelated, don't pay too much attention

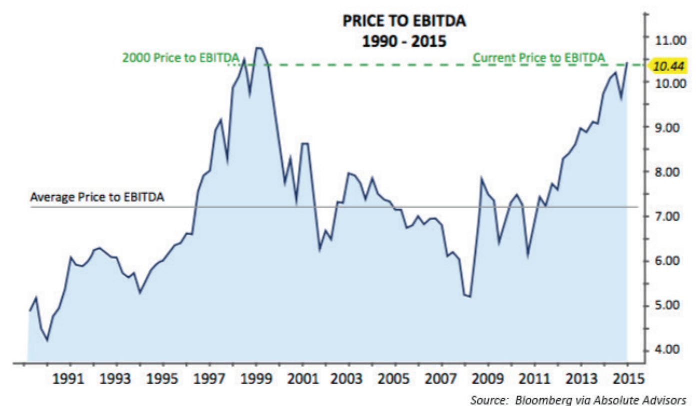
Interest Rates - For years pundits have been pounding the table on inflation and rising rates. We have been suggesting deflation is more likely and it may be that we see interest rates lower over the course of the next year. While it may be wise to hedge against eventual inflation, the next five years are more likely to see lower interest rates. Think Japan and plan accordingly.

The Switch

Market Valuation

The chart below comes from Absolute Investment Advisors and it is a different take on a concept we shared in our last newsletter. Absolute suggests that:

> *"An investor should not rely on forward P/E ratios that are influenced by notoriously overly optimistic Wall Street analysts. Nor should an investor rely on trailing twelve month P/E statistics because companies can overstate earnings in the short-term. Instead, Nominal GDP, Revenue and EBITDA (cash flow) can be useful statistics because they are difficult to manipulate or 'adjust'."*



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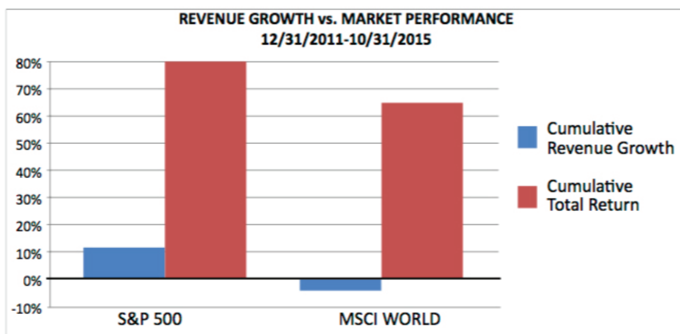
As you can see – based on this chart, stocks are as over-valued as they were in 2000 – a market that was considered to be the most over-valued market ever. This should give investors pause.

The next graphic also comes from Absolute Advisors and it shows the difference between the growth in revenues and the performance of the stock market. What you can observe is that since 2011 revenues for the World markets have been negative while prices have grown and for U.S. markets revenues have been anemic vs the rate of price movement. This is evidence of an artificially stimulated equity market:



Source: Bloomberg via Absolute Advisors

Market History and Downside Risk

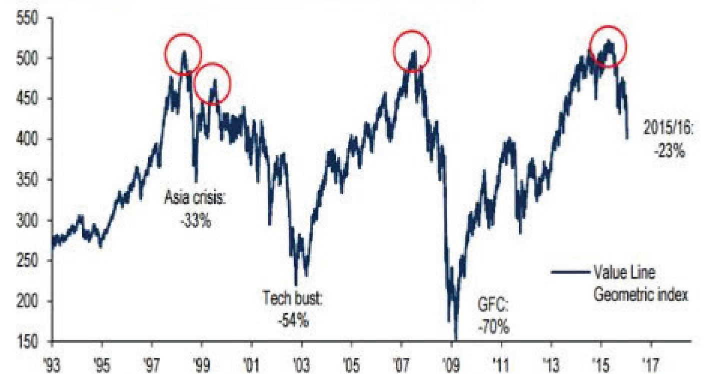
The Value Line Geometric index was introduced in 1961. It is an equally weighted index, includes 1,675 publicly traded stocks and reflects the movement of the median stock better than other averages. In contrast, the S&P 500 is weighted by market capitalization so it emphasizes the movement of the largest stocks.

The Value Line Geometric index includes small and large companies. Another interesting phenomenon that can take place near the end of market rallies is small caps can start declining before large caps. Some see this as evidence that the smart money is selling while mom & pops are still buying the big recognizable names. It can also be a sign that money managers are selling the smaller less liquid names and holding or buying the larger more liquid companies that would be easier to sell if the market comes under pressure. This divergence is sometimes described as the generals running up the hill but the troops retreating.

If we look at this index going back to 1993 we can see some interesting things:

1. This index is almost back to where it was in 1997
2. This index is already down more than 20% since the highs in May of 2015
3. The last two major declines in this index were down 54% and 70%

Here is the chart:



How Low is Low?

We think it is constructive to consider the downside risk in the market. Given that we have just seen two 50% plus declines in the broad market averages in the past 15 years, we think it is reasonable to think that the market's downside risk today is at least 50%. That does not mean we have to go there – we just think it is a reasonable possibility to consider.

So what is the worst case? For this discussion we turn to two analysts who have a long track record of making market forecasts that have been contrarian and have played out. John Hussman puts his base scenario this way:

> *"I remain convinced that the U.S. Financial markets, particularly equities and low-grade debt, are in a late-stage top formation of the third speculative bubble in 15 years. On the basis of the valuation measures most strongly correlated with actual subsequent*

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market return (and that have fully retained that correlation even across recent market cycles), current extremes implies 40-55% market losses over the completion of the current market cycle, with zero nominal and negative real total returns for the S&P 500 on a 10-12 year horizon. These are not the worst case scenarios, but run-of-the-mill expectations."

So what is his "worst-case scenario?

"A truly worst case scenario, at least by post-war standards, would be for the S&P 500 to first lose half of its value, and then to lose another 55% from there, for a 78% cumulative loss, which is what would have to occur in order to reach the .45 multiple we observed in 1982. We do not expect that sort of outcome. But to rule out a completely pedestrian 40-55% market loss over the completion of the current market cycle is to entirely dismiss market history."

Albert Edwards from Societe General has been highlighted in recent articles for work he presented at his "Woodstock for Bears". You can find the charts through *Business Insider* with a Google search. The following is a quote taken from a *Market Watch* article:

"According to Edwards, global strategist at Société Générale and prominent perma-bear, the stock benchmark could fall as much as 75% from the recent peak of 2,100 to trade around 550. Edwards argues that stocks are already in a bear market—commonly defined as a 20% fall from a recent high—and that U.S. industrial production is shaky and could represent the beginning phases of a recession. That's bad news for stock-market bulls.

'The previous bear market low was in March 2009 when the S&P reached 666. I think we'll go below that within this bear market,' Edwards said at the sidelines of a conference in London on Tuesday. "

Edward backs up his position with a lot of in-depth research and it is important to keep in mind that this is not someone hawking gold coins or canned food. This is a highly respected strategist within one of Europe's largest banks. Part of his conclusion is based on an expectation that we will see a Shiller PE of 7x on the S&P – roughly what we saw in 1982. Neither Hussman nor Edwards are calling for the end of the world. They are not nearly the most bearish forecasters out there.

It can't be emphasized enough that the future is impossible to predict. It is psychology and expectations that we are trying to address here. Anyone who said that the market would fall 50% in 2007 was laughed at. Anyone who suggested that the Nasdaq could plummet 80% in 2000 was considered hyperbolic – too ridiculous to be taken seriously. The next message is the most relevant in terms of what we do:

If your financial plan is based on assumptions of you making 8% or more over the next ten years by investing in the stock market, you may want to reconsider your plan!

Wall St always wants to sell a rosy scenario but that is not how it always plays out. Our goal is to help you reach your goals regardless of what the stock market does.

Interest Rates, Inflation and Deflation

For years pundits have been pounding the table on inflation and rising rates. We have been suggesting deflation is more likely and it may be that we see interest rates lower over the course of the next year. Since the Fed has raised interest rates one quarter of one percent the stock market has lost 10% and the ten-year treasury is back under 2%. The market is not listening to the Fed.

Japan has been trying to raise interest rates with no success for more than 20 years. We think it is more likely that interest rates move lower this year than it is that they move substantially higher. This should impact how you think about investing and your plans for borrowing. It should also call into question the validity of current Federal Reserve policy.

For greater insight about Fed policy and interest rates we would encourage you to read Hoisington Managements 4th quarter update written by Lacy Hunt.

Create Your Own Economy Corner

Money Matters Too

At Global Vision Advisors we subscribe to the idea that your wealth includes your health, your time, your relationships and your money. It is actually what wealth really means – a wealthy life. Too often people who rightly honor the facets of health, relationships, and time pay too little attention to money.

People have hang-ups around money. Sayings like *"The desire of money is the root of all evil"* sound familiar to most of us. However,

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money is just one more area of a healthy, wealthy, balanced life. To ignore it or downplay it does not serve anyone. The under appreciation of money can lead to stress and unhappiness.

Money represents energy, work, productivity, contribution. It allows us to give beyond our own needs and make a difference beyond our own physical capacity.

Our relationship with money is a fascinating realm of self understanding. Embrace it. Determine the relationship that you want to have with spending, saving and using money. Don't keep it in the shadows. By understanding what is important about money to you, you can use it as the tool it is meant to be rather than have it use and move you.

> *"Money isn't everything, but it's right up there with oxygen."*
> Zig Ziglar

In the spirit of creating your own economy, we wanted to share something that we received from Casey Research that we think is a good encapsulation of wealth building principles. In the future we will explore each in greater detail. Take a moment and see which of these you are using to build your wealth:

Casey Research Wealth Building Basics. Six Pillars:

1. Active Income Stream – work or business
2. Ownership stakes in enduring high quality businesses that can be held for long periods of time
3. Accumulating income producing real estate
4. The accumulation of ownership stakes in natural resource deposits.
5. The accumulation of wealth insurance vehicles and assets:
   - Insurance policies and annuities
   - Precious metals
6. Early stage investments

Please note:
Indices mentioned are unmanaged and cannot be invested in directly. Past performance is not a guarantee of future results. These are the opinions of GVA and not necessarily those of Cambridge, are for informational purposes only and should not be construed or acted upon as individual investment advice.

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