GVA Newsletter

November 2015

Anything Goes

"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved." - Ludwig von Mises 1928

"God knows where this is going. It's very dangerous and could be disastrous." - Carl Icahn September 2015 speaking about Zero Interest Rate Policy

It's November and from a market perspective we find ourselves in a similar position as last year. The broad indices were down for the year into early October until a rally brought the Dow and S&P 500 back to breakeven for the year. Last year we saw the market rally continue into the end of the year to generate a positive return for 2014. There is no doubt that we could see a repeat of that pattern. The strongest period for stocks has historically been from November to May.

The difference between this year and last year lies under the surface. Commodity markets and emerging markets are even weaker now than 2014 and showing signs of global slowing. Leadership in the market is very narrow, somewhat similar to 2000 and 2007 where the big cap indexes held up longer than the rest of the market.

While this is all very interesting to observe, none of it changes our view of what is transpiring in the economy or the amount of risk that exists in the stock and bond markets. And it does appear that something important is changing. The reality of the underlying weakness of the global economy is becoming harder for even the most ardent optimists and stock market bulls to ignore. More importantly, in fact we believe most importantly, it is becoming almost main-stream to question the efficacy of central bank policy. We say most importantly because credibility of central bankers is at the heart of the stability of the financial system. Without that credibility and implied backstop for the market, investors' willingness to take on risk would likely diminish significantly.

If there is anything to be learned from the last six years it is that central banks can and will do things that might historically have been unimaginable. We have had zero percent interest rates for six years in the U.S. and our central bank alone has purchased trillions of dollars in assets to stimulate markets. Despite these unprecedented policies we are on the brink, if not already in, a global recession. Many savvy economists and market watchers predicted this outcome. But we now know that you must expect the unexpected. Could the Fed expand asset purchases by another $10 trillion, call for negative interest rates and ban the use of cash in an effort to further manipulate markets and push asset bubbles higher? Anything goes.

Unfortunately these policy responses have the potential to increase risk in traditional investment strategies and serve to delay the inevitable corrective process of the markets. The idea of solving a debt problem with more debt is still holding sway. But more voices are calling for allowing markets to normalize and regain some semblance of traditional capitalism; where price discovery is guided by the intelligence of markets rather than central planners.

It is important to mention that we have a rationale behind our incessant focus on the risk in today's markets. We believe that opportunity favors the well prepared and we see brighter days in our future. It may not sound like it but we are at our core optimists and our belief is that informed investors are the best investors. If in fact we do see another period of market turmoil similar to 2002 and 2008, we think the opportunities will be potentially greater for long-term, durable investment. We are in winter but spring will come again.

There are three things that we think are critical for investors to consider today:

1. We may be in a secular bear market that began in 2000. Secular bear markets have historically lasted roughly 18 years and end in an environment of below average valuations. We are 15 years into this one but given the magnitude of the over-valuation at the top, it is reasonable to expect that this bear market will be longer than average - perhaps another 5 years.
2. The policies that The Fed has engaged in to fight deflation actually exacerbate deflation. Quantitative Easing (QE) and Zero Interest Rate Policy (ZIRP) foster deflation by encouraging malinvestment and excess capacity. The Fed in all its wisdom has created a short-term rise in asset prices, delaying the natural healing process of the economy and making the downside worse.
3. We have 40% more debt in the world than we did in 2007. The 2008-2009 financial crisis was a debt crisis and we have more debt today and much more debt relative to income. Logic would suggest that we have not solved the problems that caused the crisis, rather we have delayed the day of reckoning.

Only time will tell if the thesis we are operating under is correct but history and current economic data is decidedly in our favor.

Thanks for reading,

Matt and Tom

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Executive Summary

Markets - The case for the secular bear. Could we be in a secular bear market that began in 2000? There is a compelling case for this thesis.

The Fed - A graphic look at what the Fed has done since 2009 Why it looks as though they have painted themselves into a corner.

Opportunities and Dangers - Broad market indices in the US still present significant dangers from our view and sectors such as Junk Debt and Health Care Stocks could be the next to fall. But opportunities are developing in areas such as oil & gas and commodities where a lot of pain has already been experienced.

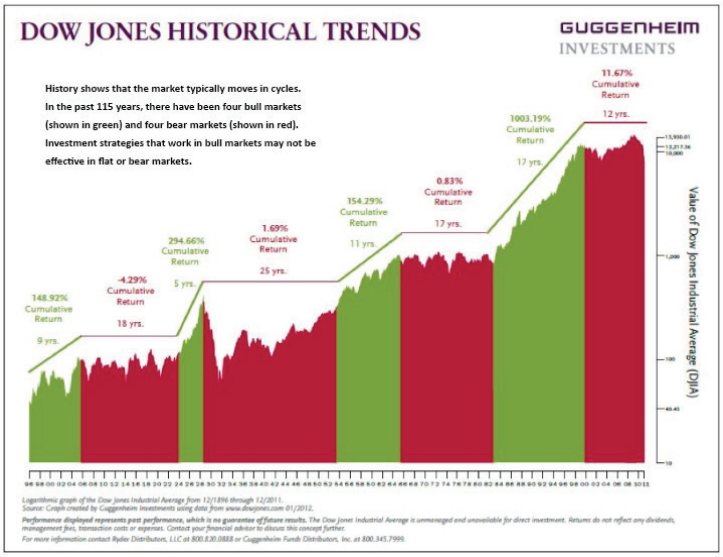
Create Your Own Economy Corner - Understanding Your Values - An important step in understanding what you want and why you want it is clarifying your values.

Anything Goes

Secular BearMarkets

Our thesis since 2003 and held with greater conviction since 2008 has been simple: We are in a secular bear market that began in 2000. Secular bear markets begin at historically high valuation levels in markets and end at historically low valuation levels. Secular bear markets average roughly 18 years in duration and often contain three cyclical bear markets and two cyclical bull markets. The shortest secular bear market in the last 100 years was roughly 15-17 years long depending on what research you use.

Let's look at a few charts to illustrate the conversation. The first chart comes from Guggenheim Investments. The chart is updated through 2013 and we have been observing this chart since 2003. What is being illustrated is secular bull (green) and bear (red) markets in the Dow Jones going back to 1895.



The way this chart is drawn it looks like the shortest secular bear market in the past 100 years was 17 years long from 1965-1982. What is hard to see from this chart is what separates the bear from the bull. What delineates the red from the green? It is not arbitrary, the lines are drawn by experts in market valuation. To get a better look below we have a chart from Business Insider that shows the S&P over roughly the same time period but marks the valuation on the beginning of each cycle:

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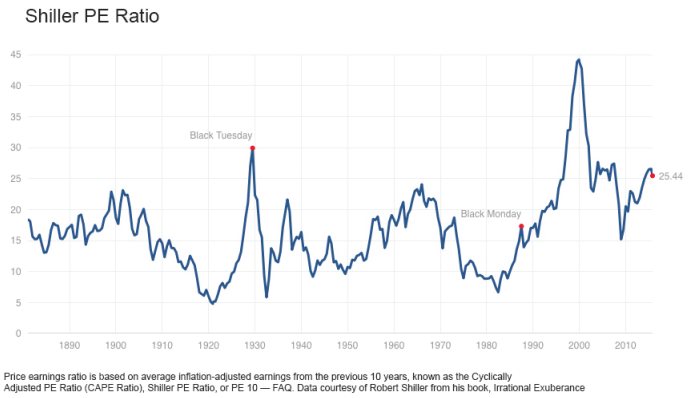
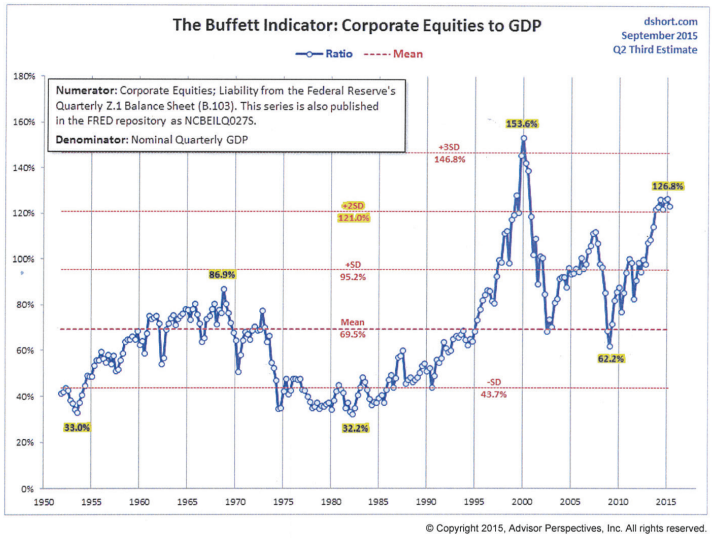
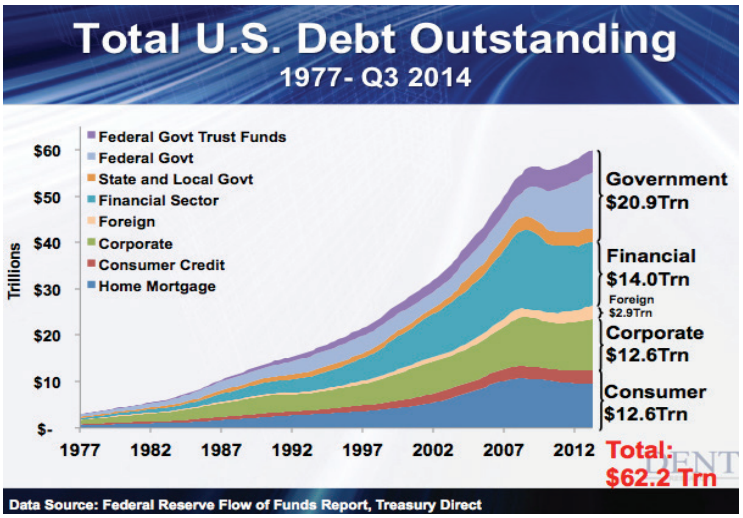
Just to add a little more dimension, we have included two more charts. The first one is the Shiller Cyclically Adjusted Price Earnings where Robert Shiller has taken a ten-year average P/E ratio that he argues gives a better sense of valuation. You can actually see how this lines up with both previous charts where bear markets begin at peak valuation in 1929, 1966 and 2000. Bull markets begin at points where we have sustained below average valuations: 1920, 1950, and 1982. From this chart we can also see that there have only been two times in history where we have had higher valuations in the market than we have today; 1929 and 2000 which suggests to us that the market is over-valued relative to history.



Lastly we have a chart that illustrates the ratio of corporate equities to GDP. This is considered Warren Buffett's favorite indicator of market valuation. We use it here because we think it illustrates how valuation can go below average and stay below average for a sustained period of time as this measure did during the late 1970's and early 1980's.

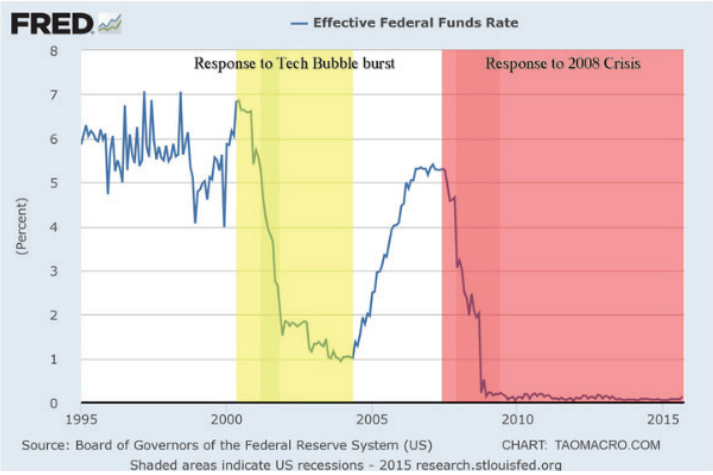


Bear markets are either characterized by high levels of inflation or high levels of debt and deflation risk. This market is of the debt/deflation variety and the bear market from 1966 to 1982 was of the inflation variety. It is just as critical to understand the difference in the type of bear market you are in as it is to understand that you are in a bear market. It is also critical to understand why the Fed is so loath to raise interest rates even with stock prices near historical highs. They are deathly afraid of the debt bubble they have created and have painted themselves into a corner. Let's look for a moment at what they have done over the past 15 years. As a reminder, below is the chart of the growth of debt in the U.S. over the past 40 years. Notice that while debt dipped down in 2008 it has resumed its climb:



Fed Policy

We have two charts to share with you concerning Fed Policy. The first depicts the path of the Federal Funds rate since 1995.

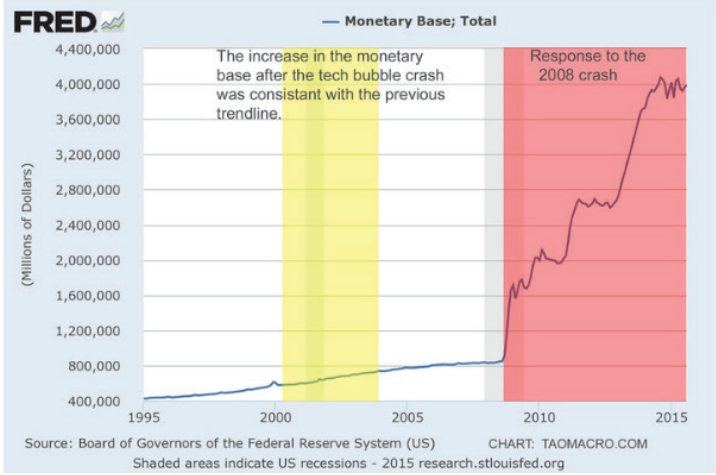


You can see that the Fed aggressively lowered rates during the 2000-2002 recession and market decline and then raised rates into 2005 and 2006. Part of the reason they raise rates is so they have somewhere to go if/when the economy goes through its next natural cycle of contraction into recession. The Fed after all has never believed it can end the business cycle it has just tried to stabilize the impact of the business cycle on prices and employment.

What you can also observe is that in the 2008-2009 recession and market decline The Fed lowered interest rates to zero and has kept short-term rates at zero for six years. This is unprecedented. In September there was an expectation that The Fed would raise interest rates 25 basis points or one quarter of one percent. This is barely a move at all and yet they still did not move.

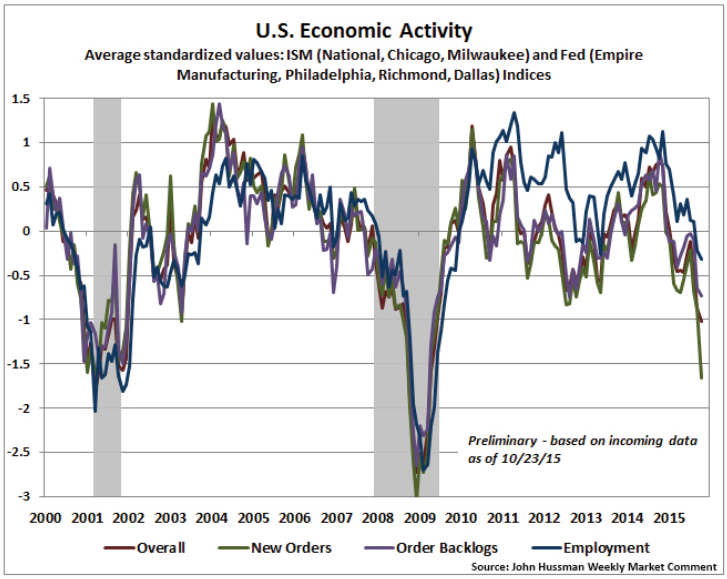
The fallout from their failure to raise interest rates cannot be overstated. They came across as confused, uncertain and not in control. The problem is that Central Bankers are the ultimate con-men. The term comes from "Confidence men". It does not matter what the truth is, central banker's most powerful tool is the ability to make people believe that they are in control. Their third policy tool is "forward guidance". For example, when European Central Bank head Mario Draghi said during the Greek debt crisis that he would "Do whatever it takes and believe me it will be enough" he stoked the market's imaginations. This led to interest rates for sovereign debt declining averting a crisis even though some of the solutions that were being proposed were in direct violation of the laws establishing the European Union. On October 22, 2015 the market rallied partly because Draghi announced plans to expand QE (Quantitative Easing) in Europe. It is interesting to think of the pattern we have been in. If the economy is weak enough so policy makers must throw more stimulus at the problem, equity markets rally. This is pure financial manipulation and not indicative of a healthy market or economy.

The next chart shows the balance sheet of the Fed going back to 1995. What you can see is that the balance sheet of the Fed grew steadily but slowly from 1995 to 2009 where it reached roughly $800 billion. Then in 2009 the Fed began engaging in the most aggressive asset purchases in its history and has taken the assets on its balance sheet up to $4.2 trillion. They do this as a way of keeping long-term borrowing cost low to try and stimulate investment and economic activity.



Before 2009 it was inconceivable that the Fed would engage in such unprecedented actions. What is really mind blowing is that it does not appear to have worked. What else could you conclude when after six years The Fed can't even raise interest rates one quarter of one percent? Not to mention that an objective look at economic data suggests that the economy is rolling over into contraction. Below is a chart of U.S. economic activity from John Hussman which he precedes with the following description:

"The following chart updates our standard economic review of regional and national Fed and purchasing managers' surveys. The October Philadelphia Fed report was particularly weak on the new orders front, which is complicated by the fact that it's also one of the more reliable surveys as an indication of broad economic activity. The chart below reflects available data through Friday" (October 23, 2015).



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The Fed began tapering its asset purchases toward the end of 2013 and since then the market has stalled. Below is a chart of the S&P from January 2014 until the end of October. Below that are similar periods during the last two market tops: January 1, 1999 - October 31, 2000 and January 1, 2006 - October 31, 2007. Try to recall how those other periods felt. Markets had sold off and there was some anxiety, but the rebound in October bolstered the bulls and everyone wanted to believe that the party could go on forever. And, as we mentioned earlier, if it were not for eight stocks the market would be negative for the year right now. This feel a lot like a market that is topping - even if we see a new high:

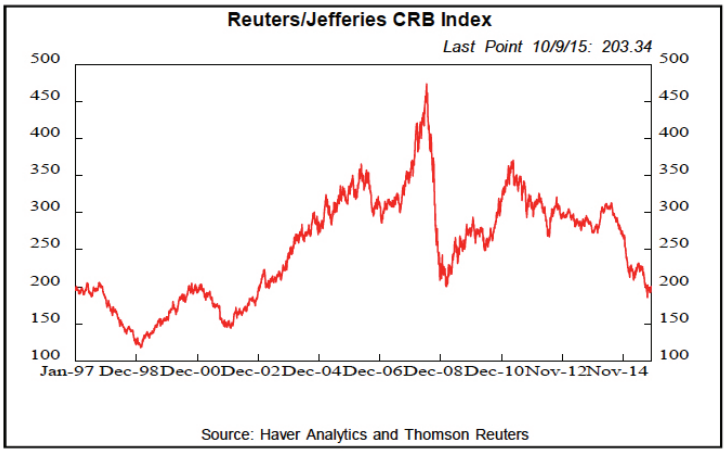
When we say anything goes, we must be able to imagine that if the market rolls over, the Fed may do something unexpected. In 2009 expanding the balance sheet by $4 trillion was unexpected. This time around they may need to do more. And it may not matter. We can't predict what market prices will do. But we can evaluate and understand the amount of risk and leverage in the market and we can understand the value of an investment based on its expected cash flow.

Opportunities

Central Banks around the world are trying to create inflation. What they have done instead is create excess capacity and mal investment. This is deflationary. Stan Druckenmiller recently put it this way:

"I don't know when it's going to stop. And on Inflation, this could end up being inflationary...but there is nothing more deflationary than creating phony asset bubble, having a bunch of investors plow into it and then having it pop. That is deflationary."

So let's look at one chart to illustrate the deflation vs inflation debate that we have been writing about for seven years. This chart shows the CRB Index going back to 1997. The CRB is a basket of commodities, copper, lumber, wheat etc. If anything should show inflation pressures it would be this.



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In 2011 we argued that we would not see persistent inflation but rather its opposite - deflation. As you can see from the chart the CRB is now below the lows of 2009. This is what Druckenmiller means when he says that convincing everyone to jump into a phony bubble is deflationary. China is a great example. They used debt to finance projects that had no demand. They convinced the world that they would grow forever and people piled into commodities and emerging markets based on the perception of growth. Now these are the areas that are getting hit hardest and investors are losing large amounts of money.

Commodities and oil are selling off steeply creating massive dislocation in the mining, drilling and related sectors. We cannot mention specific companies in this newsletter, but there are several that stand out as examples of companies that were widely touted as no-brainers in 2011 that are suffering greatly right now. Those who argued that inflation and never ending growth from China would lead to massive spikes in inflation drew the wrong conclusion.

Commodities, including oil are cyclical. Like broader markets they tend not just to mean revert but mean invert. While the headwinds of slowing global demand and tougher lending requirements will be constraints for some time, we think that opportunities are being created here.

One area in particular that we think is worth investigating is in the area of oil and natural gas - particularly in the less commodity sensitive segments of this market. Our concern about the potential for oil prices to decline required us to exercise patience in the last few years and that patience has paid off so far. As we mentioned above, we expect to see the headwinds affecting this market persist so it is important to exercise caution. But there are areas of this market that are beginning to offer very attractive relationships between price and cash flow. If you would like to discuss the how, what, where and when of this investment theme just give us a call. As we have mentioned in the past, the format of this newsletter does present some constraints.

The point is this: if you have been aware of the environment and patient for the almost inevitable developments in commodities and oil, then today you are licking your chops instead of licking your wounds. Is this market timing or is it recognition of value or the lack of it? We think the latter.

Investing in oil and natural gas is not for everyone, certainly not for investors who abhor investing in any part of the fossil fuel industry. We are pointing out financial relationships but there can be more to investing than just dollars and cents. Some investors might prefer to invest in solar and wind because it fits their personal values and/or they may see greater growth opportunities in new energy technologies. This is a conversation we love to have with clients, the conversation about how to have it all work together so you can feel great about your potential for profit and the method that you go about achieving it.

Create Your Own Economy Corner

Values and Principles

What are your highest personal values? Have you ever taken the time to explore this question? This can be a funny conversation because the word "values" can have a moral or political charge. But taken in its simplest form values just means what is important to us. For the purpose of this discussion let's look at a reference from Wikepedia:

"Personal values provide an internal reference for what is good, beneficial, important, useful, beautiful, desirable and constructive. Values generate behaviour[1] and help solve common human problems for survival by comparative rankings of value, the results of which provide answers to questions of why people do what they do and in what order they choose to do them."

The power of understanding our own personal values is that it helps us to understand why we do what we do. It also helps us to make choices that have a higher likelihood of creating a satisfactory outcome. A feeling of fullfillment as opposed to regret. So if we know that or highest values are health, wisdom and independence, we might view a decision differently than if our highest values are contribution, dependability and respect.

Two great thinkers in the world of personal growth have made great contributions to this inquiry. Anthony Robbins encourages the exploration and identification of personal values as a centerpiece of his work. Tony also suggests that personal values can be malleable: that you can choose the values that match or help to create the person you ultimately want to become.

Stephen Covey in his seminal work "The Seven Habits of Highly Effective People" discusses values a different way. He discusses values as the map but principles as the territory:

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"Principles are not values. A gang of thieves can share values, but they are in violation of the fundamental principles we're talking about. Principles are the territory. Values are the maps. When we value correct principles, we have truth - a knowledge of things as they are."

When we discuss personal wealth we experience the conversation as a rich exploration of multiple facets of life including time, health, relationships and money. True wealth in each of these areas centers around each individuals personal values. Understanding our own values, what they are today and what we might like them to be to create the lives we want to create, can be a powerful tool for achieving our goals.

Our minds work in mysterious ways and often we resist personal exploration even at the most cursory level. If you are looking for a place to start we have a great and simple way to begin this process with our "Discover Your Values Exercise". Let us know if you'd like to learn more and thanks for reading.

Matt and Tom

Giving Back

Global Vision Advisors believes that being involved in our community and giving back to causes we are aligned with is an important aspect of our business. We wanted to let you know how we're giving back to update you on where our efforts have been focused during the last quarter and to show you some of the impacts the charities we support have made.

In September GVA sponsored and helped organize The South Shore Hospital Croquet Classic. Matt is on the board at South Shore Hospital and has been part of this particular effort for the past six years. The event is put on by a group called LINKS and raises money specifically for the pediatric programs at South Shore Hospital. In the past this money has gone to giraffe beds in the NICU unit, comfortable sleeper beds for parents so they can stay overnight in the same room with their child, and support items for the kids such as stuffed animals, blankets, games and toys to make their stay more like home. This year the event raised over $30,000.

For the fourth year in a row this October GVA was a lead sponsor for the Type One Renegade Run. The Renegade Run is a 5 mile obstacle course held at Wompatuck State Park in Hingham that raises money for type 1 Diabetes.

If you'd like to learn more about the causes we support, please contact us or visit their websites.

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