GVA Newsletter

March 2018

The Song Remains the Same

"The data on the high price of the market is clean and factual. We can be as certain as we ever get in stock market analysis that the current price is exceptionally high. In contrast, my judgement on the melt-up is based on a mish-mash of statistical and psychological factors based on previous eras, each one very different…Yet, strangely, I find the less statistical data more compelling in this bubble context than the simple fact of overpricing." Jeremy Grantham January 3, 2018 Viewpoints Bracing Yourself for as Possible Near-Term Melt-Up

The market had an unfamiliar tone to it in February 2018. We spent the months of December and January reading year end summaries and New Year forecasts as well as trying to make sense of the tax reform package. There was already a lot to unpack before volatility erupted sending the major averages down 10% with daily moves that have not been seen since 2008. Grantham's quote above captures the sentiment of many market watchers in January. There has been a sense that we know that the party will end, and likely it will end badly…but not just yet. Grantham's firm GMO continues to estimate that, regardless of how things play out in the short-term, U.S. stocks, as an asset class, will be lower seven years from now. However, Grantham is warning that stocks could go up another 50% in the short-term. These kinds of contradictions are mind-boggling.

The world is constantly changing and many of the changes are exciting opportunities for wealth building in areas such as energy, technology and life sciences. On the monetary front we have a new Fed Chair which lends a sense of uncertainty. On the fiscal front we have a Republican dominated government that seems to have lost its long-held sense of fiscal responsibility. So how, in the midst of such incredible transformation, can we write a communication and call it "The Song Remains the Same"? Particularly when so many pundits are gushing about how positive the economic fundamentals are?

Our answer is this: the fundamental driver of the 2008 crisis was unsustainable debt. The driver of the stock market's rise over the past nine years was an experiment by central banks around the world to drive down interest rates and encourage risk taking. The end of this story has yet to be written. Central banks are now attempting to remove the stimulus. There was never a question that they could make stocks rise. The question was would it work to generate sustainable economic growth and what kind of instability would they create as they tried to exit? What they have created is a debt bubble that is larger than the debt bubble that led to the crisis in '08 and '09. Worse, they have encouraged the worst behavior possible by incentivizing debt and dis-incentivizing saving and real investment. Furthermore, the net impact of the tax reform is essentially more of the same – short-term stimulus that benefits the corporations and encourages stock buy-backs and special dividends in hopes that the wealth effect will eventually drive wage inflation and real demand throughout the economy. We have our doubts. What we continue to believe is that unprecedented debt levels and aging demographics in the developed world will be the primary drivers of the macroeconomic picture in the coming years.

Alan Greenspan will ultimately be dubbed the original architect of this cycle of boom and bust economics. He had his own words for the investing community when on January 31, 2018 he said the following in an interview with Bloomberg:

"I think there are two bubbles: we have a stock market bubble and we have a bond market bubble."

Our concern, as always, is how to help our clients reach their goals. If the only options for investing are stocks and bonds in a traditional buy-and-hold approach we think investors could be taking more risk than they are aware of. Particularly if the chosen instrument for investing is passive index strategies. But there is a big world out there and some good minds that understand the problems we face and ways to invest within that context. We will try in this letter to highlight some of the reality on the ground. If you are not yet a client we hope you would consider a conversation to review how are you are positioned to reach your most important goals.

Thanks for reading.

Matt and Tom

Executive Summary

- **The Mood at the Top** - Forecasts from January 2008 give some insight to what the herd thinks at the top of the market cycle.
- **Interest Rates** – perhaps the most important question of the day. What happens in a world awash with debt when interest rates rise? The US Bond market is twice the size of the US stock market.
- **Tax Reform** – more stock buy-backs.
- **Wish List** – Get prepared
- **Create Your Own Economy Corner** – Life Lessons from an Un-

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The Song Remains the Same

The Mood at the Top

If you look back at the major tops of economic and market cycles you will see uniform optimism. This is the great paradox that we have highlighted before. Chief among the optimists are the major market forecasters who are paid to predict a growth environment, friendly to financial assets. Case in point is the summary from 2008. Below are the forecasts from the top analysts in January 2008:

Actual Data January 1, 2008		**Actual Data December 31, 2008**
S&P 500	1,468	903
Ten Year Treasury	3.74%	2.52%
Fed Funds Rate	3.5%	0-.25%

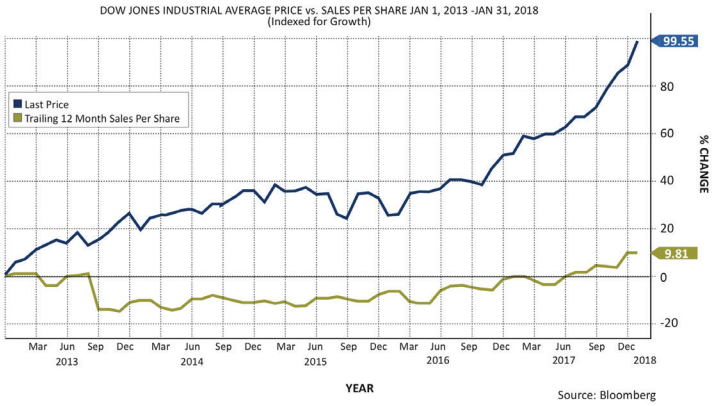
Forecasts from the major investment houses for 2008:

Deutsche Bank (Larry Adam)		
S&P 500 '08 target:	1640	Missed by 45%
10-year Treasury Yield	4.75%	Missed by 47%
Fed Funds Rate	3%	Missed by 92%
JP Morgan (Thomas Lee)		
S&P 500 '08 target:	1590	Missed by 43%
10-year Treasury Yield	5%	Missed by 50%
Fed Funds Rate	4.5%	Missed by 94%
Merrill Lynch (Richard Bernstein)		
S&P 500 '08 target:	1525	Missed by 41%
10-year Treasury Yield	3.7%	Missed by 32%
Fed Funds Rate	2.5%	Missed by 90%
Citigroup (Tobias Levkovich)		
S&P 500 '08 target:	1675	Missed by 46%
10-year Treasury Yield	4.4%	Missed by 43%
Fed Funds Rate	3.5%	Missed by 93%
UBS (David Bianco)		
S&P 500 '08 target:	1700	Missed by 47%
10-year Treasury Yield	4.0%	Missed by 37%
Fed Funds Rate	3.0%	Missed by 92%
Bank of America (Tom McManus)		
S&P 500 '08 target:	1625	Missed by 44%
10-year Treasury Yield	5.0%	Missed by 50%
Fed Funds Rate	3.0%	Missed by 92%
Morgan Stanley (Abhijit Chakrabortti)		
S&P 500 '08 target:	1525	Missed by 41%
10-year Treasury Yield	4.5%	Missed by 44%
Fed Funds Rate	3.75%	Missed by 93%
Goldman Sachs (Abby Joseph Cohen)		
S&P 500 '08 target:	1675	Missed by 46%
10-year Treasury Yield	4%	Missed by 37%
Fed Funds Rate	3%	Missed by 92%
Bear Stearns (Jonathan Golub)		
S&P 500 '08 target:	1700	Missed by 47%
10-year Treasury Yield	5%	Missed by 50%
Fed Funds Rate	4.75%	Missed by 95%
Lehman Brothers (Ian Scott)		
S&P 500 '08 target:	1630	Missed by 45%
10-year Treasury Yield	4.2%	Missed by 40%
Fed Funds Rate	3.25%	Missed by 92%

Notice that there is not much divergence among these forecasts. Note that the average expected return for the S&P 500 is roughly 10% - pretty much what they predict every year. Also notice that nobody predicted the 10-year would be under 3% or that the Fed Funds Rate would be at .25%. Pretty much every year the prediction is for slightly higher interest rates, slightly higher inflation and a stock market that is higher by its historical average. This describes the best environment to own stocks and bonds which is the major bread and butter for the asset managers.

We don't fault these people for their forecasts, but after 25 years in the business we don't put any value in their forecasts either. Here's what we do put some value in: actual sales, actual debt, actual revenues. Below is a chart that comes to us from Absolute Advisors. This shows the difference between price of the Dow Jones Industrial Average compared with 12 month sales per share. What you can see is that the price of the index has indeed moved up tremendously since 2012 but during that time sales per share have flat-lined. Here is how Absolute Advisors describes this ratio:

"The Price/Sales Ratio for the Dow is beyond excessive. It would need



to fall 40% just to get back to the pre-2008 crisis PEAK."

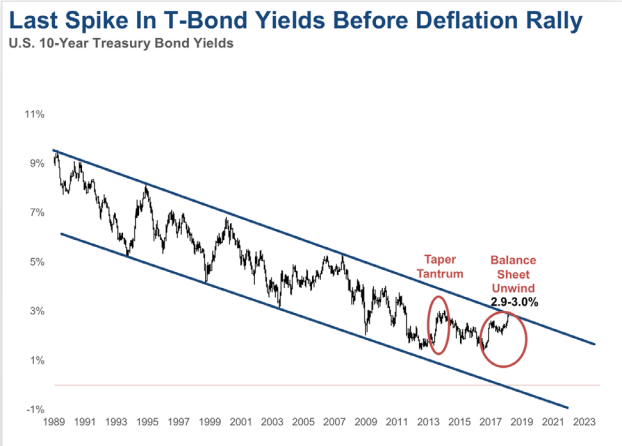
The other point that Absolute Advisors makes so well is that the numbers above are per share and subsequently take into account share buy-backs. In other words, without buybacks sales and revenue may have been net negative. This chart in particular is why we have been telling our clients that the diving board keeps getting higher while the water in the pool continues to get shallower. This is an environment to be extremely cautious with wealth that you hope to retain.

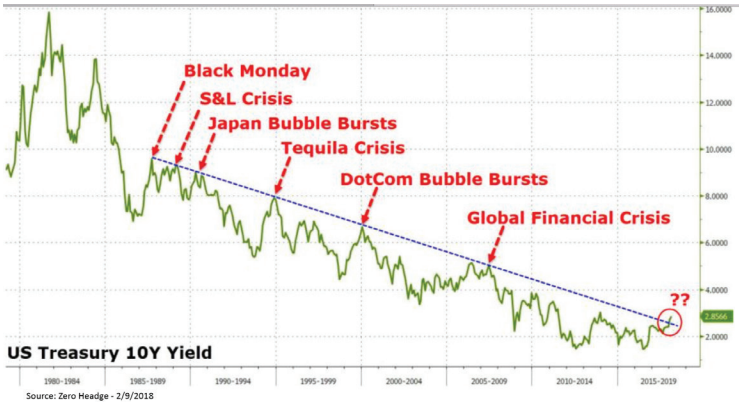
Interest Rates

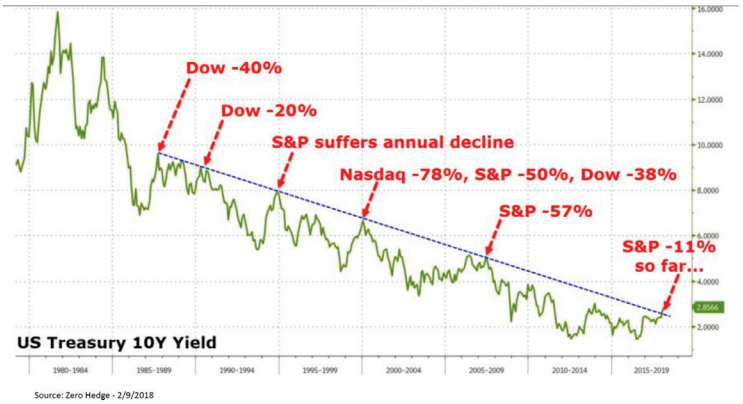
The major question of the day, in our opinion, is what are interest rates going to do and, very importantly, why? Interest rates generally move for two reasons: inflation and growth or credit risk. Most are arguing that interest rates are rising due to rising inflation pressures and economic growth prospects. This same case has been made since 2010, most notably in 2011 and 2015. And yet the inflation and growth did not materialize. This time may be different, as many indicators are suggesting. But that conclusion is far from guaranteed.

In the U.S., the bond market is twice the size of the stock market. More importantly, changes in interest rates affect much more of the economy than changes in stock prices. For instance, in 2017 household debt increased by $572 billion to $13.15 trillion. This is made up of auto loans, student debt, credit cards, mortgages and home equity loans. The cost of servicing all of this debt rises when interest rates rise, taking dollars away from other spending and curtailing growth. This affects every business and individual at some level, whereas stock prices directly affect a much smaller percentage of the population and economy.

Below is a chart of the interest rates on the 10-year U.S. Treasury Bond, which serves as a benchmark for interest rates in our economy. Since the 1980's every time the rate on the 10- year has hit this channel it has set off some financial difficulty. We are now at the top of this channel:







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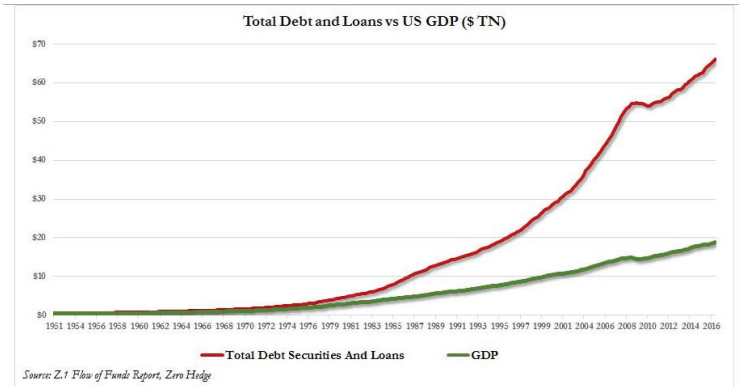
The more debt our economy accumulates, the more sensitive it is to



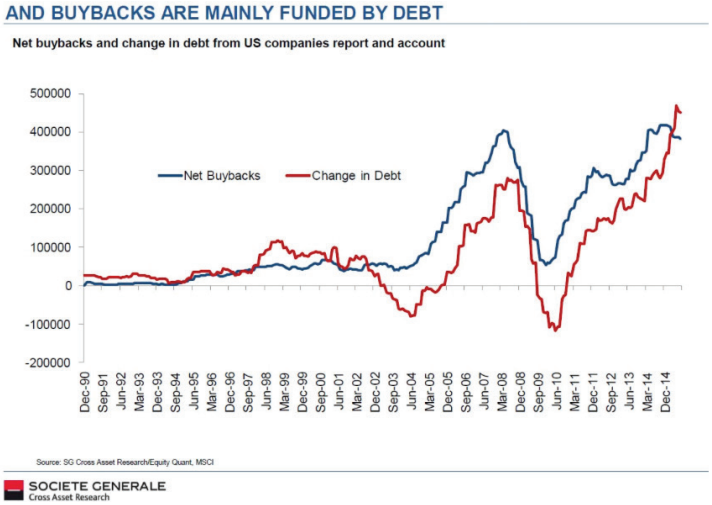
interest rates. Below is a chart of debt and GDP going back to the 1970's. Notice the small dip in 2008 that created the Great Recession:
The real concern that we have is if interest rates are rising due to redit risk rather than inflation and growth. What does that mean? Put simply, if the U.S. is considered by its creditors to be a higher risk, then we must pay higher interest rates to borrow. This concern could be a driver that pushes interest rates in the U.S. up through this channel which would be a negative for stocks and bonds and would not be supportive of other assets like real estate and commodities.

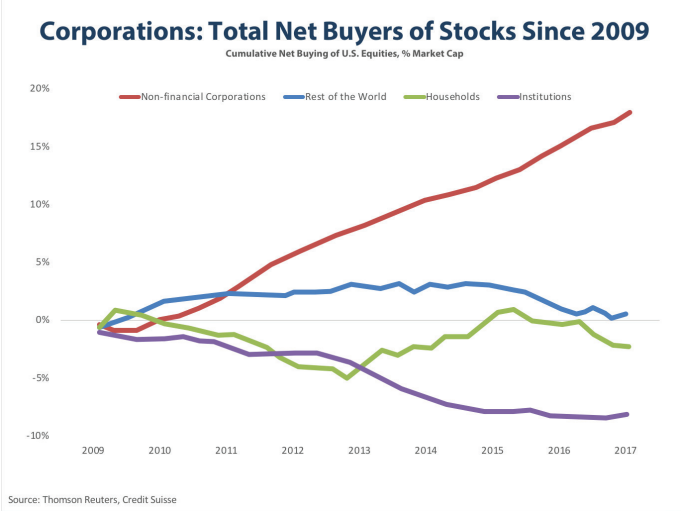
The conclusion of economists that we follow including: David Rosenberg, Gary Shilling, Albert Edwards, Harry Dent, Lance Roberts, Lacy Hunt, to name a few, is that interest rates have not seen their generational low and that the predominant pressures in the economy are deflationary, not inflationary, and that the U.S. is still the cleanest dirty shirt in the laundry basket. If they are right, then the place to invest right now is long-term U.S. Treasuries. But we have to remain open to all possibilities including the impact of poor fiscal management by our government leaders.

Fiscal policy is hard to predict, as is monetary policy. But we think it is worth considering that the Federal Reserve may be much more concerned with the impact of its policies on the bond market than the impact of its policies on the stock market. Coming out of 2008-2009 the Fed was focused on avoiding recession, today their concern appears to be more focused on financial stability, runaway inflation and the bursting of the bond bubble. That focus does not bode well for stocks.

Tax Reform & Stock Buy Backs
We have written at length about stock buybacks and debt in past communications. Without getting into the details of the tax reform package, the one fairly universal conclusion of economists is that the major impact of tax reform will be more money flowing through corporations. The other universal conclusion is that most of that money will go toward stock buybacks, special dividends and mergers and acquisitions.

Oddly, the greatest amount of stock buybacks occurs at peaks in the market and most of that buying is financed through debt. This has





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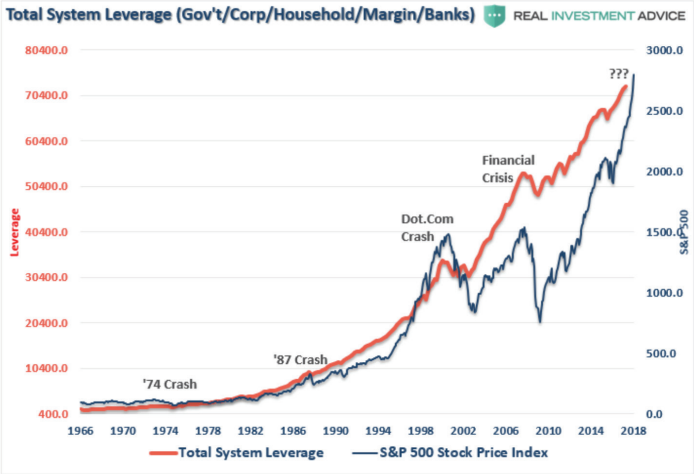
been the case since 2009 and corporations have been the largest buyers of stock in the markets. Below is a chart we have shared in past newsletters from Societe General:
The conclusion we have drawn from the balance of investment research we follow is that corporations have been using cheap debt to buy back their own shares rather than investing more heavily in new productive capacity. This works great as markets rise, but it leaves many companies with much more debt relative to revenue which is painful as the cycle reverses – either with higher interest rates and higher costs of debt financing, or with recession and declining revenues.

Since Trump's election, markets have been on a tear with expectations of deregulation, tax cuts and higher government spending. Share buybacks are on pace to be the highest on record. We don't know whether the final melt-up in stocks is still yet to occur, or whether we have seen the melt-up in expectation of events that have already occurred. There is a chance, not insignificant, that the run



up to January 26, 2018 was that melt-up. The final chart we leave you with shows the growth of debt and the movement of stock prices going back to 1966:

Wish List

According to his famed newsletter and interviews on CNBC, Warren Buffet is sitting on $116 billion in cash (23% of Berkshire Hathaway) and claims that he can't find anything that is attractively priced. That certainly says something about this market.

Our advice to investors is that now is a good time to build a wish list. What would you want to invest in if you were given the opportunity to go shopping with stocks and other investments on sale?

1. Long-term bonds when interest rates peak – which may be soon
2. World class companies trading at a discount
3. Asia – One Belt Road, India, Southeast Asian emerging markets
4. Commodities, commodity producing emerging markets
5. Real estate
6. Robotics, biotech, alternative energy

Those areas are a good place to start. If you want to think really outside of the box about nascent trends that may develop into something bigger – speculations if you will - consider the following: we don't begin to understand the word of blockchain and are not recommending investment there – but there is a there there. Blockchain is about decentralized information and transaction verification. This is a trend with significant demand.

Create Your Own Economy Corner - Lessons from an Unlikely Source: "The Wolf of Wall Street"

We recently came across an article on CNBC about life lessons from the "Wolf of Wall Street". Jordan Belfort's story of debauchery and excess was recently portrayed by Leonardo DiCaprio in Martin Scorcese's "Wolf of Wall St." The article was an interview focused on how Belfort pulled his life back from utter ruin. The three keys to success he sites are as powerful as any work by Anthony Robbins himself:

1. "You have to have a vision that inspires you so when you think about it, it makes you jump out of bed in the morning to really have a life that is far better and far greater than it is today.
2. That vision, your why, has to be about others and not about you."
3. Have high standards and be willing to do the work. "It's about having a match between your standards and your vision."

We are all imperfect, that is human nature. But we all have within us, the capacity to learn, grow and make a difference, regardless of our stage of life or what we have done before.

Global Vision Advisors' commitment is that we serve to help people clarify their vision and their purpose, that we always raise our standards in the service of that commitment.

Thanks for reading,

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Matt and Tom

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