GVA Newsletter

January 2019

And Now for Something Completely Different

"Of all the delusions that have infected the minds of economists, central bankers, and the investing public in recent years, perhaps none is as short sighted and pernicious as the idea that aggressively low interest rates are "good" for the economy and the financial markets.

"There is, of course, a certain truth to that idea, roughly equivalent to proposing that snorting amphetamine laced cocaine is "good" for one's energy, or that walking into a bar and randomly choosing partners while wearing a blindfold is "good" for one's love life. In each case, however, the validity of the claim comes from subverting the word "good" to mean nothing more than a short-lived burst of very bad choices." - John Hussman November 28,2018

Something is changing in the markets. The quote above from John Hussman is not the change, but the awareness of the reality he describes, in our opinion, will be part of the change.

What is changing is the markets appreciation of and approach to risk – often referred to as sentiment. The deeper reality that we continue to make things worse with monetary and fiscal policy will come later. What many market participants may experience on the way to waking up to a new reality is likely to feel like cognitive dissonance. We fully expect more of what we are seeing today: lots of finger pointing. People will point to policy error by the current Fed. They will also point to a trade war with China and others and political conflicts like the government shutdown. This will be a drama that plays out before us but no one can predict the timing or magnitude of asset price movements as the market reacts to the unfolding drama. Therefore, we continue to approach investing with humility and caution.

Global growth is slowing and many markets are in bear market territory already. Volatility is rising. We have created significant bubbles in debt, particularly corporate debt, as even Janet Yellen acknowledged recently. Credit spreads are widening as they did in 2007.

Our thesis has been that the entire experiment of zero interest rate policy and quantitative easing would ultimately end badly. It appears to us that we are in the beginning stages of that happening.

What we will try to summarize in this letter is what is changing in markets and why. As our primary focus is helping our clients reach their goals, we will also outline what we see as current and future opportunities for investing in this highly risky environment. If you are approaching retirement or are just interested in protecting your capital for better opportunities to grow your wealth, we hope you find our thoughts useful and would always be interested in a conversation about how you should fit your investment strategies to meet your goals and the current investment environment.

Thanks for reading.

Matt and Tom

Executive Summary

- **Credit Cycles and How They End** - This is the center piece of understanding today's economy and markets. There are short-term and long-term credit cycles and we appear to be at the top of both. If so, the downside in many assets could be considerable. Ray Dalio, of Bridgewater and Associates, the largest hedge fund in the world, has been addressing this repeatedly.
- **Economy - Recession Risk** – Credit Cycles peak just before recessions. This is accompanied by high consumer confidence and record earnings.
- **Markets** – According to Deutsche Bank and Bank of America, a record 93% of assets posted negative real returns in 2018. We will summarize 2018 returns as well as what current valuations say about expected returns. The "Melt Up" potential in stocks still has believers but GMO argues that we are witnessing the bursting of the bubble right now.
- **Policy Options, And Policy Error** – Of major concern is that we appear to be heading into our next, and what was always inevitable, downturn, in worse shape than we were in 2007 and with much less opportunity for effective policy response. But the policy error should be laid at the feet of Alan Greenspan, Janet Yellen and particularly Ben Bernanke.
- **Investment Strategy** - Building an effective framework for the investment environment helps to determine where the best place for investing may unfold over the short and long-term. Cash is king short-term but being in all cash would constitute extreme market timing. Regardless of whether markets ultimately crash, we do think we are seeing important changes in trends. We currently favor value conscious, cash flow investing combined with effective tactical strategies.
- **Create Your Own Economy Corner** – Financial planning lessons from one of the greats.

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Credit Cycles and How They End

Ray Dalio, of Bridgewater Associates, is someone market participants and policy makers pay attention to for a reason. He has built the largest hedge fund in the world with over $150 billion under management and he has a way of communicating fundamental principles of economic activity. He wrote a New York Times Bestseller titled Principles in 2016. His latest book is titled Big Debt Crises which was released in November of last year. We would encourage you to look up his YouTube video "How Markets Work" and then read his article called "To Help Put Recent Economic & Market Moves in Perspective" found here https://www.linkedin.com/pulse/help-put-recent-economic-market-moves-perspective-ray-dalio/, which he released in December.

We have suggested the video before. At the end of the video Dalio suggests that the conclusion of the debt cycle can result in what he referred to as "beautiful deleveraging". His more recent conclusions are not as optimistic. In fact, while at the World Economic Forum in Davos recently he said, "The next economic downturn is what scares me most." In his December article referenced above he begins as follows:

"At the biggest picture level, there are three big forces that interact to drive market and economic conditions over time. They are 1) productivity growth, 2) the short-term debt cycle (which typically takes about 5-10 years, and 3) the long-term debt cycle (which typically takes about 50-75 years). These factors also affect geopolitics both within and between countries, which also affect the market and economic conditions."

His conclusion is that right now conditions look a lot like 1937, just before markets fell 50%:

"So, it appears to me that we are in the late stages of both the short-term and long-term debt cycles. In other words, a) we are in the late cycle phase of the short-term debt cycle when profit and earnings growth are still strong and the tightening of credit is causing asset prices to decline, and b) we are in the late-cycle phase of the long-term debt cycle when asset prices and economies are sensitive to tightenings and when central banks don't have much power to ease credit."

Below is chart from Bank of America showing the history of Fed Tightening cycles and how they end.

The Fed's and other central banks attempts to reflate the economy through zero interest rate or negative interest rate policy and quantitative easing have increased global debt by more than 40%, provided a weak and very uneven economic "recovery" leading to increased social tension only to temporarily raise risk asset prices which are more than likely to completely reverse in the next downturn. This is one reason Mr. Dalio is scared of the next downturn. Another reason is the social and political ramifications that are likely to accompany that downturn.

David Rosenberg, of Gluskin Sheff, summarizes the macro-economic picture this way:

"The next chapter of the story is the downturn, which starts in Q2 or Q3 in my judgement. The chapter after that is the reversal of Fed policy from restraint to stimulus, and the chapter after that is the realization that the government does not have enough monetary or fiscal policy ammunition to generate a recovery. The final chapter is about 'helicopter money' or the 'debt jubilee' - concepts which made Ben Bernanke a household name in the marketplace when he discussed these as last-resorts in November 2002 and again in March 2003." - David Rosenberg "Snack with Dave" December 28, 2018

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Economy – Recession Risk

Again, from David Rosenberg, also from December 2018, where Rosenberg is making the case that we are likely headed into recession this year.

"History is on our side. There have been 13 Fed tightening cycles since 1950. Ten of these landed the economy in recession, and neither the consensus nor the Fed staff saw them coming when they actually started. So before knowing anything else, the fact that we have been in the midst of a Fed tightening phase sends recession odds north of 80%."

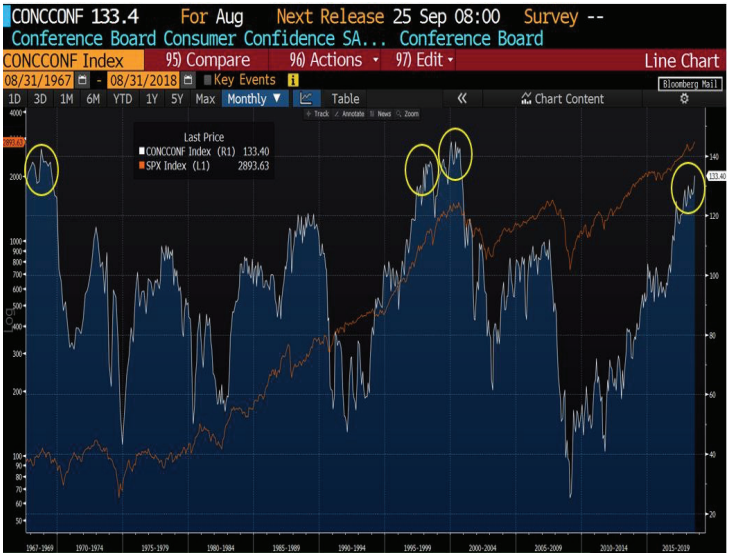
It is important to note that Rosenberg points out that consensus economists and the Fed failed to see the trend change. In other words, most of the people you see on CNBC and read about in Barrons will get it wrong. It is also important to note that stock markets generally precede the economy. So, if Rosenberg is correct, then the declines we saw at the end of last year were not a correction in a bull market, but the beginning of a bear market. We still have to wait and see.

Someone who has also gotten most of the important trend changes right in the past 40 years is Gary Shilling. Interestingly, both he and Rosenberg were at one time Chief Economists at Merrill Lynch. Gary Shilling puts the recession odds at 2/3's citing each of the following as potential forerunners of the economy peaking then rolling into contraction:

1. Output exceeds capacity
2. Stocks fall
3. Central Banks tighten
4. Yield curve inversion near
5. Junk bond-treasury spread opens
6. Housing activity declines
7. Corporate profits growth falls
8. Consumers are optimistic
9. Global leading indicators drop
10. Commodity prices decline
11. Downward data revisions
12. Emerging-market troubles mount
13. U.S - China trade war escalates.

We are already seeing every one of these factors unfold.

One of the greatest paradoxes of market cycles is that things look the best at the top and consumers are the most optimistic. In 2018, consumer confidence hit a high not seen since 2000 see below:



Unfortunately, the peak in debt comes with the peak in confidence. When the downturn comes that debt acts like an anchor until debts sufficiently clear. This is something we should see in the completion of this cycle; i.e. during the recession or down-turn.

Markets

"Though it will be essential to monitor market internals for periodic shifts in investor psychology, by the completion of the current market cycle, I continue to expect the S&P 500 to lose nearly two-thirds of its value." - John Hussman November 1, 2018

Despite the overwhelmingly positive expectations for 2018 coming into the year, 2018 was a tough year for most assets. December was the worst December on the Dow since 1931. Here are the highlights for the year:

US REITS	4.7%	
DXY (Dollar)	4.6%	
Barclays Agg	-.2%	High Quality Bond Index
Gold	-1.7%	Gold
S&P Bonds	-3.3%	Broader Bond Index
S&P 500	-5.2%	
Dow Jones	-6%	
Nasdaq	-4.2%	
STOXX Europe 600	-13.6%	
Shanghai	-24.6%	China
FTSE 100	-14.4%	UK
MSCI EAFE	-13.7%	Developed International
MSCI EEM	-14.5%	Emerging Markets
WTI Oil	-24.9%	
MLP Index	-12.4%	
HRFX	-6.72%	Hedge Fund Index

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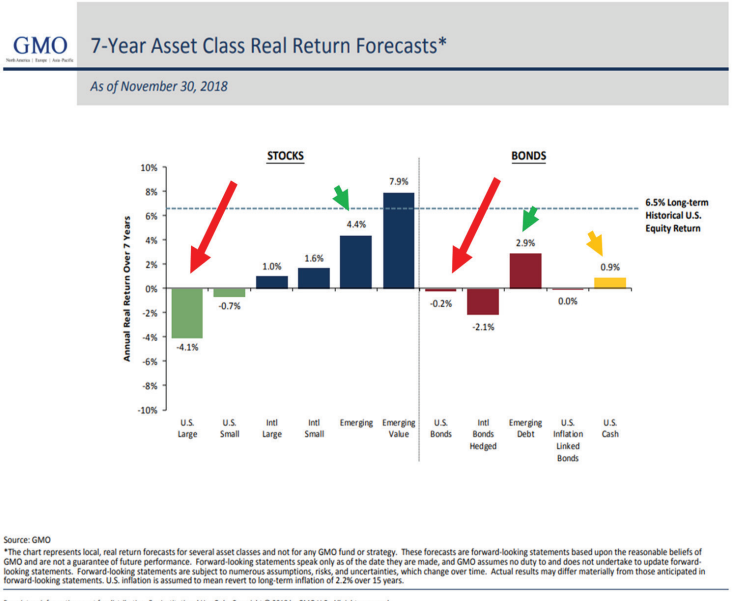
Once again, the consensus estimates are for broadly positive moves in most equity indices in 2019 – particularly the U.S. We have no idea what will happen next year, however, longer-term, valuations continue to suggest that U.S. markets are very overvalued which would indicate negative performance for some time. Below we share the 7-year forecast for several asset categories from GMO:



The takeaway is that, according to GMO, the U.S. is expected to lose 4.1% per year over the 7-year period beginning November 30, 2018. What history tells us is that this is not generally a smooth gentle decline, but rather, sharp declines followed by some recoveries.

Two other measures of valuation suggest that U.S. markets are more over-valued than any time in history. The first chart is the Price -to-Sales ratio of the S&P 500 and the second is referred to as "The Buffett Indicator" which shows Market Cap-to-GDP.

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Anecdotally, we read a report indicating that Buffett's Berkshire Hathaway has maintained a steady $100 million in cash over five calendar quarters. While he has been buying his own stock during that time, and reducing the float, it would indicate that he does not see much value in this market.

Valuation is not a timing device, but it is a good indicator of long-term returns.

Melt-Up Thesis

In mid-2017 we discussed the possibility of a "melt-up" in stocks. In early 2018 Jeremy Grantham of GMO (Grantham, Mayo, van Otterloo) wrote a white paper about the possibility and the nature of how bubbles end. At that time our conclusion was that we had seen the melt up and one of its manifestations was Bitcoin rising to $20,000

per coin. But we have the utmost respect for Grantham and his firm and he is considered an expert on bubbles.

This January GMO released a white paper titled "Is the US Stock Market Bubble Bursting? A New Model Suggests Yes". I'm sure you can find it on the web. But here are the conclusions from the paper written by Martin Tarlie:

- *"A new model suggests that from early 2017 through March of 2018, the U.S. stock market was in a bubble.*
- *Driven by negative changes in sentiment, the bubble started to deflate in the fourth quarter of 2018, despite of strong fundamentals.*
- *Our advice, consistent with our portfolio positions established in Q1 2018 – as usual, we were early – is to own as little U.S. equity as your career risk allows."*

Today there are still a few analysts that we respect that are calling for a final "blow-off top" in stocks. The thesis is that this bubble will end in a final panic buy into stocks sending it up 50-60%. This would look like the end of the dot-com bubble or the final thrust of oil prices in 2008. If we had to put odds on this we would give it 25%. Even these analysts are suggesting that after the final top, we should expect a devastating bear market.

What we have learned, however, is that the topping process in stocks tends to be characterized by the dissipation of hope over time. This was true in the broad markets in 1974, 2000 and 2007. Bottoms tend to be spikes of fear. Commodity markets tend to top with spikes of fear of scarcity. But some stock market peaks do spike: like the Nasdaq in 1999 or the Dow in 1929. It is still possible. But investing for such an outcome is not investing – it is speculating. We would advise that money allocated for this type of event be speculative money – money that you can afford to lose without impacting your goals.

Policy Options – And Policy Error

As Ray Dalio and David Rosenberg have suggested, Central Banks have less ammunition to fight the next downturn when it comes. Others, such as Nassim Taleb, and even the "Group of 30" which includes Mario Draghi, Mark Carney and Tim Geithner have suggested the same.

For the first time since Paul Volker, we have someone at the helm of the Federal Reserve who is willing to be the adult in the room. Jeremy Powell has attempted to do what needs to be done to restore balance to our economy and position the Fed to be able to respond to future shocks. Ultimately, he will likely fail, and we will look more like Japan for at least some period of time.

Central Bankers have an impossible job and we would not want to be in their shoes. But the sum total of our education related to the role of central bankers in a functioning economic system suggests that Alan Greenspan succumbed to the pressures of bankers and politicians and Bernanke twisted the worst monetary theories and exported those theories globally. We do not think history will look kindly upon these experiments.

But here we are, and as we concluded 10 years ago, the greatest risk continues to be deflation rather than inflation. Lacy Hunt of Hoisington Management is someone who we think has the best grasp of the situation, in the tradition of Irving Fisher in the aftermath of the 1929-1933 crash. Here is one snippet from his 2018 fourth quarter review:

"However, as noted, our current lower rate and inflation circumstances are due to lower velocity of money, higher debt, and poor demographics. Therefore, a larger percentage decline in inflation and interest rates can be expected. Even a mild recession in 2019 would put the Fed in an untenable situation…The risk is rising that the U.S. will not only return to zero short rates but, as they have in Japan, might remain there for several years."

Investment Strategy

We see the following trend changes beginning to take shape in the markets:

1. Active over Passive
2. Value over Growth
3. Cash Flow vs Momentum
4. Sell the rallies vs Buy the dips

Gary Shilling's Investment Themes for 2019 include the following:

1. Long the dollar
2. Sell emerging market stocks and bonds
3. Sell U.S. overall market indices
4. Short commodities – including oil
5. Small long-equity positions in health care, consumer staples and utilities
6. Log Treasury Bonds
7. Short Bitcoin
8. Heavy cash position

Each of our clients' broad portfolio allocations are geared toward the achievement of their unique financial goals. Everyone has different time frames and risk tolerances. But we do maintain a relatively short

list of investments and managers that we prefer. Our broad philosophy can be characterized as an endowment model for retail investors - 30/30/30 which is as follows:

1. Have as large a cash allocation as is appropriate, 10% with in portfolios but more in bank accounts/CD's or similar
2. Roughly 30% in fixed income – currently we favor high qual ity fixed income and are cautiously looking to extend dura tion with Treasuries. We expect that ultimately interest rates will head lower when the market rolls over.
3. Roughly 30% in Absolute Return or Tactical Strategies
4. Roughly 30% in equity. Currently that includes real estate – particularly health care and apartments, MLP's for their cash flow and expansion of the use of natural gas for utility scale, electricity (although we continue to work toward more sustainable/renewable sources), dividend paying stocks, inverse equity targeting industries and companies with unsustainable debt on their balance sheets, and active long/short international equity where valuations are more attractive.

We also think that it can make sense to have some portion of your retirement come from guaranteed sources. If interest rates do decline again, locking in some of the interest rate gains we have seen may prove very valuable. We believe that at least 30% of your retirement income should come from guaranteed sources – that includes social security and pensions. Ben Bernanke is known to invest most of his retirement assets in annuities. We said we disagreed with him – we did not say we thought he was completely stupid.

Create Your Own Economy Corner - Financial Planning Lessons from One of the Greats

My greatest inspiration to becoming a financial advisor was my father, Phil Havens, who passed away this past December. Dad taught me so many important life lessons that apply to good financial management and creating a life worth living. He was a teacher, a coach and a headmaster. He chose a professional path that he knew would not be the most financially rewarding, but the rewards he received for a life of following his passion and making a difference for others were priceless.

To follow his chosen path, support his family, and create the vision that he desired, required discipline, good judgement, support from good advisors and a little luck. But here is how he did it:

1. Spend less than you make and invest the difference.
2. Start saving early
3. Choose your life partner well.
4. Take care of your health and energy.
5. Make time for friends and family
6. Know the difference between your short-term investments and your long-term investments and invest accordingly.
7. Be willing to delay gratification.
8. Set aside funds for the pleasures in life -enjoy the flight as well as the destination.
9. When you see an opportunity, be willing to take some risk.
10. Don't ever let debt rule your life but use leverage when appropri ate.
11. Don't let emotional attachment to any asset drive your decisions.
12. When you get good advice follow it.
13. Give away some of your income every year to causes you believe in.
14. Never stop learning and growing.
    - Keep up with the changes in the economy and technol ogy to the degree you can.
    - Keep improving yourself
    - Keep listening and learning from others
15. Live with passion and demonstrate it by putting the work in.
16. Never give up on your vision.

We will miss you dad but your influence will go on forever.

Thanks for reading,

Matt and Tom

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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