October 9, 2018

Re: <u>SFP Conference Call Tuesday, October 23, 2018 at 6:30pm</u>

Dear client,

Since our last conference call and newsletter, the securities markets (both bond and stocks) have become much more volatile. Adding to the market gyrations is the fact that only a handful of stocks have driven the stock market this year. Most of the issues in the S&P 500 are languishing while few are going up in price. Since the S&P 500 is market weighted, the small number of large capitalization stocks is the source of this gain, not the general market. Poor market breadth is always a bad sign and if not careful an investor could get badly hurt. The number of stocks hitting new lows is telling me that a few stocks are leading the market. Today's investing environment has many characteristics of the dot-com era (circa2000) and of other previous peaks. In each instance, the cause of each market decline was due to a sustained rise in interest rates.

Expansions do not die of old age; they die because of a rise in interest rates. The rise in rates will eventually cause a recession, but not anytime soon until I believe that the 10-year Treasury note reaches 3.50%. However, if inflation rises above what the Fed believes is appropriate, then interest rates will rise further and quicker. The economy will be squeezed. According to our research colleagues at BCA, inflation pressures will begin to surface over the next twelve to eighteen months as capacity bottlenecks start to appear. This may lead to even more interest rate hikes, certainly more than what the markets expect. Therefore, with the economy running strong, the Fed can hike rates a lot more. This is the major reason why the stock market has experienced some major heartburn since late August.

The big question to ask is: where this fed action, increased volatility, and poor market breadth lead us? To answer that question we will look back at what we said in June. The combination of global growth, rising economic vulnerabilities outside the United States and a more challenging Fed interest rate policy caused us to lower the asset allocation to equities. Although the market has so far proved us wrong, I am of mindset to be cautious in our approach. The absolute direction of the S&P 500, the next few months could be challenging. U.S. stocks have been able to decouple from those in the rest of the world, especially the bloodbath taking place in emerging markets, but this state of affairs may not last. As we mentioned above, a similar period in 1998, prior to the dot-com burst in 2000, experienced a decline of 22% between July 20, 1998 and October 8, 1998 in what was then a massive bull market. Obviously, we have not experienced any such decline yet, but it could happen. You never know what is lurking around the corner, maybe Tesla imploding?

At this point, with a possible recession looming in late 2019 or early 2020, it doesn't make sense to increase the equity allocation by a large margin. At the moment, we are sticking to our asset allocations just in case.

It is instructive to examine the past to see if we can learn from history. For one, I have learned that when there is a sustained rise in interest rates, at some point, it chokes off the economy and the stock market. For example, when the Federal Reserve raised interest rates from 4.5% in 1998, to over 6.4% (see chart 1) in 1999, the market declined in year 2000 as the dot-com boom burst into flames and did not begin a recovery until 2003. It took 15 years for the tech heavy NASDAQ to recover (See chart 2). Even the S&P 500 which had tech heavy stocks in it took seven years to recover from its peak in 2000 (See chart 3).

Chart 1 (US Treasury Index 1990-1999)

Chart 2 (NASDAQ Index 1998-2018)

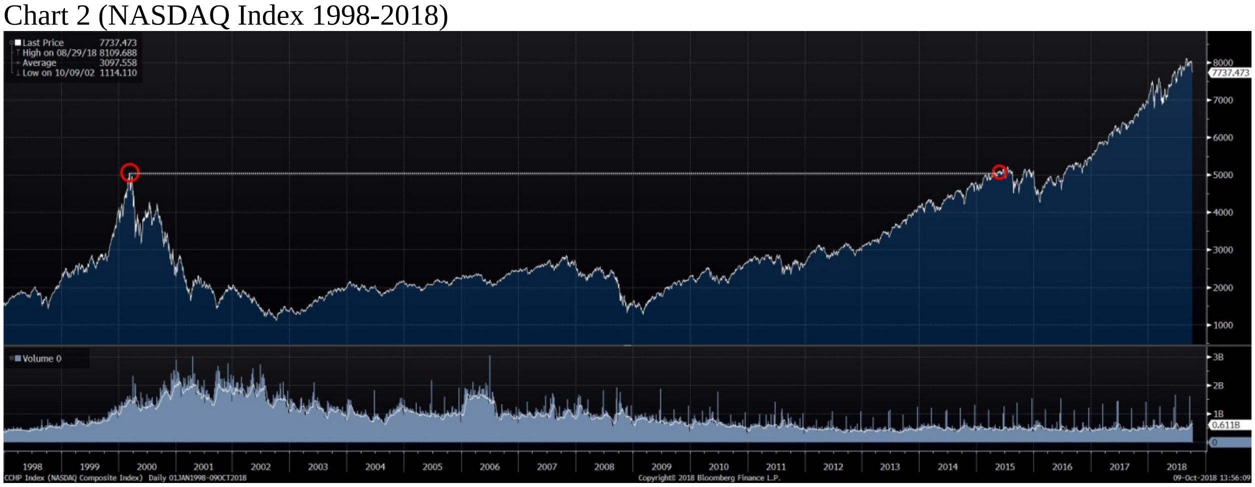
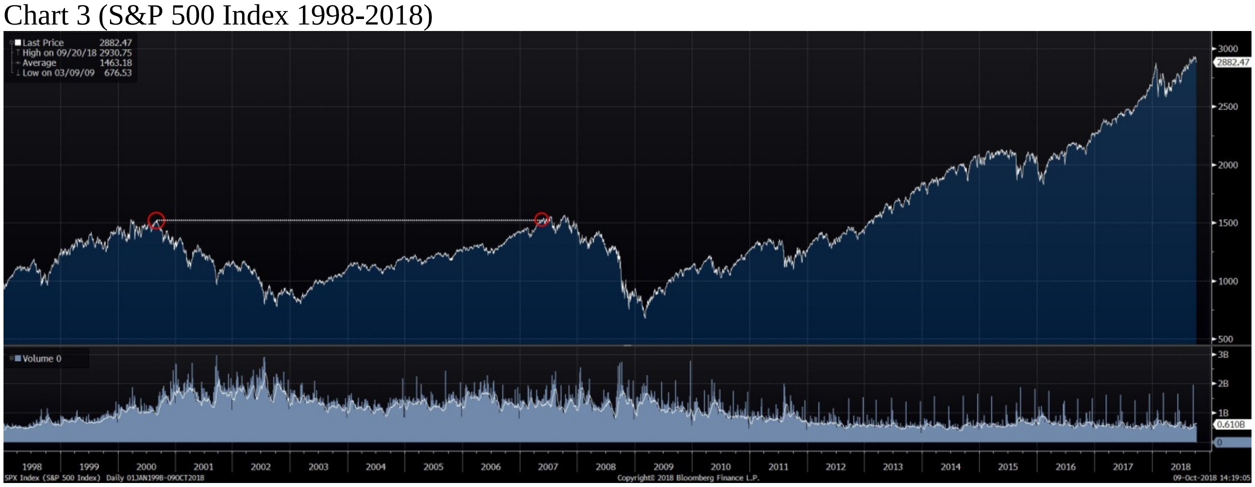


Chart 3 (S&P 500 Index 1998-2018)



The Facebook-Amazon-Netflix-Google (FANG) stocks of today were like Cisco and Qualcomm in 2000. Qualcomm peaked in 1999, trading at absurd valuations of 144 x book value and a Price to Earnings ratio of 1000. I recall being in my doctor's office, listening to him bragging how smart he was to buy Qualcomm. This was in 1999, right before the dot-com bust. As we can see in chart 4, Qualcomm peaked in 1999 and still has not recovered to its former glory. Cisco is another example of overpaying for growth. Cisco was trading at absurd levels in 1999 and has never even come close to its former peak and, although Cisco has increased its earnings year after year between 1999 and now, the stock has never recovered (chart 5). Why is this so for Qualcomm, Cisco, and many other stocks of that era? Investors simply overpaid for growth and the valuations of those stocks were too high in relation to their excellent growth prospects. The FANG Stocks, in my opinion, are now in a similar position as the dot-com stocks were in 2000.

Chart 4 (QCOM 1998-2018)

Chart 5 (CSCO 1998-2018)

As we see from chart 2 that if you had your money invested in 1999 in a NASDAQ index fund, (QQQ) you would have had virtually no return for 19 years. Looking at chart 3, we see that the S&P 500 peaked in 2000 and never fully recovered until 2007. Why? Again, due to overvaluation. This is why we judge individual stocks not indexes because in the past we have been able to generate positive returns when the indexes languished. However, there is no guarantee we will be able to do this in the future. Our ideas about diversification that include bonds and stocks, in my opinion, and in the opinion of many academics and professionals, have been a prudent and proper way to manage your money.

When the broad market breadth is flat and too few stocks are leading the pack, in my opinion, this signals trouble. Add to the fact that interest rates are rising - it is a time to be cautious. Granted, we may been too cautious since June as the trade wars seem to recede a bit, at least with Canada and Mexico. However, we still have China to contend with. Businesses and investors may be underestimating both the Trump Administrations resolve with regards to China and the resulting economic and stock market impact. In terms of China trade there may be further shocks to the system. We remain cautious preferring to buy bonds at this point, but keeping the maturities shorter than we usually do. However, if there is a correction of 20% or more even during a recession that is most likely to occur by 2020, then we will increase the allocation to stocks as valuations become more reasonable. Somehow in the 40 years that I have practiced money management this type of analysis and thinking has served me and you well.

Please join us on our next conference call which will be held on **Tuesday, October 23, 2018 at 6:30pm**. To join the conference call, **please dial the toll-free number: 1-800-914-8405.** **Once prompted, enter the access code: 5486434, followed by the # button**.

Best regards,

Steve Yamshon
Investment Counsel