October 21, 2016

Dear Client,

As we move into the autumn season, we have had a relatively quiet and good performance year in spite of Brexit. Several years ago, I read several excellent books on improbable events that essentially told me to think about the unexpected, not the expected. This is called a Black Swan event. In a Black Swan event, a risk that is totally unsuspected comes out and takes a whack to the securities markets. It could be Brexit, or it could be a Trump win in the upcoming election. In any case, it is always a good idea to be prepared.

In the last few months, the stock market has treaded water in most part due to the anticipated rise in interest rates as well as nervousness concerning lackluster corporate profits. It doesn't help that the electioneering has been less than subtle. Even with that backdrop, liquidity conditions will largely remain favorable for risk assets for some time even in the face of rising interest rates. The December rate hike won't be that much and most likely will not be too restrictive.

The problem doesn't lie so much with an increase in interest rates as much as it does with corporate profits. The market is way too optimistic in this regard and any disappointment could cause a correction in stock prices. Multinationals will have a headache as the U.S. Dollar rises due to an increase in interest rates.

Equities could be vulnerable to a near term correction, but the longer term outlook for stock markets outside the U.S. looks reasonably good. We are starting to scour markets in Europe and Japan where value seems to be much better. This doesn't mean we are abandoning the U.S. markets, not at all. However, as of late, we having been reducing U.S. equity exposure when warranted.

If interest rates move substantially higher, which I don't believe they will, bond prices will go down. For the most part, we don't use bond funds. Therefore, if the price of a bond declines, it is not so worrisome if an investor holds individual bonds like most of you. Why? Simply because we hold the bonds to maturity and the investor will get his principal plus interest when the bond matures. Of course, that depends if the bond defaults or not, but since we have investment grade bonds and no-high yield bonds, the likelihood of that is remote.

The major reason why I don't use bond funds is that the typical investor is fickle and short-term minded. For example, if an investor is in a bond fund and wants to redeem his or her shares, the fund will have to liquidate their bonds if many investors liquidate. This means the bond manager may have to sell when it isn't prudent to do so or when the time is not favorable. Investors can get stampeded and worse, the remaining investors will really lose. With individual bonds, we hold them until maturity. In addition, we ladder our bonds with different maturity dates so the entire bond portfolio is not either in short-term bonds or long-term bonds.
The bonds that are most vulnerable to an increase in interest rates are high yield (junk) bonds, foreign bonds, and Treasuries. We stay away from those categories except for a limited amount of treasuries.

Inflation has been heating up and no surprise here. The U.S Federal Reserve has been printing money for 10 years and although it took a while for inflation to rear its head, it looks like it is now moving up. We have been buying Treasury Inflation Protected Bonds as a hedge and we will continue to purchase more as warranted.

Speaking of inflation, gold is almost in our price range where we would purchase it as a “portfolio protector” once again. Stay tuned!

Lastly, our colleagues at BCA Research have published an interesting geopolitical strategy report on the upcoming U.S. election. I think you might find it quite interesting as it incorporates some elements of what I referred to above as ‘the black swan event.” I hope you enjoy this informative article as much as I did.

On behalf of all of us at Stevens First Principles, I would like to thank you for your continued confidence in us and I wish you a very happy fall season.

Best wishes,

Steven Lee Yamshon
Investment Counsel