**Summary of January 2017 Conference Call**

**NORA:** Welcome to tonight's conference call. This time of year Mr. Y usually visits our offices to ask Steve what his thoughts are about the global securities markets and about his thinking about the New Year prospects. Unfortunately, Mr. Y couldn't make it this year as he is preparing for a tough economic climate in China. Mr. Y is familiar with Steve's involvement with the University of Oxford and his global meeting with colleagues in the United Kingdom so, Mr. Y asked his friend, Doc Martin, to fill in for him and interview Steve. We hope you enjoy tonight's enlightening and informative conference call.

**DOC MARTIN:** Good evening Steve, I hear you go to the U.K. often, mostly to Oxford.

> **STEVE:** Yes, Doc I do, I love it there. When I go to Oxford I go to learn something about business, the global economy, stocks and bonds. I get to meet with some of the world's brightest professors and colleagues.

**DOC MARTIN:** Tell me about your typical day.

> **STEVE:** I wake up and have a great English breakfast. Sometimes I stay at a hotel 2 miles out of town so I can walk to the Saïd Business School or, sometimes I stay in the college I graduated from which is a 1 mile walk. I meet in classes with colleagues who are from all over the world or I meet with strategy, economic and finance professors from the University. We talk about investments, politics, global economics and a lot of interesting stuff. I usually eat lunch at the School with my mates and we discuss all sorts of things. In the afternoon, I usually sit in classes that are of interest to me such as the global economy, the effects of Brexit, impacts of China and so-on. Lastly, when class is over we go to the local Chinese restaurant for dinner and then off to the pub.

**DOC MARTIN:** I hear you are an Oxford Graduate?

> **STEVE:** Yes, I am, I have three Masters Degrees from Oxford.

**DOC MARTIN:** Wow impressive! But did you learn anything and what do you get out of these visits, beside big airline and food costs?

> **STEVE:** What Oxford does for me is it keeps me linked with the global community and that gives me a valuable insight me can't get anywhere else. Let me give you an example. If you really want to invest in China, do you read about it in financial publications or listen to the brokers who generally know not too much? Or listen to the so called experts who are generally wrong? No, you listen to the men or women in the trenches, the ones who live and breathe China every day. Normally, the Chinese are very reserved and don't like to talk too much, especially about sensitive subjects. However, after a few beers at the pub, they really open up and you learn a lot. This is why we have largely been avoiding China for now. Although the Chinese stock market did fairly well last year, the economics point in the other direction. Furthermore, because of my causal talks with colleagues in China, I found out how the government manipulated their stock market in order to repair the damage from last year's speculative crash. I also learned from my colleagues that the majority of the people in the U.K. were in favor of leaving the European Union.

**DOC MARTIN:** Did you take advantage of Brexit?

**STEVE:** Yes, I did. In our fund, YYR, I had shorted the British pound through the liberal use of options when the pound was at 1.32 to the U.S. Dollar. On the day of the Brexit vote, I was travelling to San Francisco and I checked into the office only to find that the news was saying that Britain would not leave and that my position was way down. However, by the time I got to Knob Hill for dinner, the situation had completely turned around and the U.K. had voted out. The fund did very well as the pound sunk to $1.26 to the U.S. Dollar.

**DOC MARTIN**: What else did you learn on your last trip?

**STEVE**: That Brexit is only one part of a global dissatisfaction with the ruling elite. Britain was first but the United States was second with the election of Donald Trump, and Italy was third with its recent election. Further elections across Europe will spell problems for globalization and the ruling elite. The people, like it or not, are tired of politicians not getting things done and they are getting tired of the same old ruling elite who are corrupt and privileged.

**DOC MARTIN**: Can this be good?

**STEVE**: Maybe if you live in Cornwall, but certainly not for the rest of the world. Bill Clinton's push into globalization fueled a massive expansion in global trade that was beneficial to the United States and everyone else. Yes, unfortunately, it did hollow out Middle America and British manufacturing jobs as those jobs went to lower wage countries. Many people lost their jobs and that is unfortunate, but many of them retrained and found better paying, higher skilled jobs to replace them. There are always pros and cons to globalization, but the bottom line is that it has been beneficial.

**DOC MARTIN**: What about China? Are they playing fair?

**STEVE:** That is a good point. China is not playing fair and we need to do something about it. China has implemented these non-market trade barriers like restricting the number of American films played in China to 34 per year or requiring foreign companies to joint venture with Chinese companies and then transfer over their technology. That has got to stop. Fair trade not free trade is the only way the global trading system can operate properly.

**DOC MARTIN**: Even in Cornwall, we have noticed an upturn in inflation. How does that play into global trade?

**STEVE:** I'm glad you mentioned inflation. Inflation and bond yield have passed a cyclical turning point but this doesn't mean that we are going to experience a large inflation, at least not yet. A sustained uptrend is here and that is reflected in the rise in interest rates.

**DOC MARTIN**: Are you doing anything about it?

**STEVE:** Yes, we started to reduce the maturities of the bond portfolios. Last year (2016), we sold a few longer dated bonds and reduced the average length of maturities. We still like bonds and we will use that money to buy bonds with maturities of up to three years.

**DOC MARTIN**: I noticed that my bond portfolio had a rock year?

**STEVE:** The first 6 months of the year were absolutely great for bonds as interest rates slightly declined after the Brexit fallout. However, after the U.S. election, bond yields went up and bond prices went down at one of the fastest clips I have ever seen.

**DOC MARTIN:** What is your interest rate forecast?

**STEVE:** I'm not Carnac the Magnificent, you know the old Johnny Carson character that he played on the Tonight Show? I have some suspicions that the ten year treasury will be at least 3% by year end 2017 and 4% by 2019. That means credit card, home line of credit and mortgage rates will go up.

**DOC MARTIN**: What will that do to our bond portfolio?

**STEVE:** In December, I reduced the maturities of the longer dated bonds and I have a lot of bonds with shorter dated maturities. The shorter dated bonds won't get hurt too much.

**DOC MARTIN:** Why don't you use bond funds?

**STEVE**: I don't use bond funds for exactly this reason. If I buy individual bonds, I can hold them to maturity and receive every penny I paid for them plus interest if the bond doesn't default. By the way, I have never had a bond default on me yet. If I own bond funds, then I am subject to the fund holders selling their shares. To pay the shareholders, the bond manager has to sell bonds exactly at a time when he shouldn't. The rest are left holding the bag. Long bond funds are down 12% this year. We are not. I don't buy bond funds because I can simply hold bonds until their maturity and I won't get trampled.

**DOC MARTIN:** Thank you for that, I appreciate it. Back to Inflation. What is a TIP? Is that what I am supposed to give to Bert Large?

**STEVE:** No Doc, a TIP is a Treasury Inflation Protected Security. It is a bond that has its interest rate rise with inflation. If interest rates rise too much, they can get hurt like other bonds, but at least you are protected against the ravages of inflation.

**DOC MARTIN**: Why have bonds at all?

**STEVE:** In a rising stock market, like the one we have had since the November U.S. election, it seems like not having bonds would be a good idea. After all, stocks rose approximately 4.6% since the election and 4.6% before the election. Bonds dropped around 9%. However, people's memories are short and they forget how important bonds are as a diversification tool. Anyone remember the market crashes in years 2000 and 2008-2009? Bonds skyrocketed in price as yields plunged and kept the portfolios from having any significant or permanent losses. Bonds provide a useful tool for diversification and protection. Congress is assessing the possibility of taxing bond interest at capital gain rates instead of ordinary income. That will be a big boost to bonds. We also have much more corporate bonds than government ones. The corporate bonds held up much better than government bonds in the last 2 and ½ months.

**DOC MARTIN**: Why should I diversify and why shouldn't I have an all stock portfolio?

**STEVE**: Some folks don't diversify and do have an all stock portfolio. For example, YYR is an aggressive and concentrated portfolio with no bonds. However, it is volatile and, can you stomach that? Let's say for example, that you had an all stock portfolio in 2008, would you be happy if the portfolio went down 37%?

**DOC MARTIN**: No, I would be frightened.

**STEVE**: That's why we have a portfolio that includes stocks from the U.S. and foreign countries, as well as bonds and sometimes gold. It is the diversification that reduces risk and increases return over the long haul.

**DOC MARTIN**: It looks like we have had a very good year in spite of bonds. What does the Great Carnac see in 2017?

**STEVE:** The U.S. Dollar has shown amazing strength in 2016 and I expect it to continue rising another 5%. A rising dollar puts pressure on corporate profits as companies export less goods and services to the rest of the world. This could limit corporate profits.

**DOC MARTIN:** What is your opinion of the stock market in 2017?

**STEVE:** After steep climbs in November and early December, both the bond market and the stock market are overdue for a pause. The bond market looks to be stabilizing and even backtracking a bit on interest rates; although, I expect interest rates to continue marching upward in 2017. The stock market has become more divorced from reality. Doc, have you ever treated a patient who was as loony as Steve Jobs was?

**DOC MARTIN**: Yes, do you remember Mrs. Tishell the pharmacist?

**STEVE:** Yes, I do. She was psychotic.

**DOC MARTIN**: Just like Steve Jobs, she has a distortion reality field in that she believes what she wants to believe, not necessarily what is the truth.

**STEVE:** That is how I feel about the stock market today. It has broken away from the fundamentals because of the election of Donald Trump. Although the domestic economy is on a reasonable sound footing, stock prices have now discounted way too much good news. Consumers have become extremely hopeful with the Conference Board confidence survey surging in December. This entire rise is due to better expectations about the future. It is unclear whether much of this translates into much better consumer spending. Preliminary reports about holiday spending do not show much improvement over last year.

**DOC MARTIN**: How does this affect stocks?

**STEVE**: Evidence of exuberant overshoot is apparent at the sector level. We are cautiously optimistic and constructive on stocks. We have increased our stock allocations, even though 2017 will prove to be very volatile as the Trump presidency runs into headwinds.

**DOC MARTIN:** Earlier you talked about globalization, the U.S. Dollar, China, emerging markets and Trump. What do all these regime changes mean and what are the implications for investors?

**STEVE**: For one, the end of falling inflation and rising interest rates, moves away from fiscal conservatism, negative feelings towards globalization and a rising U.S. dollar will affect corporate profit margins. People will still search for yield but rich valuations in bonds don't warrant an increase in holdings. The U.S. stock market is modestly overvalued but the conditions are ripe for an overshoot. There is a good chance of a 10% or so correction early in 2017 and that would represent a good buying opportunity. We are keeping a higher than normal cash balance waiting to buy stocks. Valuations are better in Japan and Europe. Two markets where we are fishing. Relative monetary conditions favor Japan and Europe. Oil should range between $50 and $60 this year.

**DOC MARTIN**: You have referred to Black Swan Events in the past. Do you see any?

**STEVE**: A black swan event is an event that is not predictable, it is an unpredictable event. So most economists and investment folks think that the odds of trade war with China are low. I say the odds are high leading to a black swan event. President-elect Trump has been pretty active in China-bashing. I expect the Chinese to retaliate when it comes to issues in the South China Sea and with Taiwan. And the Chinese are not playing fair with trade; the Chinese government came up with a $29 million fine against GM for so called "price fixing." GM cars sell better in China than domestic producers and the Chinese powers don't like that. To sway the public to reduce their purchases of GM cars, they came up with a bogus charge. This has occurred in the past with Qualcomm, Apple, Volvo, and Kentucky Fried Chicken. I don't think Trump is going to let this stuff continue.

**DOC MARTIN:** I'm near retirement. I hear you do financial planning. Is that a good thing for me?

**STEVE**: Around year 2000, I noticed that as people were getting older, they weren't adequately preparing for retirement. Many people simply outspend their means and when it comes time to retire, they fall short. Later, we noticed that most people were over insured or they had no estate plans. How did they plan for their kids' college? These questions came up. That is when I changed the direction of my firm. Yes, we invest our clients' funds in diversified portfolios using individual stocks and bonds and sometime mutual funds. We assess your risk and assess your stomach for volatility. And, we invest your money in a prudent manner in a diversified portfolio that will not always beat the S&P 500 index. Most of the portfolios are balanced with stocks and bonds so it is ludicrous to have a portfolio of stocks and bonds be compared to an all stock portfolio. Besides, that is not the point.

We are here to help all of our clients with financial planning and any question that they have about that subject and more. We are your advisors and we do much more than invest your money. If I were you, I would take advantage of that.

**DOC MARTIN**: Now that I am married to Louisa, I am finding how expensive things really are. Any last words?

**STEVE**: We had a very good year in the stock market, not mainly due to the aftereffects of the Trump election, but because of a well-designed and balanced portfolio that was doing well before the election. I anticipate a very good 2017, but it will be rocky, that's for sure. I am expecting a 10% or more correction early this year, but I am willing to ride it out and you should too. Outside of fixed income only portfolios, I am reducing the bond allocation. In balanced portfolios, I am increasing the stock allocation slightly, not dramatically.

On behalf of all of us at SFP, I wish you a Happy New Year and I look forward to seeing you in the coming months as I make my rounds.

**DOC MARTIN**: Are you coming to Cornwall any time soon?

**STEVE**: Yes, I am in June after my pilgrimage to Oxford. Cornwall isn't thinking of splitting from Britain is it?

**DOC MARTIN**: No, I don't think so. That would be like the National Health Service be the first choice of Britons to go when they are sick.