Summary of October 2018 Conference Call

The combination of slower global growth, trade protectionism, the Italian budget crisis and U.S. Treasury yields have made U.S. equities increasingly vulnerable to a phase transition from euphoric optimism to a more sober appreciation of the risks facing the global economy. Economic growth in the United States remains robust while economic growth outside the U.S. is slowing. This desynchronization explains in large part the increased market volatility of the past few weeks. Eventually, the U.S. and the rest of the world will have to converge.

The good news is that the U.S. economy is still quite healthy and none of our recession indicators are flashing red. This suggests that the correction that started a few weeks ago is just a correction. The other good news is that we lowered our exposure to stocks, beginning in June, and shortened the maturities of the bond allocation. I think that the portfolios are weathering this correction pretty well. The bad news is that a correction usually ends when investors stop believing that they are witnessing a correction and that a bear market is upon them. Stock market sentiment is still fairly intact, which suggests that there will be more downside to the U.S. markets before a bottom is reached. The top of Chart 4 suggests that there is a 10% or more chance that the market will correct 10% or more in the next twelve months. The middle and bottom of Chart 4 illustrate that traders and small investors are still quite bullish. When they capitulate, the bottom of the decline will be reached.

Emerging markets have already washed out with the Shanghai A share Index declining 23% year-to-date. Hardest hit were some of the market darlings like Tencent, Baidu and Alibaba. Other emerging markets such as India, Mexico, Brazil, South Africa, Russia and other parts in Asia are also significantly down.

Investors should anticipate that more declines in the U.S. markets are yet to come, but that this correction will end before a recessionary correction begins in late 2019 or early 2020. The market could correct by another 10% to 15%, but no one knows the magnitude or even if it will happen. Stock markets usually correct when stock valuations are stretched and macro fundamentals look like they are deteriorating. Looking back to 1929, we can see from Chart 1 that the real U.S. economy peaked in summer of 1929 and its demise accelerated in the fall and towards the end of the year. Today, the economy would really need to deteriorate before the stock market crashes. When we look at Chart 2, the stock market declined 20% in one day on October 19, 1987. The culprit for the 1987 decline was a weak dollar and rising interest rates. However, the market quickly recovered in 1988 and 1989 with no recession.

Today, we have a similar situation with interest rates rising but in contrast, a rising dollar. Eventually, this combination of a rising dollar and higher interest rates will choke off the economy and the market will lead the recession down. Again, we are not there yet. One signal that the economy may be slowing and money is becoming restrictive is the slowdown in residential real estate sales. This could be a large fundamental factor telling us that the macro fundamentals are starting to deteriorate in an environment in which stock valuations are not cheap. Yet Chart 3 demonstrates that the economy remains strong. ISM orders are still strong although it may be starting to flatten out. The same is true with durable goods orders although planes from Boeing and tractors from Caterpillar may start to have an impact as Chinese tariffs take hold.

As long as the leading economic indicators on the top of Chart 3 stay above the line and keep rising, a recession is improbable, unless some sort of financial shock occurs.

Recessions are more likely to occur when the economy experiences significant imbalances such as in 1929 or the market meltdown of 2008, or the dot-com bust in 2000.

At this juncture, there don't seem to be any concrete economic imbalances except that the United States is growing and the rest of the world is not.

Buying on the dips in the early stages of a bear market is a recipe for disaster. Witness those who bought on the dips in 2008, only to find out that their stock selections declined even further. However, buying when there is a plain vanilla correction is a perfectly good strategy. The problem lies in trying to figure out which is which.

This leads us to think that any sustained rise in interest rates will lead to not only a correction, but also a recession. However, we are not there yet. The recent market sell-off will not deter the Fed from continuing to raise interest rates as they have done in the past when markets slip. This time, inflation and an overheated economy may prevent them from dropping interest rates to save the market. If you recall, the Federal Reserve has been raising interest rates all this year even though the market had a large temporary decline last February.

What drives the stock market upward beside good economic growth? Easy money. The Fed, until this year, had the monetary spigots wide open. In some of our previous conference calls and newsletters, I had mentioned that the Fed was moving towards unchartered waters when withdrawing monetary stimulus by reversing quantitative easing (QE) policies. I had said that no one knew what the real effects or consequences of the QE experiment would be once QE stimulus was withdrawn. We are now finding out what those effects are with a fast spike in interest rates. Rising stock prices and easy money caused economic growth to strengthen and tighter money eventually weakened economic growth and stock prices.

What concerns me is that monetary policy may already be too tight. The bounce in gold may have signaled this factor. I am of the opinion that the Fed will continue to raise interest rates regardless of where the stock market is until the market cracks.

History has pointed this out in the past. In 7 of the past 8 recessions where the stock market has declined, interest rates were the cause. In a seminar I gave in 2003 at UCLA, I pointed out that every bear stock market decline was caused by a sustained rise in interest rates.

As I said in the past, I am of the opinion that when interest rates move past 3.50% on the U.S. Ten-year Treasury, the U.S. stock market will have trouble digesting that interest rate level. As we speak, the 10-year is at 3.15% down from 3.25% just a couple of weeks ago.

China and trade protectionism remain a focal point on my radar. China has a slowing economy and a rising debt problem. The timing of a trade war between the U.S. and China couldn't have happened at a worse time. To understand some of the dynamics that are affecting China, we need to know that they do not have a true market economy. They have a socialist economy that is heavily directed by the Central Communist Party.

In short, President Xi calls all of the shots. State owned companies represent over 30% of China's GDP. China's non-state owned enterprises create over 80% of all jobs while state owned companies take 80% of all bank borrowings. This causes a large distortion in China's quasi market-socialist economy. The State owned enterprises have low productivity and high corruption because their motive is not to make the most profit, but more as a vehicle to keep people employed and the Communist Central Party needs to avoid high unemployment in order to maintain control.

Three phases drove China's growth the past 40 years. The first phase was economic reform started by President Deng. Second was capital accumulation. China has one of the highest savings rates in the world reaching 47% of GDP. Now China is entering the third phase in which economic reforms have reversed and productivity has slowed down considerably.

Particularly worrisome is that the Chinese Central Government has recentralized the collection of taxes forcing local governments to take on all sorts of risky ventures and issue massive amounts of debt. This local financing is in large part financing much of the infrastructure and Chinese real estate projects. China and its local governments have burdened themselves with lots of debt and this could be somewhat problematic if the country growth rate falls much below 6%. It is possible that a trade war with the U.S. could facilitate a lowering of China's GDP below 6%.

In the past 20 years, Chinese GDP has increased 6 fold, but the Chinese stock market has only doubled. Interest rates in China are 14% for bank loans and the corporate bond yield is 11%. These extraordinary bond yields are suffocating business leading to a slowdown. The Chinese government is purposely trying to ease the debt burden by deleveraging, but they are boxed in. The People's Bank of China is reluctant to lower rates for a fear of capital flight and a more depreciated currency. A lower Chinese currency could exacerbate the outflow of money from China. In order to fully understand the ramifications of China's debt, you must understand the asset side as well. As we have said above, China has massive savings with much of the debt held internally. Therefore, China's debt problem is not as serious as it seems to be when looking in from the outside. I think China's debt overhang is manageable. Now Chinese monetary policy is easing somewhat, which should lead to an eventual recovery.

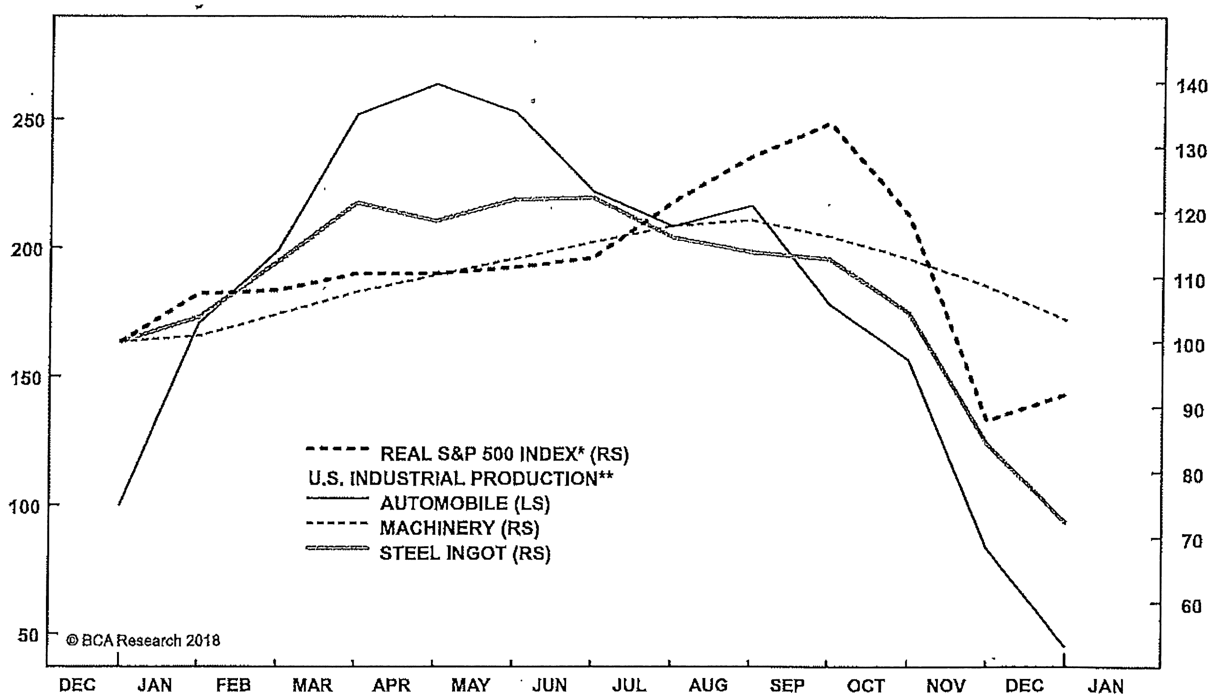
What could lead to a recession in the U.S. earlier than 2019 or 2020? For one, a prolonged trade war with China could have some important ramifications, but that is not our base case scenario. The economy is running strong even with Chinese tariffs in place.

However, an unexpected spike in interest rates due to an unexpected spike in inflation or oil reaching $100 per barrel could set off a recession. Oil spiking above $100 is not as far off as you might think. If Iranian oil sanctions bite, Venezuela oil output continues to decline at the current rate, and the Saudi's retaliate by cutting their oil exports for any punishment that the world may deliver, then you will have a major oil spike that would set of a recession like it did in the 1970's.

Investment Conclusion

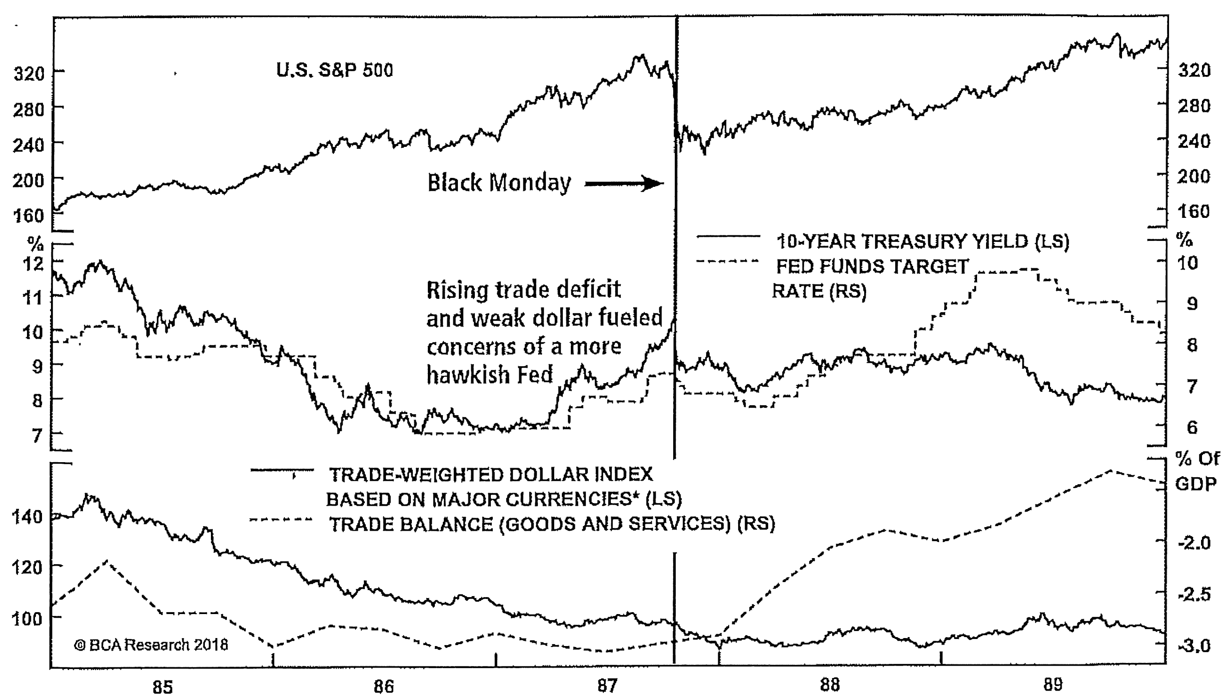
The path of the Fed funds rate is at the heart of our assessment of when the business cycle and the equity bull market will end. If the Fed maintains its gradual pace through all of 2019, hiking the Fed funds rate by 25 basis points every quarter, we estimate that monetary policy will turn restrictive about a year from now. If the Fed speeds up its timetable, or spooks markets and drives up long rates by telegraphing a higher terminal rate, we would likely bring forward our expectations for the end of the equity bull market. If our take on inflation is proven correct, the Fed will act more hawkishly than markets expect and raise rates higher and quicker than what the markets expect. Bonds with long maturities would suffer. Thankfully, we don't have many. We are keeping bond maturities shorter than we normally would in anticipation of higher rates. We believe it is very unlikely that developments overseas will deter the Fed from pursuing measures to rein in worryingly high inflation, and caution investors from placing too much stock in the notion of an emerging market like Alan Greenspan did in 1998. The Fed's mandate is exclusively domestic, and events outside of the United States' borders matter only to the extent that they threaten to impinge on the U.S. economy. Finally, we note that it's not all doom and gloom, blood-red CNBC graphics aside. As the S&P 500 declines, its prospective returns rise if we're correct that the bull market has another year left in it. We are buyers of a correction (a 10% peak-to-trough decline), and will return to overweighting U.S. equities if the S&P 500 dips into the 2,600-2,640 range, bounding correction territory. Stay tuned

CHART 1



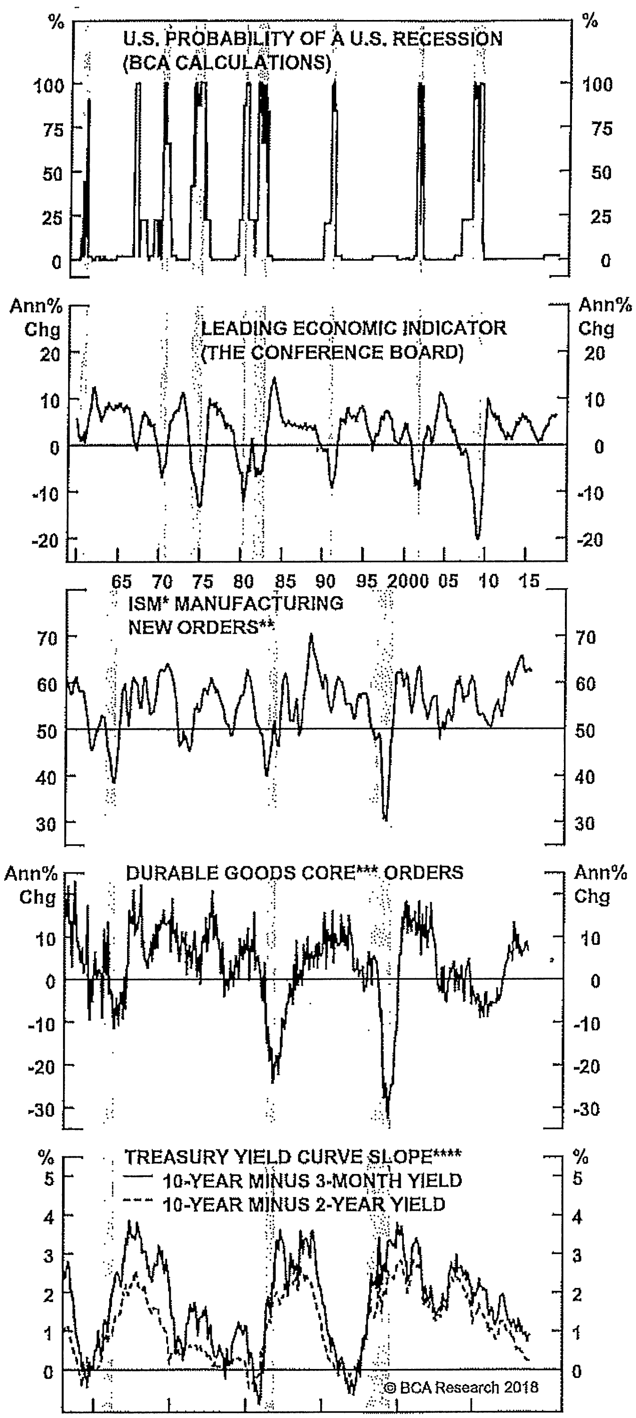
** SOURCE: ROBERT SHILLER ONLINE DATA.
** SOURCE: NBER MACROHISTORY DATABASE.
ALL SERIES REBASED TO DECEMBER 1928 = 100.

CHART 2



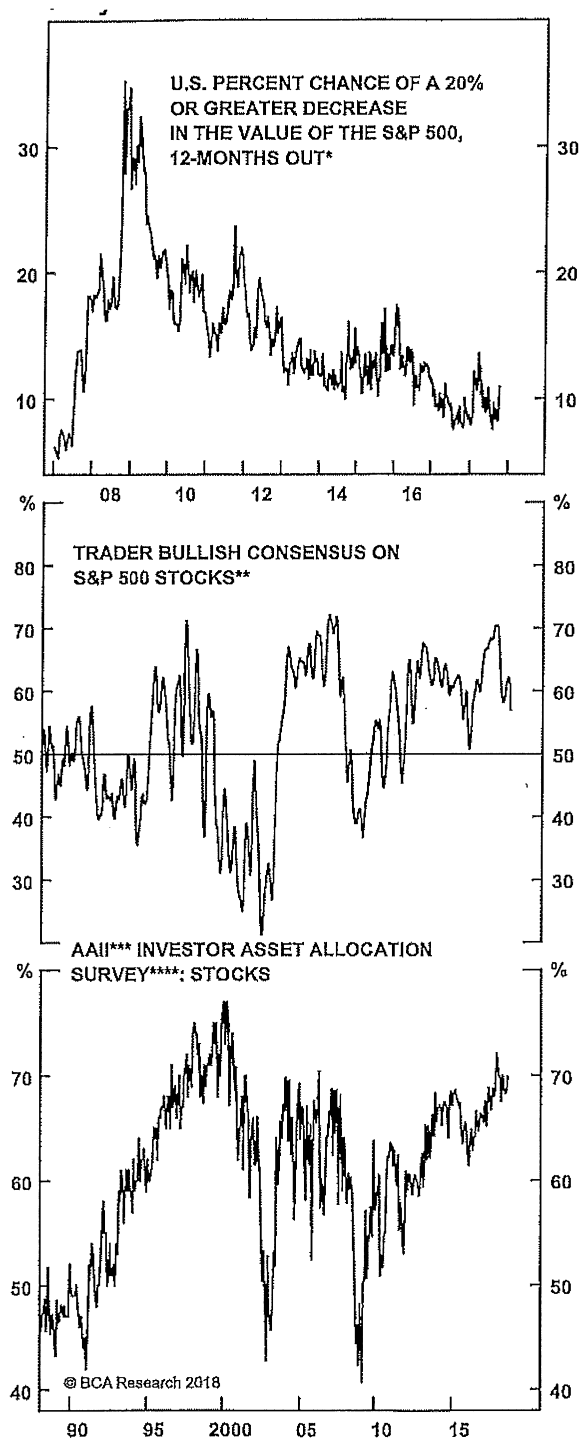
* SOURCE: FEDERAL RESERVE.
NOTE: VERTICAL LINE AT OCTOBER 19, 1987 (BLACK MONDAY).

CHART 3



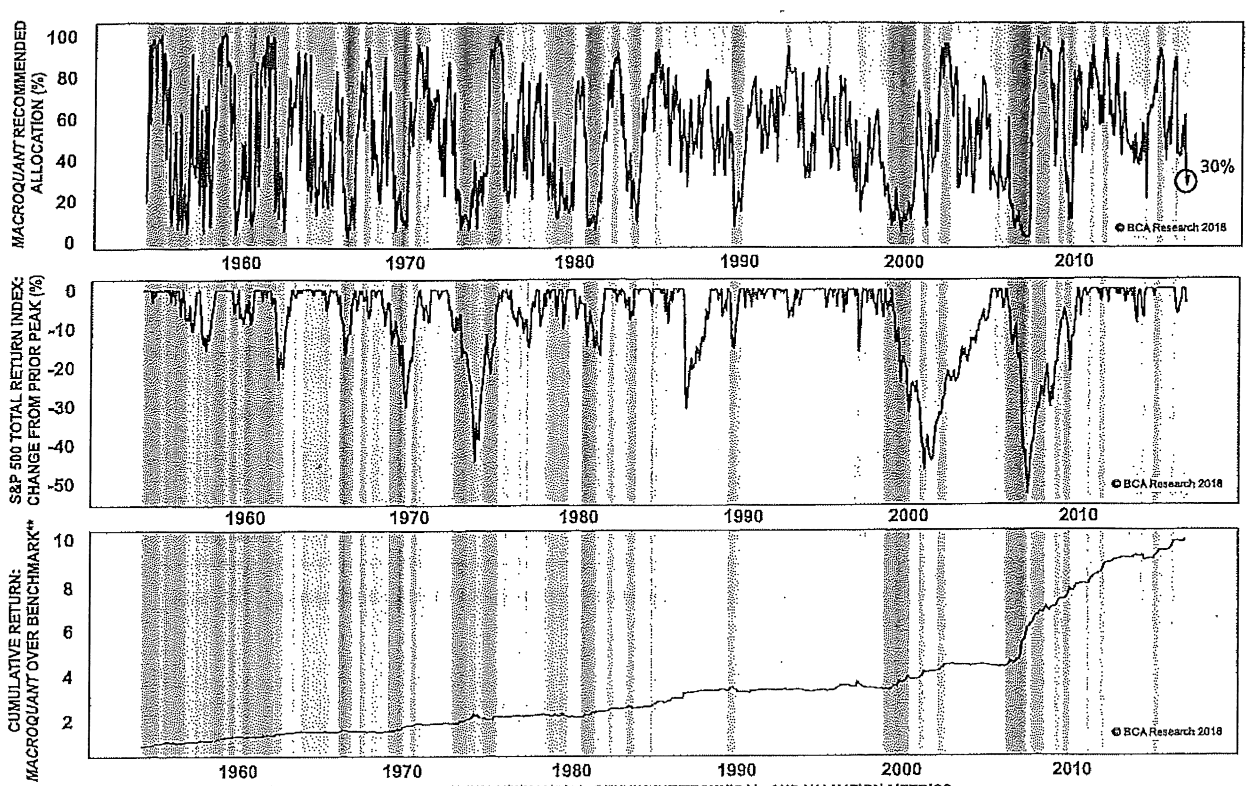
* INSTITUTE FOR SUPPLY MANAGEMENT.
** SHOWN AS A 3-MONTH MOVING AVERAGE.
*** MANUFACTURING NONDEFENSE CAPITAL GOODS EXCLUDING AIRCRAFT.
**** BASED ON MONTHLY DATA.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED PERIODS OF RECESSIONS.

CHART 4



* SOURCE: MINNEAPOLIS FED.
** SOURCE: MARKETVANE.NET. SHOWN SMOOTHED EXCEPT FOR LATEST DATA POINT.
*** AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS.
**** CURRENT PERCENTAGE OF PORTFOLIO.

CHART 5



* THE MODEL IS BASED ON 95 BUSINESS CYCLE, MONETARY/FINANCIAL, SENTIMENT/TECHNICAL, AND VALUATION METRICS.

** BENCHMARK REFERS TO PORTFOLIO CONSISTING OF 50% EQUITIES (S&P 500), AND 50% CASH, WHEREAS THE MODEL PORTFOLIO IS CALIBRATED SO THAT, ON AVERAGE, IT IS IN STOCKS 50% OF THE TIME AND 50% IN CASH.

NOTE: RED SHADING INDICATES INTENSITY OF BEARISH ALLOCATION TOWARDS EQUITIES, WHEREAS GREEN SHADING INDICATES INTENSITY OF BULLISH ALLOCATION TOWARDS EQUITIES.

SOURCE: BASED ON *MACROQUANT* MODEL VERSION 0.9.