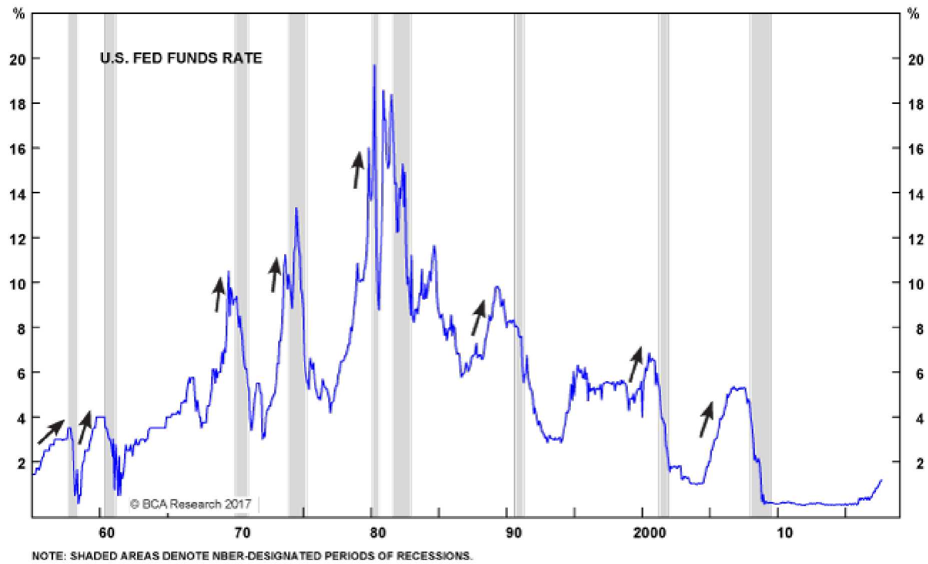
August 28, 2017

Even with geopolitical turmoil, the stock market has shown remarkable resilience. In the past few weeks, global equities have vaulted to all-time highs and for the most part, the markets have shaken off geopolitical risks and focused on global growth.

I am less concerned about politics than I am about a potential rise in interest rates. The Federal Reserve is on the cusp of unwinding its balance sheet and is on track to raise interest rates a fifth time later this year. In short, monetary tightening can spell trouble for the stock market. Our economic colleagues at BCA are fond of saying, “Expansions don’t die of old age, they are murdered by the Fed.” Our own research has demonstrated that each time the Fed had raised interest rates significantly, a recession has followed. Chart 1 illustrates the correlation effect of interest rates and recessions. The upward arrows represent the Fed raising interest rates while the shaded areas represent recessions. If it follows that stock markets decline when recessions ensue, then it means that a meaningful stock market decline could follow the onset of a recession.

Chart 1



Chen Zhao, former strategist for BCA Global Investment Survey, spoke at our 2017 Investors’ Forum. He made his case why a recession is unlikely in 2018, but could occur in 2019. He said that the economy has been somewhat lackluster since the financial crisis of 2008 with growth in the economy being subpar since then. Chen has referred to this condition as “soggy”. Depending on where economic growth is, an economy can be either on fire, ice or soggy. Most recessions happen after the economy has been on “fire” and when the Fed raises interest rates to cool the economy down. In other words, to have a recession, the economy needs to be on fire, but this has not been the case. The economy has been lackluster and soggy since 2009. However, what have been on fire are some sectors of the stock market like stocks such as Facebook, Amazon, and Netflix. For me, Chen and others who have experienced the year 2000 dot com crash, this speaks of caution.

In my doctoral dissertation, "Human Action and the Securities Markets" I had researched the boom to bust cycle in Japan and found many similarities between Japan and the U.S. The Japanese Stock Market peaked at 49,000 in 1989 and it is still less than half of what it was in 1998. The NASDAQ peaked in the year 2000 and still has not regained its prior peak (see Chart 5). In my research, I discovered that speculative bubbles have many characteristics in common. Using the Japanese Stock Market as an example, Chart 2 diagrams the typical boom to bust cycle. This is similar to the U.S. Markets in 2000, 2008 and now. Things could get nasty if interest rates were significantly raised in the US.

The term Minsky Moment was coined by Paul McCulley of PIMCO after the Russian Financial Crisis of 1998. It was named after economist Hyman Minsky. A Minsky Moment is defined as a period in which stability encourages risk taking, which leads to a period of instability, which causes more conservative and risk-averse (deleveraging) behavior, until stability is restored, continuing the cycle. In this more general view, the Minsky Cycle may apply to a wide range of human activities, beyond investment economics.

Chart 2

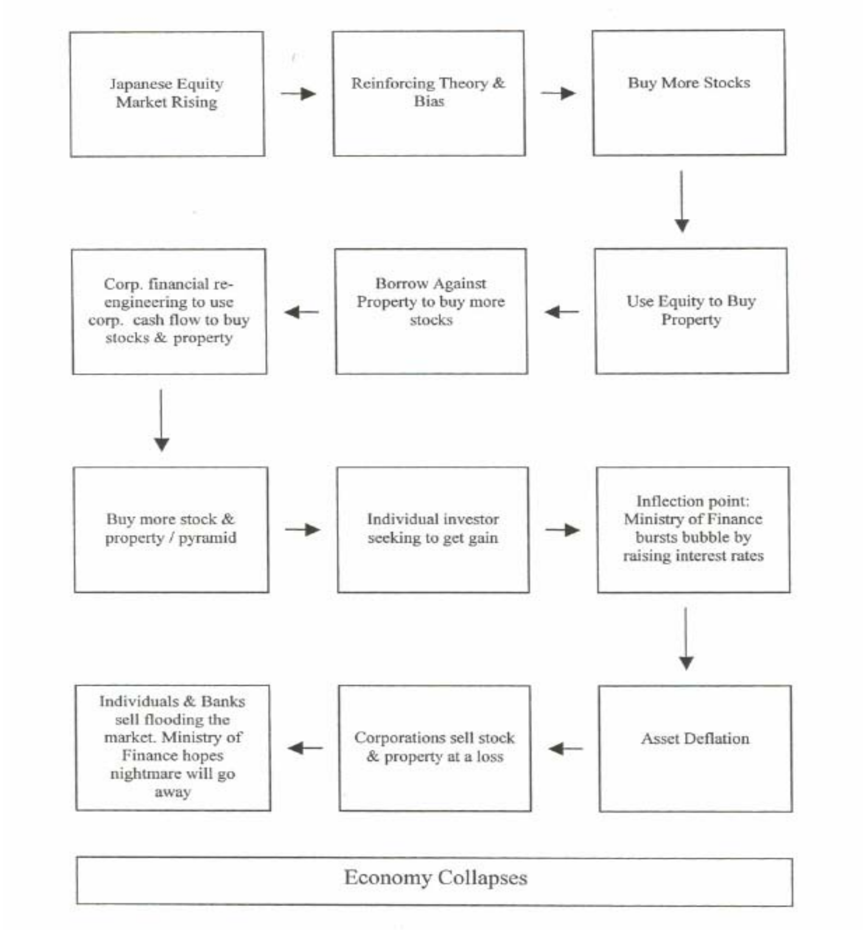
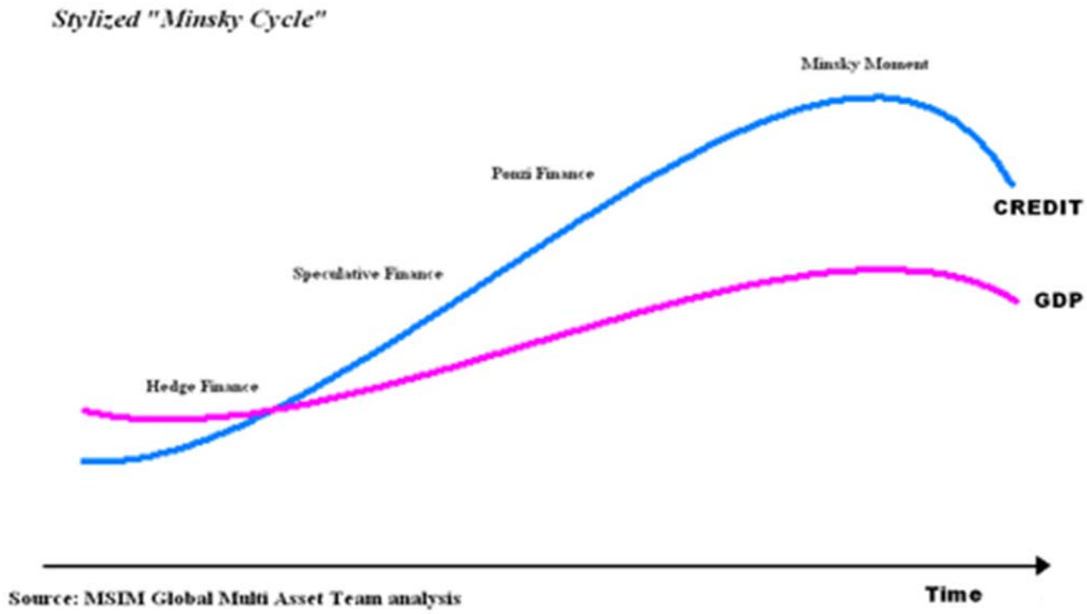


Chart 3- The Minsky Cycle



A number of late-1990s macro indicators we track currently are signaling similarities to a market top. While each cycle is different, the parallels with the late-1990s are hard to ignore.

With regard to interest rates, the Fed has tightened policy four times this cycle and is on track to lift rates in December anew. If it manages to raise the Fed funds to the median estimates of 3.25% in 2018, then the magnitude of monetary tightening would resemble that of the late 1990s.

While I do not foresee a recession in the next year, the time to buy some insurance is when global equities are near all-time highs. My sense is that a garden variety 5-10% pullback is possible in the coming months, but we would view this as a buying opportunity.

It might be instructive to visit what I had written to clients in 1998*, when a similar bout of speculative fever struck then as it is now. The ending picture for the speculators was not pretty.

*"*Bubbles don't end gradually and neither will the U.S. bubble. However, the timing for the demise of the market seems likely to be delayed until there are more cyclical pressures globally which argue for a more pronounced liquidity squeeze in the U.S. Presently, it would appear that the current U.S. liquidity squeeze will be gradual and drawn out leaving a more serious squeeze for later when the rest of the world has better growth momentum and there is less capacity overhang. Nonetheless, the current environment is hardly a positive for the U.S. equity market: overvalued prices (at least in certain sectors), and a gradual liquidity squeeze.*"

According to the Cape Schiller index, U.S. stocks are more expensive today than any time in history, with the exception of the year 2000 (the dot-com speculative crash). As you can see from Chart 4, the S&P 500 peaked in 1998 with index investors not recovering until approximately 13 years later.

Chart 4

Chart 5 tracks the NASDAQ who had fared worse.

Chart 5

Looking at Chart 5, we can see that the NASDAQ peaked in year 2000 and still, to this day, has never recovered to its high, 17 years later.

Besides Enron, Uniphase was one of those internet darlings that speculators bought blindly without asking the question: “How much should I reasonably pay for a slice of this business?” Did they understand the company’s business model or did they get caught up in a speculative fever. Many believed without any clear understanding of the company that Uniphase was one of those stocks that you could hold forever. CNBC stated that, “Uniphase is one stock you don’t want to miss. You can expect gains of over 100% per year.” Looking at Chart 6, Uniphase peaked at over $1,200 per share. However, by 2003, the stock traded at less than $100 per share and by 2004, the stock was priced under $8 per share.

Chart 6

Soon I will be thinking about what to do when the party ends and how to profit from it. In YYR, it is an easier proposition than in the managed accounts because I can protect the downside of the portfolio through the use of shorting and options. In managed accounts, I can help alleviate some of the downside by my diversification into bonds and gold. I fully understand that bonds are not the best investment right now, but they do serve a purpose besides throwing off interest. In the event of a speculative blow off, bonds and gold should cushion a market correction. This is precisely why I have not given up on bonds, because they did a marvelous job in 2000, 2003 and 2008. A diversified and balanced portfolio is the best defense and in my opinion, for the long haul, the best offense.

Bottom-Line

The good news is that a recession isn't on the investors' radar. The bad news is that once inflation does start rising, the Fed will be behind the eight-ball. In that case, it is most likely that the Fed will have to raise interest rates quite rapidly. Historically, recessions and bear markets go hand in hand. Our research colleagues at BCA suggest that a recession is at least 18 months away. On the flip side, stronger U.S. growth will force the Fed to raise rates significantly over the next two years. This will push up Treasury yields and give the U.S. dollar a boost and this could be the catalyst for a market decline. We are remaining overweight in equities for now. However, with U.S. valuations stretched, we are starting to move towards Japan, China and Europe and we will look to reduce equity exposure in the second half of 2018, but not for now.

2017 Investors' Forum and Luncheon

This year's investor forum and luncheon was a sold out success! We broke our previous attendance records with over 100 clients and friends enjoying the informative presentations and wonderful cuisine.

Gary Myer spoke about artificial intelligence and robotics. He made a powerful case about the impact on all of us by these technologies. To help us better understand A.I. and other emerging technologies, we are initiating a relationship with Singularity University in Palo Alto, California. This link-up will help us better understand emerging technologies that we might want to include in our investment portfolio. To learn about Singularity go to www.su.org.

Chen Zhao, a gifted economist and former strategist of BCA's Global Investment Survey, gave us a fascinating presentation on the global investment environment. I have known Chen for 20 years and his talks are both informative and entertaining.

Dr. Ronald Ruby, MD, internist and endocrinologist, spoke about the diabetes epidemic and osteoporosis. Dr. Ruby is not only a medical doctor, but a researcher as well and his lecture was eye-opening with great information about these serious diseases.

I would like to personally thank Dr. Ruby, Chen Zhao and Gary Myer for their great presentations and participation.

We are having our next conference call on **Tuesday, September 12th at 6:30 p.m**. During the call, we will talk about the global investment environment and why I like China, Japan, and Europe. I will also bring to light some of the aspects of the speculative bubble that occurred in year 2000 and the similarities to today's U.S. market. Lastly, I'll be sharing more information in regards to our new "Social Responsible Investing" portfolio. 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**.

A Final Note

Over the past few years, we have been very selective in taking new clients because of our constrained capacity. Due to some technological improvements and Arash's and Robert's eagerness to take on more responsibilities, we have the capacity to increase our assets under management to a degree. We can add a select and limited number of new clients. If you know of anyone or if you feel comfortable in referring some of your friends and family to us, we would welcome their inquiry.

Warm regards,

Steven Lee Yamshon
Investment Counsel