Summary of July 2018 Conference Call

Welcome to tonight's conference call. There has been a lot going on in the world since our last call in March in the context of a slowing global economy and an overvalued stock market. Equity volatility will continue throughout the year and this is the case in the late stages of a bull market. At the current moment, we feel uncomfortable with a possible trade war looming. For example, if President Trump negates NAFTA, the markets will get rattled. In order to combat tariffs, China could retaliate by devaluing their currency. That in itself could be very disruptive. This poses an immediate threat to stocks. Another headwind to the stock market is a prolonged rise in interest rates. So far the pace of interest rate increases has been gradual, but this all depends on the inflation picture. However, the outlook for stocks will be more challenging in the next 6 to 12 months. There is a risk to our view in that equities could rally to fresh new highs. However, our bias towards capital preservation and views on interest rates, trade, and the late stage of the business cycle keeps us from going after the last few chips of return. With equity valuations already stretched, we would rather be early and judicious and miss out on the last few basis points of return, rather than be late and experience a large decline in portfolio value. The economy is in the late stages of an expansion and is currently running beyond full employment. What does that mean? It means that the Fed may have to be more aggressive in raising interest rates which would be bad for the stock market. Of course, the Fed could back off if the trade wars really start to bite the economy. As we have mentioned in past conference calls and newsletters, if a trade war was starting to develop, we would reduce the stock exposure in the portfolio. Indeed, we have reduced the equity exposure the past few weeks while positioning the portfolio with more defensive stocks. Defensive stocks should outperform cyclical issues and that is one reason why we sold some issues and bought others. We would temporarily increase the equity exposure if the following conditions occurred: (1) The equity market corrected by 15% to 20% in the next few months. (2) The Fed paused in raising interest rates and (3) the trade rhetoric dissipates.

Honestly, I think that the implication is that the Fed will be reluctant to deviate from its tightening path even in the face of turmoil. Hence, our position in reducing equity risks. In a sense, the market is on a collision course with the Fed. If there is one rule of thumb that is consistent, it is that the stock market expands when liquidity expands and shrinks when liquidity is reduced. One of the reasons the global stock and bond markets have performed so well since 2009, is the large expansion of the global money supply. If we take a look at Chart 1, on the bottom half of the page, we can clearly see that the BCA monetary index is moving towards tighter money. We can also see on the bottom chart that the dollar based liquidity index is falling. With the withdrawal of the Fed buying program and tighter monetary condition, it is no wonder the stock market is struggling this year. Global liquidity is retrenching. In conjunction with the monetary liquidity indexes, we can see that on Chart 2, global bank lending is starting to decline as well. After all, credit is what pushes economic progress forward. A trade war with waning global liquidity could be very destructive. In addition, we have looked at some of our other preferred indicators and they are now flashing red:

1. Flat yield curve
2. Liquidity declining
3. Gold prices in decline
4. Emerging market stocks and debt declining

We are carefully watching the trend in gold. If gold continues to decline, it will signal that the liquidity outside the U.S. is having a negative impact on global growth and will signal weak stock prices ahead.

China is already in a slowdown and the trade war between the U.S. and China will only make it worse. Looking at Chart 3, we can see three reliable indicators that point to a Chinese economic downturn. The Li Keqiang Index is a measure of industrial production and we can clearly see that industrial production is waning. In the middle chart, China imports are also in decline and this is due to the rapidly falling credit impulse (Chart 3). Along with the United States, China is restricting its monetary growth with credit tightening. Let us not forget that China is the second largest economy in the world. A trade war would be much more damaging to China than to the U.S. Believe it or not, the U.S. is a relatively closed economy with 16% of U.S. GDP coming from foreign trade. A trade war between the U.S. and China would be much more damaging for Wall Street than for Main Street. Global supply chains would be greatly impacted with a Chinese-U.S. trade war. Apple has Foxconn assemble iPhones in china and many iPhone parts are sourced from China. Imagine a large tariff on iPhones assembled in China or their components. Now imagine how other manufactured goods will have their supply chain interrupted by a trade war.

Trade, interest rates, China and a restricted monetary policy are major hurdles for the U.S. stock market. For one, underlying profit growth is starting to soften. Second, equity multiples will be squeezed by rising interest rates expectations. Since the 1920’s, P/E ratios have come down whenever the Fed raises rates. This time should be no different.

One sector of the economy that is still doing extremely well is the housing sector. As with everything else, a rise in interest rates will affect housing, but it would take mortgage rates to rise above 5.5% before any real housing slowdown to occur. Even if mortgage rates reach 5%, this level of interest rates is below the 20 year average mortgage interest rate. We advised our clients last year that if they were to originate a new mortgage or refinance an old one, late 2017 and early 2018 was the time to do it. If mortgage interest rates climb significantly above 5%, then this would crimp the sale of new and existing homes. In turn, a recession would occur. A couple of key indicators point to strong housing demand at this moment. Refer to chart 8. Housing starts are regaining momentum since the housing crisis of 2008. Housing prices are holding steady. For one, the addition of first time home buyers is a key source of demand. Another factor is that despite favorable lending conditions, a shortage exists for mortgage loans. Homeowner vacancy rates are at 1.5%, the lowest level seen since 2001.

The next recession will most likely be sparked by the Fed increasing interest rates at a time when the global economy slows due to trade issues. This could happen in 2019, but more likely in 2020.

The big question for investors is what do we do in a world that is in the midst of an expanding global trade war, rising geopolitical tension, rising interest rates and an expensive stock market? Chart 4 shows that the investment grade bond market is very expensive. Bond fund and bond ETF holders would be the most exposed as interest rates rise. This market is very expensive. Those investors who hold individual bonds may experience a paper loss, but not an actual loss if they hold those bonds until maturity. Bond fund holders take a direct hit. This is why we like individual bonds instead of funds. For bond fund holders, lower maturity duration is warranted.

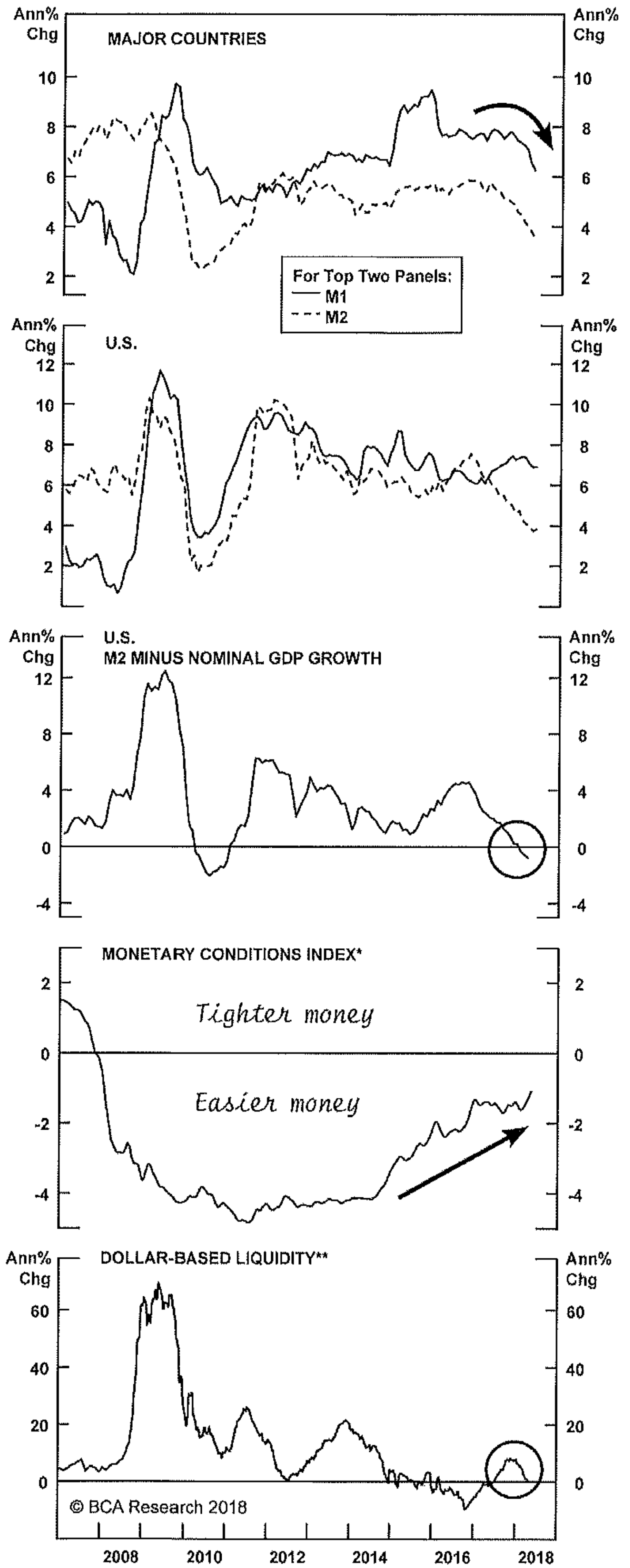
Junk Bonds or high yield bonds are similarly overpriced. The spread between high grade investment bonds and low grade high yield bonds is not large enough to compensate for the risk taken in high yield bonds, especially at this stage of the cycle. One way to invest outside of an expensive U.S. stock market is to diversify investments in areas which the equity markets are cheaper. At the moment, Europe and Japan look cheaper than the U.S. However, investing in foreign securities requires the investor to take into consideration the currency risk associated with stocks denominated in Euros or Yen or any other currency. Any adverse currency movement could wipe out any gain or principal.

As we have talked about earlier, the U.S. stock market is expensive, but it could actually move higher. Chart 7 illustrates just how expensive the U.S market actually is. The BCA valuation indicator is moving from overvalued to extremely overvalued, and is reaching the same level as it did in 1987 when the stock market crashed. Interestingly enough, the current market valuation is not nearly as overvalued as it was in 2000 when the dot-com bubble burst. However, the bottom of Chart 7 illustrates that most people now entering the U.S. stock market are extremely speculative as the market begins to take on aspects of a gambling casino. Speculation is high and uncomfortable.

In conclusion, all of the facts are pointing us in the direction of reducing equity exposure and increasing individual bond purchases. We could see an equity rally if trade tensions lessen and the fed pauses after the September 2018 rate hike. None of this is assured, but we would rather take some chips off the table now. History has taught me that it is better to be early than late.

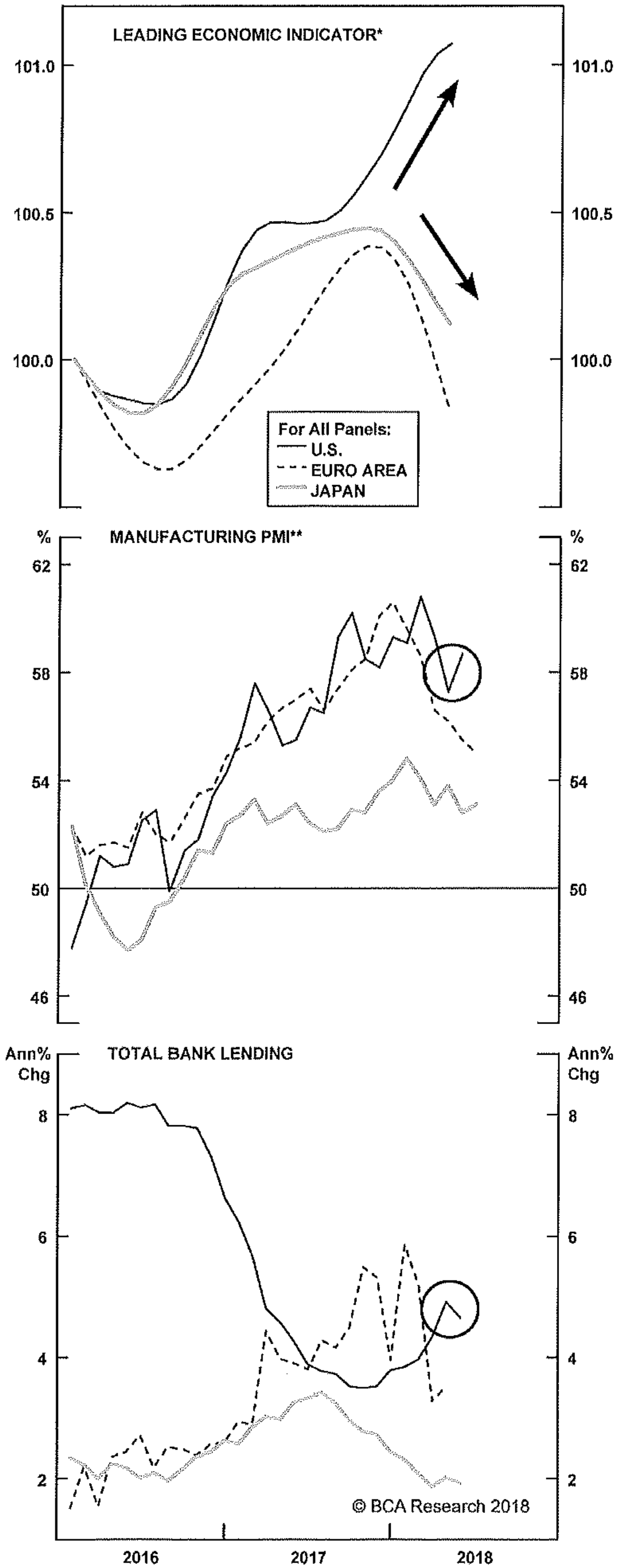
Any questions?

CHART 1



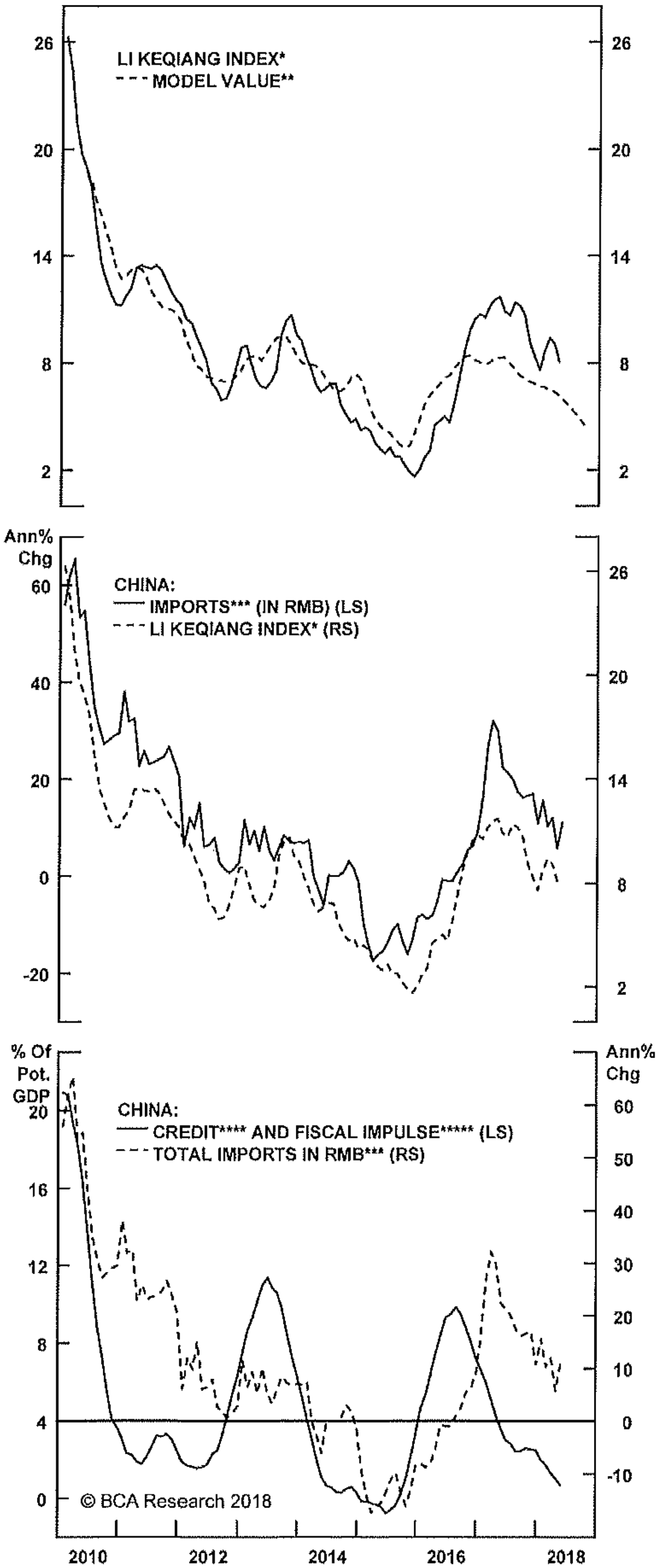
* CHANGE IN FED FUNDS RATE PLUS 1 / 10 OF % CHANGE IN BROAD MEASURE

CHART 2



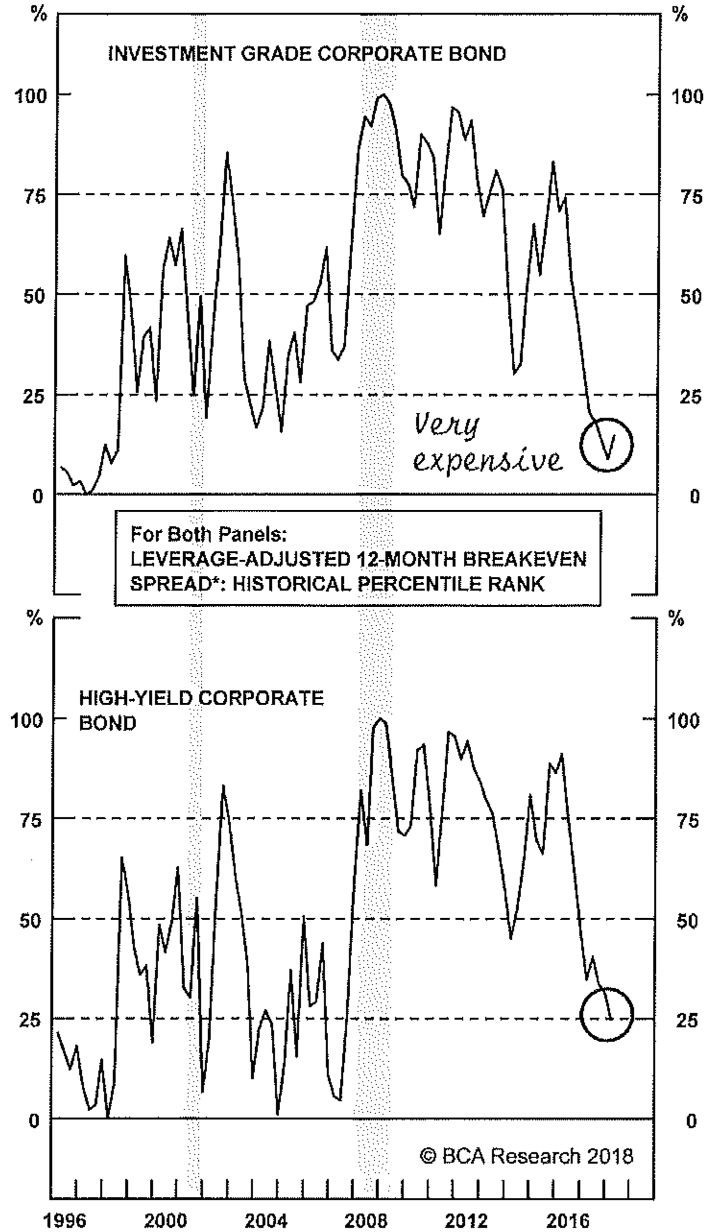
* SOURCE:CONFERENCE BOARD AND OECD.

CHART 3



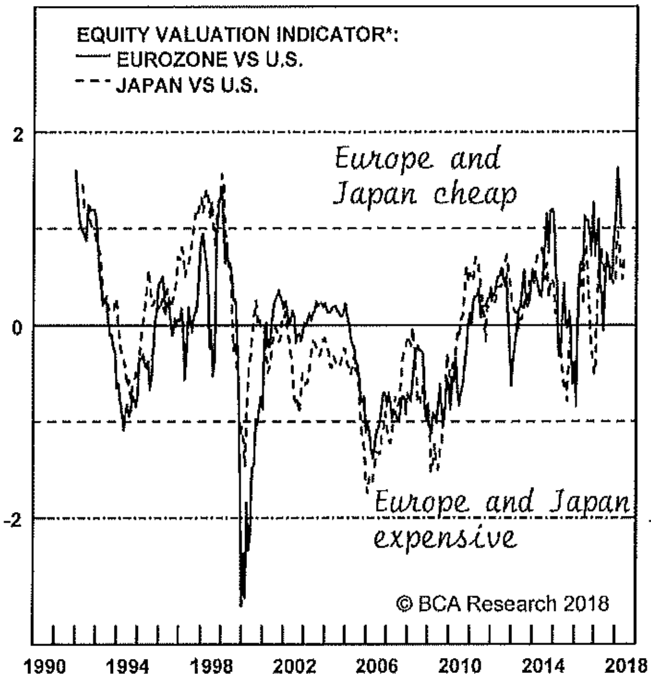
* SOURCE: BLOOMBERG FINANCE L.P.
** BASED ON BCA LI KEQIANG LEADING INDICATOR.
*** SHOWN AS 3-MONTH MOVING AVERAGE.
**** CUMULATIVE AGGREGATE FINANCING EXCLUDING EQUITY FINANCING AND CUMULATED LOCAL GOVERNMENT BOND; SHOWN AS A 6-MONTH MOVING AVERAGE.
***** CALCULATED AS CHANGE ON ANNUAL CHANGE IN CREDIT PLUS ANNUAL CHANGE IN GENERAL (CENTRAL AND LOCAL) GOVERNMENT SPENDING; SHOWN AS A 6-MONTH MOVING AVERAGE.

CHART 4



*SPREAD WIDENING REQUIRED TO BREAK EVEN WITH DURATION-MATCHED TREASURIES ON A 12-MONTH HORIZON DIVIDED BY GROSS LEVERAGE (CALCULATED AS TOTAL DEBT DIVIDED BY PRE-TAX PROFITS). SOURCE: BLOOMBERG BARCLAYS INDICES.
NOTE: SHADING DENOTES NBER-DESIGNATED RECESSIONS.

CHART 5



* DIFFERENCE IN DEVIATION FROM 5-YEAR MOVING AVERAGE ADJUSTED FOR VOLATILITY. INCLUDES PRICE/EARNINGS, FORWARD PRICE/EARNINGS, PRICE/SALES, PRICE/CASH FLOW, EV/EBITDA, PRICE/BOOK AND SHILLER PRICE/EARNINGS.

CHART 6

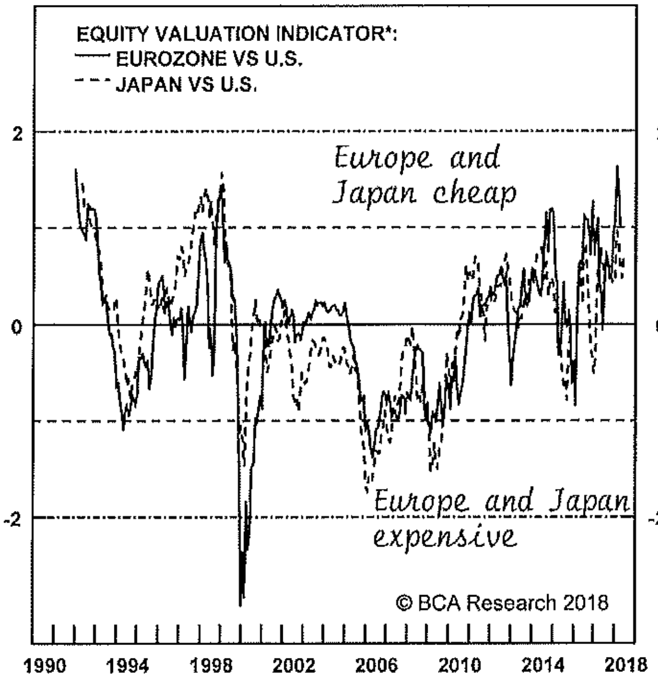


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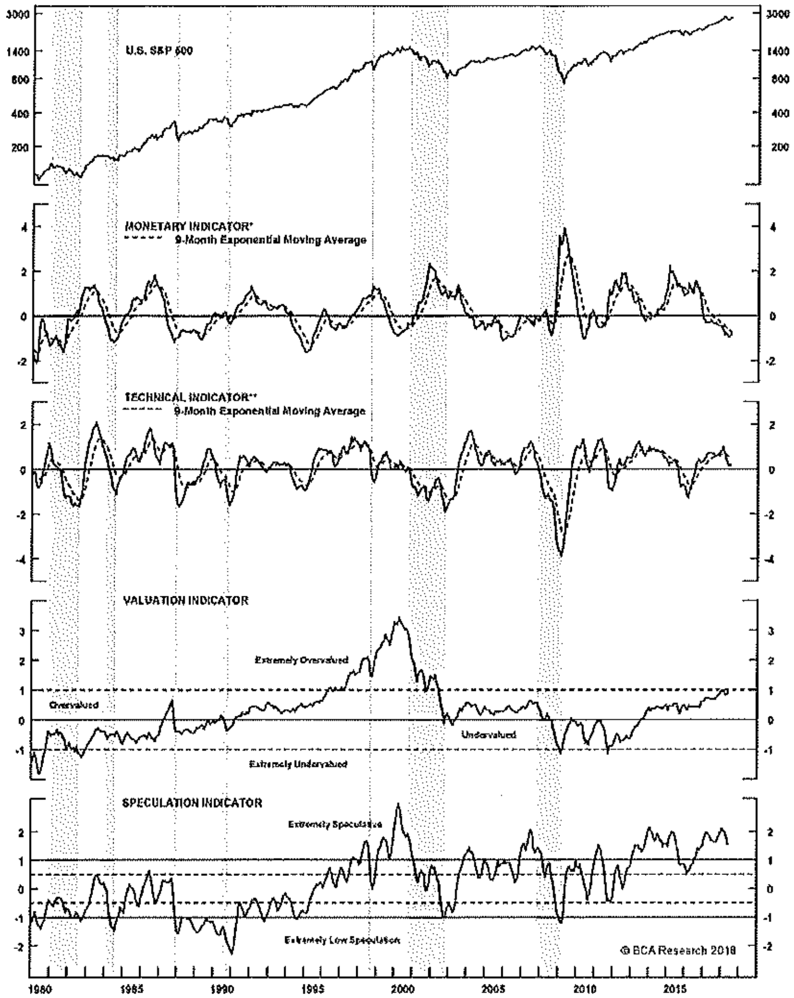
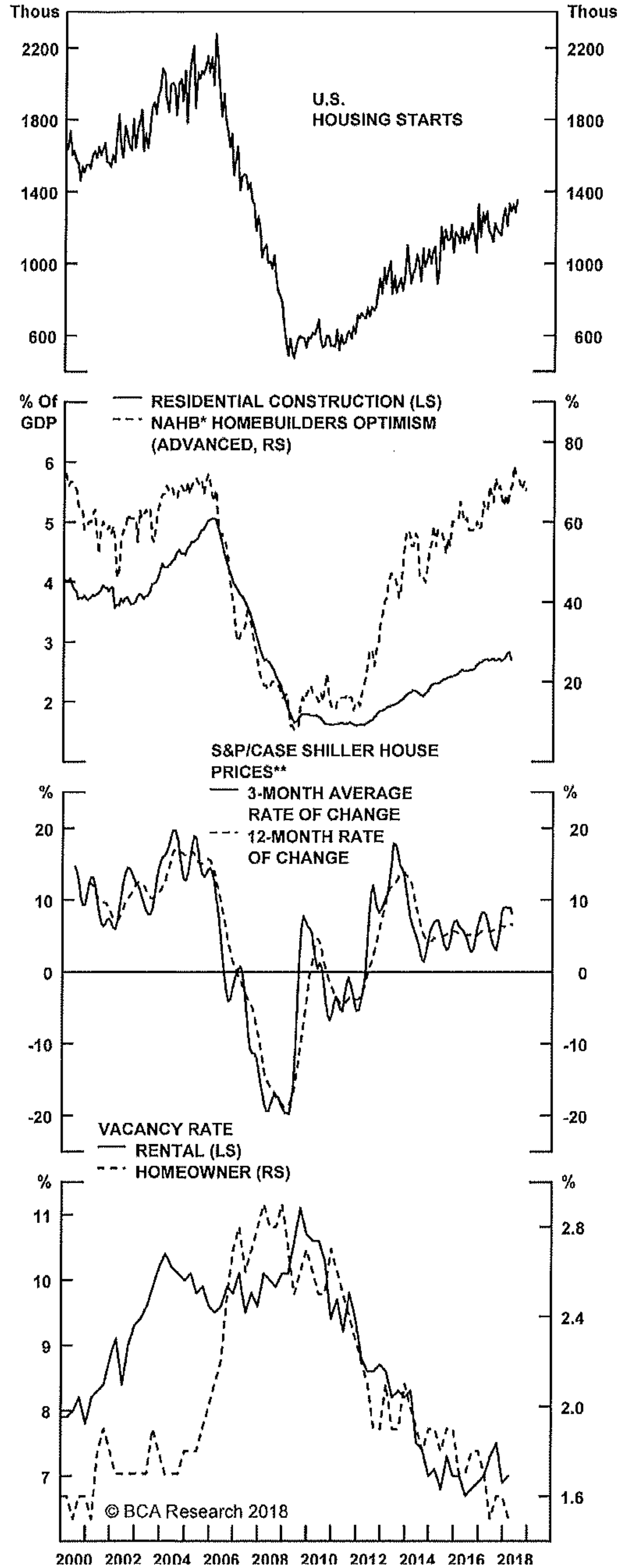
CHART 7



* SELL (BUY) WHEN MONETARY INDICATOR FALLS (RISES) BELOW (ABOVE) ZERO.
** SELL WHEN TECHNICAL INDICATOR CROSSES BELOW ZERO, BUY WHEN IT RISES ABOVE 9-MONTH EMA
NOTE: SHADED AREAS INDICATE BEAR MARKETS.

CHART 8



Thous
2200
1800
1400
1000
600
U.S.
HOUSING STARTS
% Of GDP
RESIDENTIAL CONSTRUCTION (LS)
NAHB* HOMEBUILDERS OPTIMISM (ADVANCED, RS)
6
5
4
3
2
%
80
60
40
20
S&P/CASE SHILLER HOUSE PRICES**
3-MONTH AVERAGE RATE OF CHANGE
12-MONTH RATE OF CHANGE
20
10
0
-10
-20
VACANCY RATE
RENTAL (LS)
HOMEOWNER (RS)
11
10
9
8
7
2.8
2.4
2.0
1.6
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