June 28, 2018

Dear client,

I came back from three weeks of intense learning at the Harvard Business School where I, once again, updated my skill set in investing. As you know, I constantly attend courses, pursue learning, and go to conferences to help me be a better money manager and financial planner. The world is changing quite rapidly and this helps me stay current to better serve you.

As I arrived at Logan Airport, I started to have butterflies in my stomach when I thought about returning to the school and the campus that I loved so much. It has been 30 years since I first met Bob Yellin and Emmett McDonough when we studied at Harvard together. It is an incredible place. The campus and the town of Cambridge have changed a little, but the cases and theories in the classroom have changed a lot. This past May, in class, we studied Amazon, Tesla, and a new start up called Rent-The-Runway. Interestingly, Rent-The-Runway is a successful startup that rents elegant dresses and accessories to women for special events. It is all done through the Internet and UPS. Instead of purchasing a $5,000 gown that a woman may only wear once, she can rent the same beautiful gown for a couple of hundred bucks. This startup, created by two outstanding women, is a big success. In addition to case studies on companies, we had lectures on artificial intelligence and block chain technologies. I will be making a presentation on crypto-currencies and block chain technologies at our Investors' Forum on August 4th, so don't miss it.

Of course, while I was away, I kept my eyes on the securities markets and consulted with our colleagues at BCA Research. I think that the chaotic conclusion of the G7 summit and the latest trade skirmish with China cannot be good news for the markets and that this situation is not going to fade overnight. A trade war will hurt the United States, but would punish the rest of the world even more. The U.S. economy is a fairly closed economy and hence, a trade war would probably not have severe effects on growth. However the way the trade war is waged, ensures whatever impact it has on the domestic economy will be negative. This is not only because of retaliatory efforts by the Chinese, Europeans, and Canadians, but also the aspects of the global supply-chain-goods that are inputs for the final finished product, considering that any one percent increase in foreign prices leads to a one half percent price rise in domestic prices. For example, if steel tariffs are 25%, then the price of steel increases 12.5%. Since steel is used in a wide variety of applications from cars to buildings, this adds to the inflationary pressures that are starting to surface.

The markets have taken the recent news of escalating trade tensions in stride. A benign outcome is entirely possible, but such a rosy outcome is hardly guaranteed. Protectionism is popular among many Americans and for good reason. Although nobody wins in a trade war, there are some justifications in the trade imbalances with Europe and China that need to be corrected. For one, China has the most trade protections in the world. Any foreign company operating in China must share their technology with their joint venture partner and no foreign company can operate without a partner. In most cases, the joint venture partner "leaks" the technology to state owned enterprises that start to compete with foreigners after a period of coming up the learning curve. In Europe, they don't steal technological secrets and intellectual property like they do in China, but there are many other high tariffs and non-tariff trade barriers that affect trade. For example, there is a 25% tariff on American made cars imported into the European Union, but the U.S. has only a 2% tariff on imported cars from Europe and other countries. Another example of trade tariff abuse is Canada's 270% tariff on dairy products imported from the U.S. There is clearly an imbalance that needs to be corrected. Since 1970, there have been seven major trade disputes with our global trading partners. In 4 of 6 disputes, bonds and gold out performed stocks. However, periodic trade disputes make it difficult to discern the implications for financial markets. This is one reason why we always have a bond component in our portfolios. At times, bonds outperform stocks and they certainly cushion any downside when stocks falter.

The economy is at full employment and when the economy is in this state, inflation becomes a concern as wage price increases leak into the price of goods. To combat inflation, the Federal Reserve raises interest rates and this time is no different. With inflation running at 2%, the Fed is willing to let inflation overshoot to a point before they aggressively raise interest rates to combat it. Although the Fed will most likely raise interest rates four times in 2018, three times in 2019, and once in 2020, it will remain in a gradual pattern with a ¼ point turn every quarter. The Fed alarm bells will ring when inflation hits 2.5%, which at that point, the Fed will turn from targeting policy to slowing growth. The target Fed Funds rate is 3.375% in 2019, which compared to historical figures, is still quite low.

The outlook for global stocks will be more challenging in the coming months, especially since valuations are stretched. Volatility will be the name of the game for the rest of the year which is usually the case at the late stages of the business cycle. We have reduced our exposure to equities in light of the trade skirmish being more prolonged and the resulting trickledown effect on inflation, interest rates and the economy. A trade spat is one thing, but a retaliatory trade dispute with the Chinese and the Europeans is quite another, all in the context of an expensive stock market, an environment of rising interest rates, and the possibility of inflationary pressures. I can't see how global supply chains wouldn't be affected with an all-out trade war. Therefore, it is wise to reduce the equity exposure of stocks that may have their profits impaired by such actions. If the trade situation improves, then we will increase our stocks, but keeping in mind that a recession is likely in late 2019 or early 2020. Despite the constructive economic outlook, prudence is warranted. However, there is a risk that we could be wrong in our assessment in that the market could rally to fresh new highs. We have a bias towards capital preservation and our views on the late stage of the business cycle preclude us from reaching out for the last few chips of returns. Geopolitical risks are another concern that gives me reason to be cautious. Globalization was a tailwind for stocks, but now globalization is retrenching.

If macro developments evolve as we expect, then we may shift to an outright conservative stance on stocks later this year or early 2019 in anticipation of a global recession in 2020. On the flip side, if the stock market corrects by 15% or more in the next few months, especially if the economic indicators remain constructive and the fed stops dead in its tracks on raising interest rates, we would overweight stocks in that scenario.

Our SFP investor forum on August 4th is looking to be our best event ever. We have an outstanding mix of speakers and informative presentations:

- Matt Gertken, BCA Geopolitical Strategist, will be speaking about globalization and trade.
- Ronald Ruby MD and John Armato MD will be presenting their new technology startup for preventing and treating diabetes.
- Regina Hurley brings her expertise as a sculptress to what I call Art Basel-OC.
- Steven Yamshon will be leading a presentation on Block Chain and Crypto-Currencies and discuss the state of the markets in two separate sessions.

This will truly be a World of Possibilities. Last year, we had more people wanting to attend than we had space so please join us by reserving early. You can RSVP to Katie Gibson at katie@sfpria.com or call her at 949-251-9333.

Our next conference call will be July 11, 2018 at 6:30 p.m. 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**.

As always I appreciate your confidence in us.

All the best,

Steven Lee Yamshon
Investment Counsel