BFSG, LLC September 3, 2019 Conference Call

Summary of September 2019 Conference Call

Welcome to tonight's conference call, the first one we have done since we joined BFSG in July. Our team has fit in well with our new compadres as it has strengthened our bench. Very exciting to be working with a great bunch of like-minded individuals. We have a lot to discuss tonight so let's get started.

The global stock markets have continued their roller coaster ride since our last conference call. If you recall, this market seesaw has been going on since trade frictions developed between the United States and China in 2018. I said in April of last year that the trade conflict would not be solved soon and that if it went on long enough it could be problematic. Shortly thereafter, in June 2018, I reduced the portfolio's exposures to stocks and we have maintained that position ever since.

The investment world is loaded with risks. U.S. President Donald Trump has not helped to reduce risk, on the other hand Trump is not stupid and neither is Chinese President, Xi. Both are calculating with Trump wanting to be re-elected and Xi not wanting to implode the Chinese economy. Nobody should make investment decisions based on Trump's tweets or the latest missive from the Chinese economic minister. We need to focus on economic fundamentals. I believe in signals and I am of the opinion that the bond market is signaling that this trade friction is starting to bite. If we look at Chart I-1, we can see that the 10-year U.S. treasury is at a record low. What does this mean? If the U.S. economy is doing so well, shouldn't interest rates be much higher? The answer to this question is that investors and institutions are moving into US Treasuries for a number of reasons. For one, bank reserves are kept in Treasuries and global banks need those treasuries to meet regulatory requirements. Second, global investors can get a positive return by investing in U.S. Treasuries versus a negative return like what you would get if you invested in Europe. With the USD remaining strong, the foreigners don't have much of a hedging cost, which can keep their return intact or maybe give them an extra boost in yield. Third, investors who are scared are plowing into Treasuries as a safe haven. When demand for Treasuries exceeds supply of Treasuries, yields go down.

The U.S. economy is doing ok, the rest of the world not so good. If we look at the Global manufacturing PMI indicator, we see that global manufacturing has fallen of the cliff. Most of the damage is in China and Southeast Asia because that is where the global manufacturing hub is located. The capital goods (big ticket items) and machinery-electrical equipment indicators confirm that global capital expenditure spending has hit the skids.

There has been a lot of talk about an inverted yield curve and because the U.S. Treasury yield curve has inverted, many believe this is an indicator that a recession is impending. I would agree that the yield curve is a reliable indicator of impending recessions; the yield curve is really not inverted. If we look at Chart I-2, we see the curve has inverted up to five years and thereafter it is positively sloping. Looking at the Charts below the top one, the yield curve would have to invert across all U.S. Treasuries to be a reliable indicator of a recession. I don't see it, but that doesn't mean if these trade skirmishes continue, we can't have one.

Another indicator of an impending recession is the amount of household debt the consumer has. According to Chart I-3, the consumer balance sheet is very healthy and debt as a percentage of assets is the lowest since 1985. Target, Home Depot, and Wal-Mart reported strong numbers which means people are continuing to spend. In addition, there are no systematic problems in the banking system, like in 2008, which is another initial recessionary indicator. Although corporate debt is high relative to the past (Chart I-4), the debt service is very manageable because interest rates are historically low.

The US-China trade war is taking a dangerous turn and we need to monitor the situation, but we believe the US should avoid a recession until 2021 or 2022. The Fed most likely will cut interest rates 2 or 3 times next year as an insurance policy against slowing US growth. Therefore, equities will be volatile for the rest of the year, but most likely progress higher in 2020, once lower US interest rates and Chinese stimulus kick in. Chart I-10 shows an increase in Chinese credit as they work hard to prop up their economy. China is dependent on America and the rest of the world is dependent on China. Therefore, Chinese monetary stimulus is critical to any sustained rise in the global stock markets. Personally, I think the fears of a recession this year are overblown.

Manufacturing is cyclical and moves in three-year cycles. According to Chart 1-12, the three-year cycle is advanced and a manufacturing upturn should happen once this trade dispute gets settled. In order for manufacturing to turn around, Germany needs to sell production equipment to China and China needs to manufacture products competitively.

To be pragmatic, the trade war with China is intensifying. Our colleagues at BCA Geopolitical service think that the two superpowers are locked up in a multi-geopolitical rivalry. The Hong Kong protests and tensions over Taiwan could move the trade talks off the table. The longer the trade war goes on, the more potential for a miscalculation to occur.

Europe remains in the doldrums. Savings rates are high because the consumer is not spending, and the Chinese are not buying German machinery products. Chart 1-13 explains the high savings rates of the Europeans but also shows a ray of hope. Because the continent has negative interest rates (Where you pay the bank or government to hold your money), the credit impulse has turned higher. The reason for this is that credit is incredibly cheap and the banks want to lend.

The bottom line is that in our opinion, the US economy, although strong, will slow down further in the coming months, but it should not enter a recession anytime soon. Neither debt, the banking system nor consumers pose a problem. The housing sector (new homes) is turning the corner and lower mortgage rates should spark a recovery in that sector. Global manufacturing growth should bottom once this trade dispute ends but, may be delayed due to increased political tensions between the US and China. The good news is that global central banks are responding with lower interest rates.

Looking at Chart 1-14, the global central banks are flooding the markets with liquidity. Liquidity in markets rarely fails and a 2008 scenario is highly unlikely. All three charts point to easier financial conditions, which may be a prelude to a rising stock market. However, that is not my view at this time. Investors must remember that markets are part financial, part economic and part psychological. We can crunch the numbers all day long and read the tealeaves based on historical and predicted numbers, but leaving out the psychological factors would be a mistake.

Intensifying recession fears, rising risks of ineffectual monetary policy, and escalating trade policy uncertainty that is shattering corporate America's capex plans, warn that sizable drawdown risks persist in the broad U.S. equity market in the upcoming 3-12 months.
Investment implications.

Interest rates are low but bonds are expensive (Chart I-21). Global uncertainty and the ongoing trade skirmish are keeping bonds that way. Therefore, we are going to tread lightly with purchasing additional bonds and keep the maturity of newly purchased bonds below our normal target range of 5 to 7 years. We are not being compensated for interest rate risk so I'm not going to be baited. I believe that bond yields will be higher 12 months down the road unless the global economy really falls apart. Something I don't see in my baseline scenario. Chart III-1 is very informative. According to the BCA valuation indicator, the US stock market is overvalued, which I completely agree with. Looking closely at this valuation indicator we can see that the stock market was almost in extremely overvalued territory when the market corrected itself in December 2018. The Chart III-5 on the next page confirms my suspicions that the market is not cheap by any stretch of the imagination.

What does all this mean for us?

I suspect that bond yield will be higher in the next 12 months as the sluggish economy picks up. Right now, there are too many uncertainties to predict a bottom in yields. Uncertainty has not peaked. We discussed China but we did not discuss the financial implications of a likely hard Brexit. We are positive on gold and we have been adding to our position as a portfolio protector. Our portfolio protector (although not perfect), helps us manage the downside inherit in equities. What does the portfolio protector consist of?

- US Treasuries
- Japanese Yen
- Gold

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Right now, most accounts have 2% to 3% gold. We anticipate moving that allocation to 5% in the coming months. We anticipate buying Yen this week. Lastly, we have our US Treasuries in place.

At this point, we are contemplating reducing the stock allocation by 5%, but we are on the fence in regards to this decision. No concrete decision has been made in this regard. However, if the trade war between the US and China takes a turn for the worse, we will not hesitate in doing so. Right now, for the most part, the accounts are positive for the year by a good amount. I am being pragmatic about the China-US trade situation, but not willing to abandon equities in wholesale at this point. Expect more volatility, but our defensive posture should work out to our advantage.