Summary of March 2018 Conference Call

Nora: Welcome to Stevens First Principles' first quarter conference call of 2018. A lot has been happening in the global markets since Steve finished a peaceful and relaxing vacation in Cartagena. I am glad he is rested because it turns out that he needs to fasten his seat belt for a turbulent market year.

Last year, the markets were calm with just a few volatile days but now the market has become more volatile and with good reason. As a side note, last year's volatility was not normal but abnormal. Tonight we are going to talk about what has been going on in the financial markets since January 1st and, finally, what our strategy is for 2018.

Nora: So Steve, please tell us, what is going on in the markets?

Steve: In early February, the stock market volatility roared back to life resulting in a plunge of global equity markets, but before we go into the specifics why this has happened I would like to review a few fundamentals of all markets in general.

Markets are dynamic and not static. One of the most fundamental tools we use is the role of price signaling. Markets communicate signals through the exchange of prices and, at times, prices can send signals that help interpret the underpinning reasons. For example, the market pulled back in February as the labor market signaled that wage increases could lead to inflation. The wage report was the price signal and the market was the price mechanism. I will explain more about that later in tonight's call, but I wanted you to understand the idea behind price signaling which is something I have been talking about for years.

Much of the time the market is efficient. In other words, the price of a stock is reflected in the price when that stock is trading. For some reason, unbeknownst, that efficiency breaks down. That breakdown usually happens in market panics when the pricing mechanism gets out of whack. At times, this presents a great buying opportunity, but other times, not so much. We still have to rely on the fundamentals to see if the so-called buying opportunities are real or not.

For the most part, prices are constantly trying to find equilibrium. However, at times of panic, the market is manic. Benjamin Graham best illustrated this principle in his book, *The Intelligent Investor.* Graham referred to the stock market as Mr. Market and in his analogy, Graham compares Mr. Market to a small business that has two partners.

Robert: Yes I have heard you talk about this analogy before. Could you explain it again?

Steve: "Imagine that in some private business, you own a small share that costs you $1,000. One of your partners, named Mr. Market is very obliging. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or sell you an additional interest on that basis. Sometimes the idea seems plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him and the value he proposes seems to you a little short of silly."

If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the enterprise? Only in case you agree with him or in case you want to trade with him. You may be happy to sell out when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low; however, the smart investor will be wiser to form his own ideas of the value of his or hers holdings.

Robert: Very instructive parable. I know you have done some research on market swings when you were a Visiting Scholar at UCLA under Professor Rubinstein.

Steve: Another way to look at this problem of volatile markets is to understand that the markets move from pessimism to optimism and back. Think about this possibility. Maybe the markets were too optimistic in 2017 and now they are swinging back to equilibrium (See chart 1). Prices in a marketplace are always trying to find a balance.

Robert: Does Bitcoin fit into this model?

Steve: Very good observation. Yes it does. Bitcoin is a prime example of a market that swings from optimism to pessimism based on herd mentality and those wanting a quick get rich scheme. Bitcoin moves from less than $400 to $20,000 in one year and shortly reverses to less than $9,000. And what is collateral or value behind Bitcoin? Nothing. However, this demonstrates the fickle markets trying to find a balance. Again, Bitcoin swings from optimism to pessimism (See chart 2).

Robert: What is another fundamental?

Steve: Another fundamental is that of valuation. Right now stocks are finding themselves in a precarious equilibrium. Record-high valuations are only fully justified if bond yields remain at their current levels or fall, but valuations are hard to justify if bond yields march much farther. This is one reason why the market dipped in February. The January wage report showed a 2.8% increase in wages. In the mind of the stock market participants, this represented an increase in bond yields. More worrisome to some is the feeling that the U.S. Federal reserve may raise interest rates quicker and higher than originally planned in order to combat inflation.

Robert: How will a rise in bond yields affect the stock market?

Steve: If the 10-year U.S. Treasury yield breaks 3.25% then we would start to reduce the equities and upgrade bonds. For the most part, since 1921, interest rates have been the cause of market down turns and recessions.

Today's outsized valuation has been seen only once before in modern history - at the peak of the dot com boom in 2000 (See chart 3). According to Bloomberg, the S&P index tracker (SPY) earned a negative (-2.72%) for the period December 31, 1999 through December 31, 2009 (See chart 4). Imagine how you would feel if you had an index tracker or an all stock portfolio during that time frame. That is why we have a global diversified portfolio that consists of stocks, bonds and sometimes gold. In the past, a diversified portfolio most likely would produce positive returns versus a concentrated portfolio in one asset class.

Katie: You have been mentioning the relationship between stocks and bonds. Could you explain to us how you would perceive that relationship would affect stocks?

Steve: The record high stock market valuation is fully justified when bond yields are ultra-low. All is well and good for now except if bond yields creep above 3.5%. In this case, equities would have trouble even maintaining their current level. Hence, risk assets find themselves in a precarious position. Record high valuations are justified if bond yields remain at current levels or fall, but valuations are hard to justify if bond yields march higher. Unfortunately, the exact point at which the equilibrium becomes threatened is hard to define exactly. However, our research leads us to believe that if the U.S. Treasury, now standing at 2.89%, breaks through 3.25%, we would downgrade equities and upgrade bonds.

Arash: What do you think will end this bull market?

Steve: The likely end to this bull market will be a sustained rise in interest rates. However, another shock could jar the market and that could be a trade war. Elevated trade tensions mostly with China, Canada, and Mexico are near term risks to global growth. Between now and April could be a decisive time in this regard.

Arash: Now we have a clear picture of what is going on in the markets.

Steve: Yes, at first, a rise in interest rates caused an initial decline of global equity markets. This was in early February. Then came trade confrontations in the latter part of the month. In the first downturn, most of the point slide in the S&P 500 was caused by program traders and little to do with fundamentals. However, in any decline of this magnitude, we must remember that stock markets swing from optimism to pessimism and back.

Katie: I noticed you sold some stocks and bonds last month. Can you tell me why?

Steve: In the last month we have reduced our equity exposure by selling the homebuilders, General Electric and the Exxon 2046 bond.

The homebuilders are very sensitive to interest rate increases. In addition, it looks like new residential home construction is peaking. If we take a look at Chart 5 we can see that residential homebuilding is flattening out. The raw data also told me the same thing with new home construction declining for the past five months. Homebuilder stocks are very cyclical and they are not a buy and hold. We made good money on these builders, but it was time to sell. Now it is my opinion that a substantial increase in the 30-year home mortgage will slow new construction down even more.

We were long term holders of General Electric and we had believed that the company would be successful in their turnaround from mostly a financial services company to an industrial powerhouse. However, we lost confidence in management when they posted losses much larger than expected and were not transparent in their assessment of future losses. Although we liked the Exxon bond, we wanted to shorten the overall maturities of the bond asset allocation to better prepare for rising interest rates.

Robert: Could you please review your investment strategy for the upcoming months?

Steve: Our plan is to buy a few stocks to replace the homebuilders and General Electric when an opportune time comes about. Until then, we will stick to our current asset allocations until the 10-year Treasury hits 3.25% or some other event like a trade war happens.

Nora: Thanks Steve. This was very enlightening. We will now unmute the lines and open the conference call for questions.