October 30, 2019

Re: <u>Coffee with Dr. Steve</u>

Dear client,

The stock market[1] has been moving surprisingly well this past month or so because the market foresees a resolution to the Sino-US trade deal. Of course, there are a lot of variables that need to be worked out. Of course, a deal may or may not happen, but I suspect some sort of trade compromise will be accomplished. After all, China is having difficulties with exports that are declining approximately 25% and President Trump wants to get re-elected. However, a U.S. recession cannot be ruled out, but mushy growth around 1.5% is more likely.

Some people think that the inverted yield curve is sending investors a warning that an impending recession is near. It is true, in many cases, but not all, that the yield curve is a good predictor of upcoming recessions. Yet this time it is different. Investors must remember that bond yields are negative in Japan and in Europe. These negative yields are chasing money into the United States looking for a positive return. Hence, the demand for bonds is pushing down interest rates in the U.S. We believe, if it were not for the negative interest rates, the U.S. 10 year Treasury (a benchmark for interest rates) would be closer to 3%. Therefore, the yield curve is sending out a false signal.

Little known to the general public is the fact that the Federal Reserve is pumping liquidity back into the system through a mini-quantitative easing program. Even with easier money and liquidity, the markets will continue to be volatile.

We expect U.S. growth will soon rebound, thanks to robust drivers of domestic activity, cheap money and improving credit trends.

Since the Federal Reserve will maintain easy monetary policies, the U.S. dollar should depreciate, bond yields rise, and gold will move to the downside. We have paused in buying gold until the price per ounce reaches $1,450 or below.

In the past, when the Federal Reserve increased the money supply and lowered interest rates, the stock market responded, and this time should be no different. The big question is whether the Federal Reserve's easing and renewed balance sheet expansion, Chinese stimulus, and trade tensions diminishing, will be enough to sustain the stock market rally.

Each down cycle has a different trigger, but each deflationary period triggered an interest rate reduction and an increase in the money supply. This staved off a recession and bear markets.

To us, the market is fairly valued and there is probably not much upside from here.

Investment Implications

Following the major stock market peak in 1999, value outperformed growth by a wide margin until 2007 when technology outperformed value.[2] This serves as an important lesson for today. During the 1999-2002 bear market, the previously overlooked cheap sectors or old economy stocks did very well even if the broad indexes declined. This is the period in which Warren Buffett was criticized for being a dinosaur. Although we have some technology stocks, our bias is towards value stocks. I think our stocks are in a sweet spot.

However, there are risks to consider; Brexit, Iran and China. Nothing is finalized on the China-U.S. trade deal. The elections are coming and the politicians are doing and saying anything to get elected. I am not advocating any political position, but if the policies that some candidates propose come to fruition, I think that the stock market will decline by 20% or more. Elevated risk is present.

Although we have been buying a few selected stocks here and there, we will still maintain caution and keep the portfolio investments balanced between stocks and bonds. We may increase or decrease the equity exposure by 5%.

One of my reasons for Stevens First Principles to merge with BFSG was to allow me more time to concentrate on looking at the economic fundamentals, explore new technology investments, pick stocks and spend more time with clients. So far so good! Starting this Friday and most Fridays I will be posting a weekly video talking about current events that affect markets and talk about some of our stocks. You can go to http://www.sfpria.com to view these videos each week. Thank you for your continued confidence in me and my team.

All the best,

Steven L. Yamshon
Investment Counsel

1. **The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market.**
2. **The S&P 500 Growth index comprises S&P 500 stocks with above-average combinations of the ratio of earnings growth to price, sales growth, and momentum. The S&P 500 Value index comprises S&P 500 stocks with above-average combinations of book value-to-price, earnings-to-price, and sales-to-price.**