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October 5, 2018 – Diversified Investing vs Speculation

We hope that this letter finds you well. After a volatile first half of the year, during which domestic stock indices swung in a 12+% range between positive and negative year-to-date performance, the US stock market found its footing in the third quarter and in past month has surpassed the highs set back in late January. While the stock market here at home has recovered, at least for now, the same cannot be said for virtually every other asset class available to retail investors. US large and small cap stocks, as represented by the S&P 500 and Russell 2000*, respectively, and domestic real estate investment trusts were the only major global asset classes to have posted positive real returns so far this year.

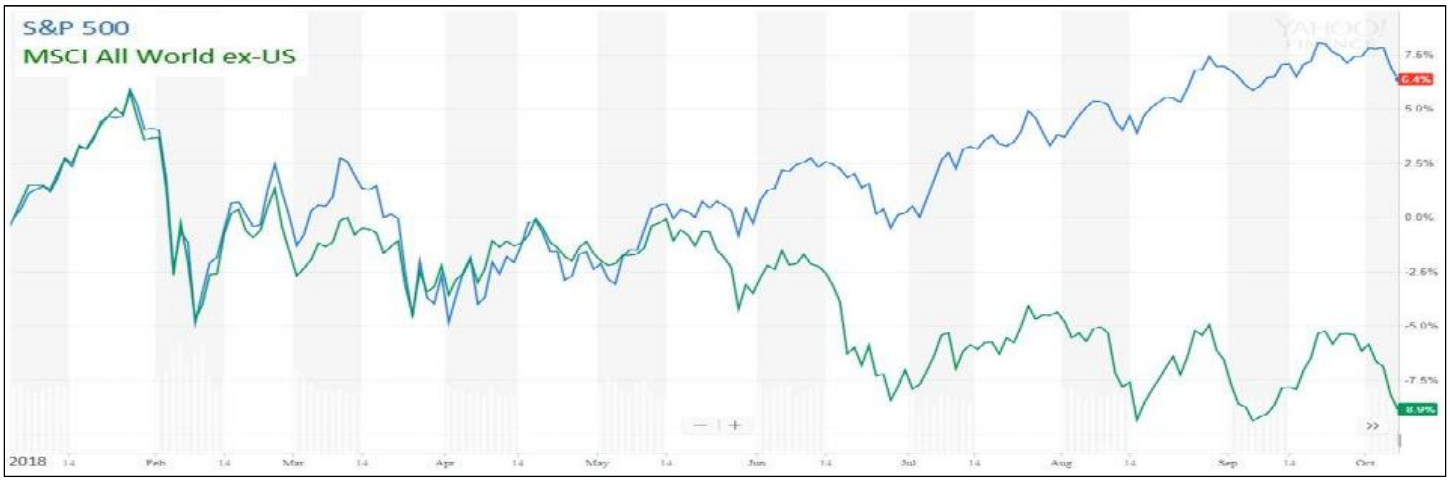
This outsized relative performance by US stocks coupled with the losses experienced this year in bond positions due to Fed tightening and rising concerns about pending inflation has meant so far in 2018 that any long-term investor who utilizes a globally diversified asset allocation discipline has vastly under-performed. Understandably, in the short run this is very disappointing. As the fear of missing out is a difficult emotion to combat, we have received a number of questions regarding our recommendation to underweight US equities.

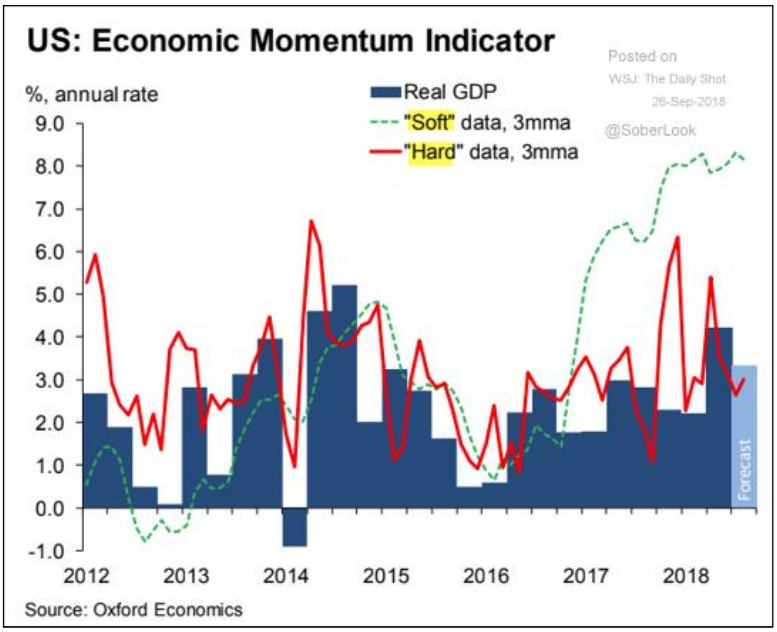
Exhibit 6: Few assets have produced positive real returns this year

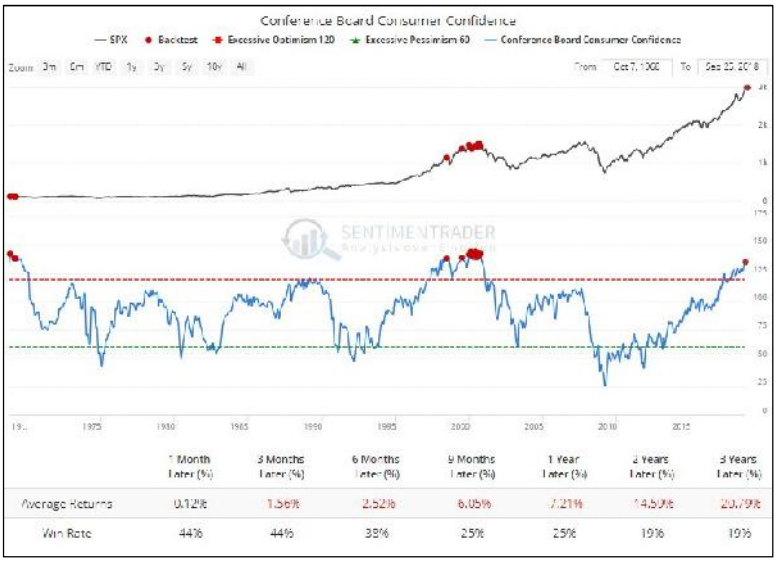
Annual Returns (USD,CPI Deflated)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
US 2Yr	-2.3%	-1.8%	1.5%	3.1%	6.6%	-1.8%	0.9%	-1.4%	-1.3%	-1.1%	-0.1%	-0.2%	-1.1%	-1.7%	-1.8%
US 10Yr	1.1%	-1.0%	0.2%	5.8%	17.8%	-8.5%	7.7%	12.2%	2.4%	-7.4%	8.2%	0.9%	-1.0%	0.4%	-3.6%
US IG	2.0%	-1.7%	1.8%	0.4%	-5.0%	15.6%	7.4%	5.0%	7.9%	-3.0%	6.7%	-1.4%	4.0%	4.2%	-4.1%
US HY	7.6%	-0.7%	9.2%	-2.1%	-26.2%	54.1%	13.4%	1.9%	13.8%	5.8%	1.7%	-5.2%	14.8%	5.2%	-0.2%
Global HY	9.5%	0.1%	11.0%	-0.9%	-27.0%	55.2%	13.1%	0.1%	17.6%	5.7%	-0.7%	-3.4%	12.0%	8.1%	-4.1%
Inflation Bonds	10.9%	-4.6%	4.7%	7.3%	-7.8%	10.6%	1.5%	7.0%	6.6%	-4.6%	2.6%	-5.7%	1.8%	6.4%	-4.7%
US Agg. Bond	1.0%	-1.0%	1.9%	2.7%	5.1%	3.1%	5.0%	4.7%	2.4%	-3.5%	5.2%	-0.2%	0.6%	1.3%	-3.1%
EM$ Sov Credit	8.3%	8.9%	7.9%	1.8%	-11.8%	26.2%	10.6%	5.5%	16.0%	-7.4%	6.4%	0.7%	7.2%	7.0%	-7.5%
EM Local Debt	0.0%	0.0%	0.0%	0.0%	0.0%	14.0%	10.9%	-2.6%	13.1%	-5.8%	-2.6%	-11.0%	3.8%	11.8%	-9.0%
S&P 500	7.3%	1.4%	13.0%	1.3%	-37.1%	23.1%	13.3%	-0.8%	14.0%	30.4%	12.8%	0.6%	9.7%	19.2%	7.6%
Russell 2000	14.5%	1.1%	15.6%	-5.5%	-33.9%	23.8%	25.0%	-7.0%	14.4%	36.7%	4.1%	-5.1%	18.9%	12.2%	11.8%
REITS	27.8%	8.2%	32.1%	-18.9%	-37.6%	25.1%	25.8%	4.4%	17.5%	1.2%	27.1%	2.1%	6.7%	6.4%	2.4%
MSCI Europe	17.5%	6.3%	31.2%	9.9%	-46.1%	33.2%	2.9%	-13.1%	17.9%	24.1%	-6.4%	-3.1%	-1.8%	23.6%	-4.4%
MSCI Japan	12.2%	21.5%	3.8%	-7.9%	-29.2%	3.6%	13.9%	-16.7%	6.5%	25.4%	-4.4%	9.1%	0.7%	21.8%	-3.4%
MSCI China	-1.4%	15.8%	78.5%	59.7%	-50.9%	58.4%	3.3%	-20.6%	21.0%	2.4%	7.5%	-8.3%	-0.9%	51.1%	-9.7%
MSCI EM	21.9%	30.1%	29.4%	34.3%	-53.2%	74.3%	17.4%	-20.5%	16.6%	-3.7%	-2.5%	-15.2%	9.4%	34.8%	-8.9%
Commodities	8.8%	25.9%	12.1%	20.4%	-29.0%	37.5%	24.5%	-10.8%	2.0%	-10.0%	-17.7%	-19.0%	20.7%	5.3%	-5.2%

Source: Bloomberg, Morgan Stanley Research

Through 9/24/2018







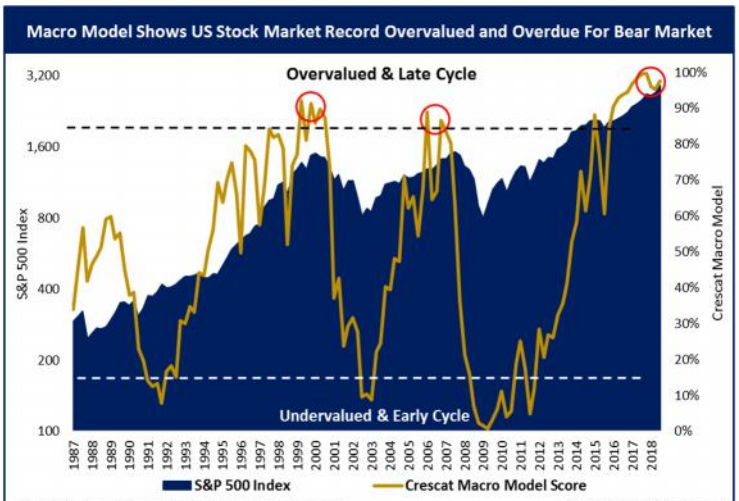
We will attempt in this letter to reiterate why it would be a bad idea to abandon our preference for a diversified, value-driven investing discipline in favor of speculating on continued US stock market outperformance.

Consumer confidence in the United States is the highest it has been in 18 years, and understandably so. The labor market is the strongest it has been in decades and wage growth is finally starting to show up in recent data. The tail-wind of corporate tax reform has goosed corporate profits, at least temporarily, and at 4.2% GDP growth in the second quarter was the fastest since 2014.

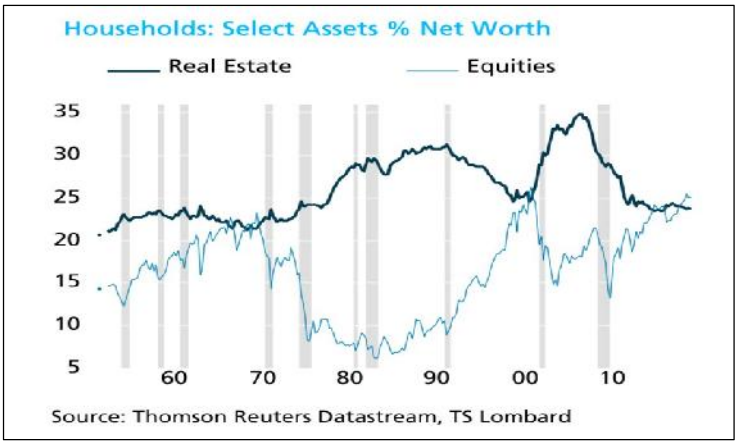
However, the year-over-year benefit of the fiscal bump delivered by tax reform will be fleeting, and despite the sky-high annual improvement in "soft" data derived from sentiment and confidence surveys, the "hard" economic data is already reverting to pre-tax reform levels we've seen for years. As can be seen in the middle left chart, it is the "hard" data that is often a better indicator of true economic conditions.

As one would expect, consumer confidence has always had a strong correlation to recent stock market performance. As can be seen in the bottom left chart, however, an excessive level of consumer confidence should not be viewed by investors as a predictor of a continuation of good times. Quite the contrary.

In the last 50 years during which consumer confidence has been measured, the S&P 500 has averaged negative returns in the 1, 2- and 3-years following instances with the current level of optimism. As mentioned above, we should not use this data alone as a predictor of future market returns, but history suggests now is not the time to add exposure to US stocks. Let's review a few other indicators sending a similar message.



Crescat Macro Model Indicators	Historical Percentile at Previous Peaks		
	03/31/2000	06/30/2007	Today
UST Yield Curve (10s-2s)	95%	77%	75%
US Unemployment Rate	89%	66%	86%
Initial Jobless Claims	87%	70%	91%
High Yield Credit Spread	22%	89%	79%
Consumer Confidence	96%	75%	86%
Savings Rate	93%	98%	69%
Total Economy Debt to GDP	52%	72%	95%
S&P 500 % of 200 DMA	99%	70%	61%
# of Quarters Since Last Recession	97%	76%	96%
Shiller P/E Ratio (CAPE)	100%	90%	94%
EV to FCF Margin Adjusted	37%	61%	96%
Median Price to Book	35%	77%	94%
Median EV to Sales	21%	79%	99%
Median Corporate Debt to Assets	84%	12%	98%
Fed Funds Rate of Change 24 months	74%	79%	91%
Volatility Index (VIX)	20%	79%	35%
Average of Percentile Ranks	69%	67%	91%
Crescat Macro Model Score (Historical Percentile)	**86%**	**80%**	**100%**

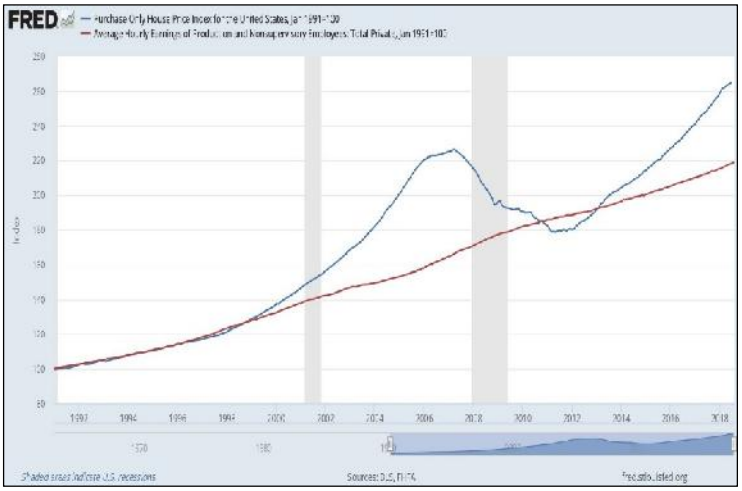


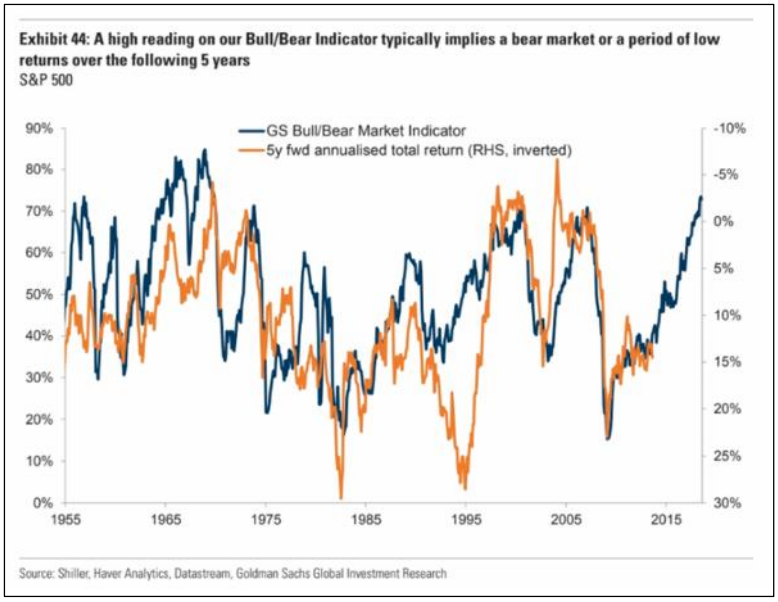
To the left is a laundry list of widely used valuation metrics and economic indicators suggesting that we are now in the late stage of the current economic cycle and that US equity markets are as expensive or more expensive than they were at the last two bull market peaks.

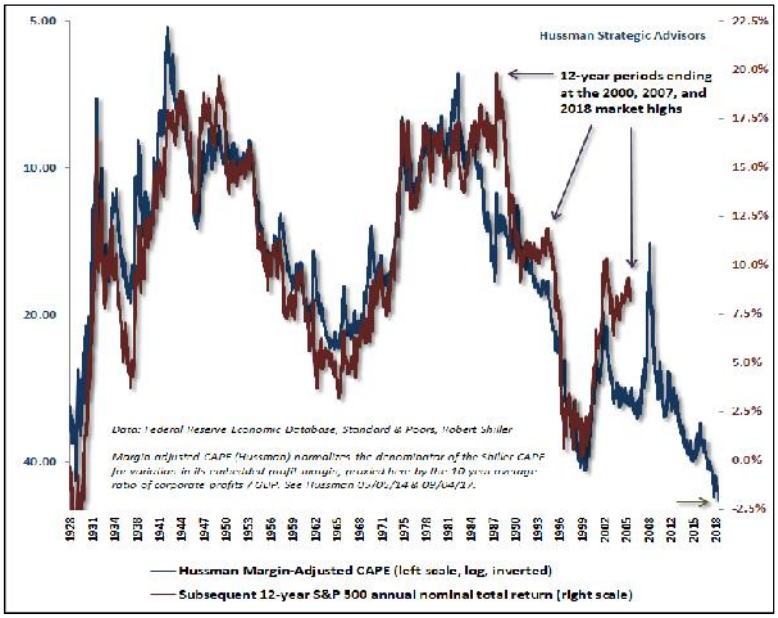
For only the third time in history, and the first time since 2000, equities represent a greater percentage of US household net worth than real estate. This despite the fact that nationally, when viewed relative to average hourly earnings, US home prices are rapidly approaching the level set in 2006, at the peak of the housing bubble.

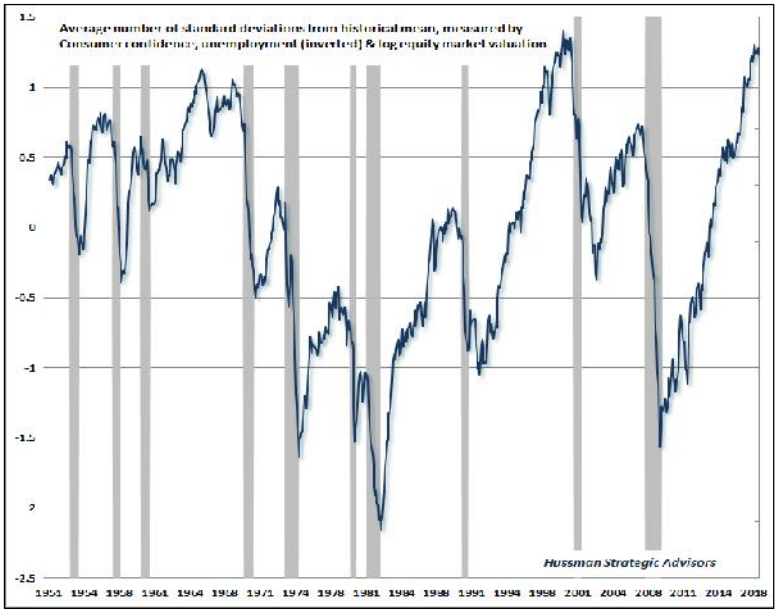
Market analyst Callum Thomas, Head of Research at Topdown Charts, recently wrote, "Cash allocations have fallen to either a record low, a cycle low or the lowest point since the dot com bubble (depending on which metric you look at)… Basically, where cash allocations are at this point is entirely consistent with the type of signs you see towards the end of a market cycle (along with high valuations, flattening yield curve, buoyant consumer confidence, Fed tightening policy, etc.) Long story short, US investors are basically all-in. Good luck to them."

Goldman Sachs' analysts are also waving warning flags on the likelihood of this bull market continuing for much longer. From Bloomberg: "A Goldman Sachs Group, Inc, indicator designed to provide a 'reasonable signal for future bear-market risk' has risen to the highest in almost 50 years. The firm's









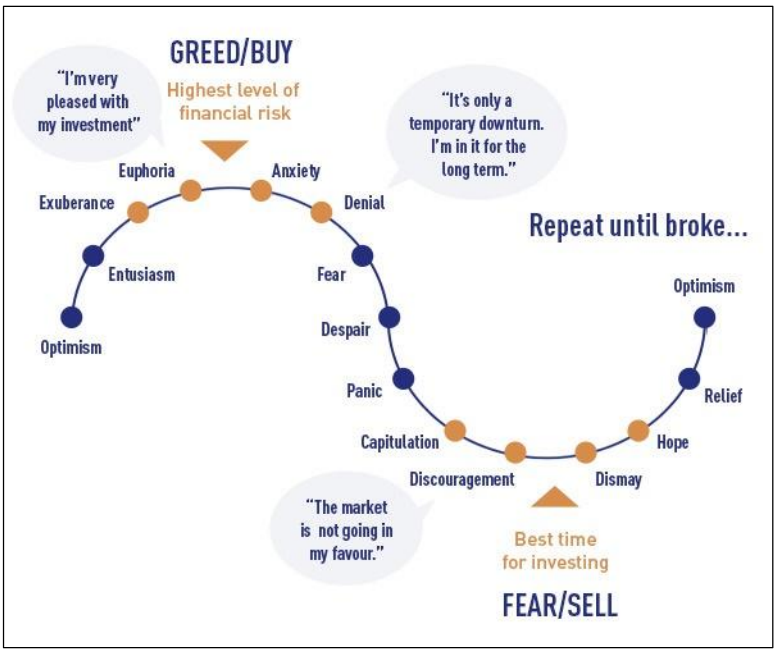
Bull/Bear Index, which is based on measures of equity valuation, growth momentum, unemployment, inflation and the yield curve, is now at levels last seen in 1969." As can be seen in the chart on the top left, this indicator in currently suggesting that the average annual total return of the S&P 500 will be negative for the next 5-years.

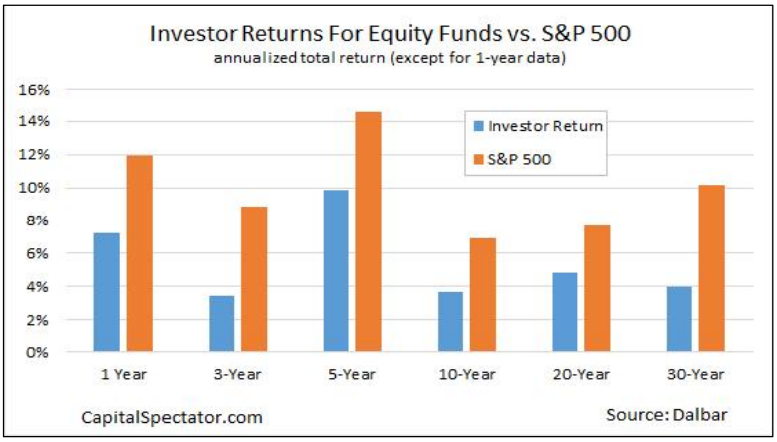
In a recent market commentary, John Hussman of Hussman Funds, who accurately predicted and whose clients thus benefitted from the stock market peaks in 2000 and 2007, had this to say about current US equity valuations:

The [middle left] chart shows the margin-adjusted CAPE on an inverted log scale, along with the actual subsequent S&P 500 average annual nominal total return over the following 12-year period. As I've observed before, the "forecast errors" that periodically emerge at bubble peaks and secular troughs are strongly correlated with the level of consumer confidence at the end of a given 12-year horizon. That's another way of saying that temporary extremes in valuations are driven by cyclical but impermanent fluctuations in the psychology of market participants between optimism and pessimism…

The [bottom left] chart reflects three key elements of economic optimism: consumer confidence, stock market valuations, and the unemployment rate. Each of these is expressed in terms of standard deviations from their respective averages, so they can be directly compared. The chart shows the average of the three (with unemployment inverted so lower unemployment results in a higher value). The first thing to notice is that the recent expansion is the longest on record, and that valuations, consumer confidence, and employment conditions are clearly near their upper extremes.

The second thing to notice about the [bottom left] chart is how breathtakingly narrow the gap is between conditions of extreme economic optimism and the beginning of recessions. There's no protracted slowing or long warning period. If you're lucky, you might get a warning from slowly deteriorating consumer confidence, as occurred before the 1980 recession. More often, the gap between extreme optimism and the start of a recession is a few months at best…





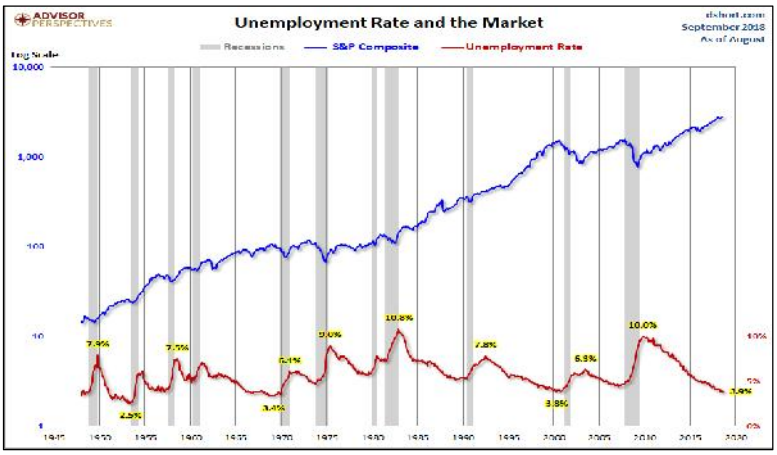
Given current valuations, even a return to average run-of-the-mill historical norms would result in a loss of about two-thirds of U.S. stock market capitalization. Meanwhile, any significant recession will likely be accompanied by a wave of corporate bankruptcies in a system where corporate debt is easily at the highest percentage of corporate gross value-added in history, and the median corporate credit rating is already just one notch above junk.

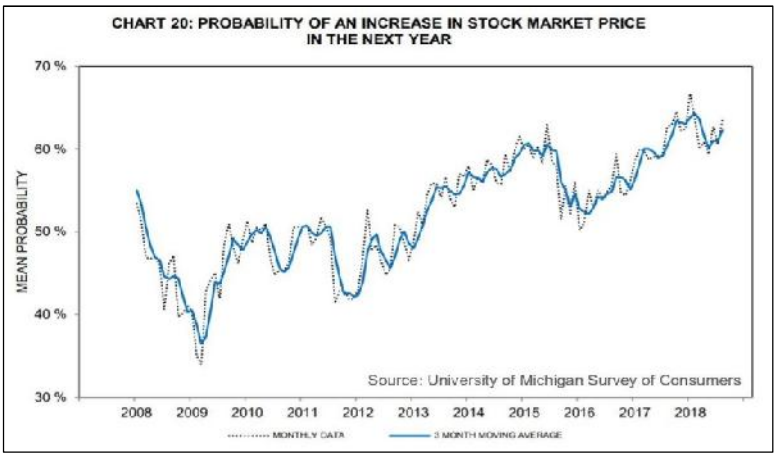
- *John P. Hussman, PhD, October 2018*

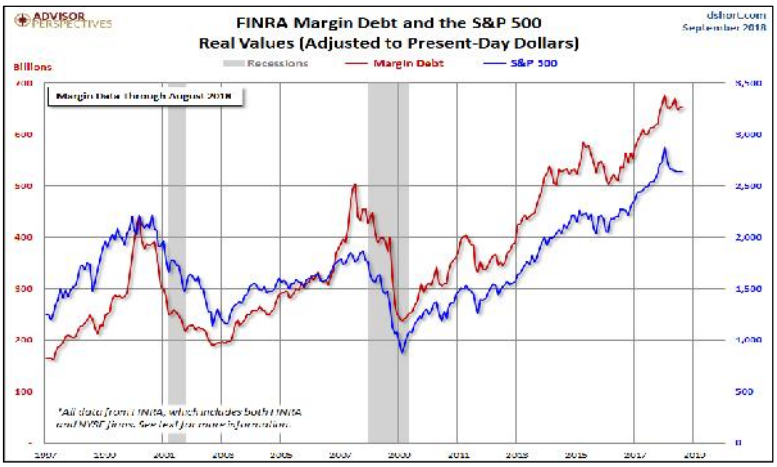
We are not suggesting that we know when the current bull market is going to end. What we are suggesting is that disciplined investors should ignore the emotional pull toward speculation and should instead allocate their savings more analytically. A short-term underweight to US equities, which are by many measures the most overpriced they have ever been, is an appropriate asset allocation decision until more attractive valuations present themselves.

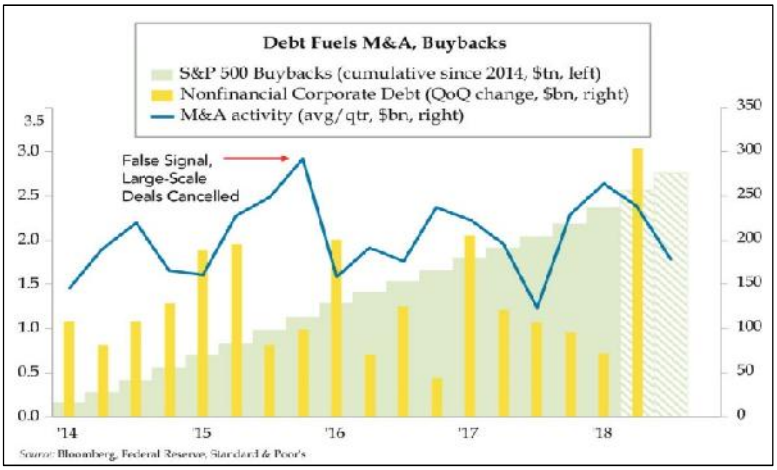
As can be seen in the two charts on the top left, outperformance of domestic vs international equities is a cyclical phenomenon. Recognizing that extended periods of outperformance by US equities have typically been followed by extended periods of underperformance can help prepare an analytical investor for what may be coming in the years ahead and encourage them to maintain a more diversified approach to portfolio construction. We don't need to nail the timing of the transition perfectly to benefit from this cyclicality, we just need to recognize and appreciate that the cyclicality exists.

Unfortunately, the average investor allows emotion and the fear of missing out to drive them to speculation, of course followed by panic selling at a loss in the ensuing bear market. A tendency toward speculation as opposed to analytical asset allocation decisions is why the average long-term return for equity investors falls far short of the return of the broader equity market itself.









Our view is that at current valuations, and at the current stage of the present economic expansion, those who are overweighting or even maintaining a neutral weight to US equities are not investing, they are speculating in hopes that stocks have reached a "permanently high plateau". See if any of the economic and market conditions outlined below sound familiar (bold emphasis added):

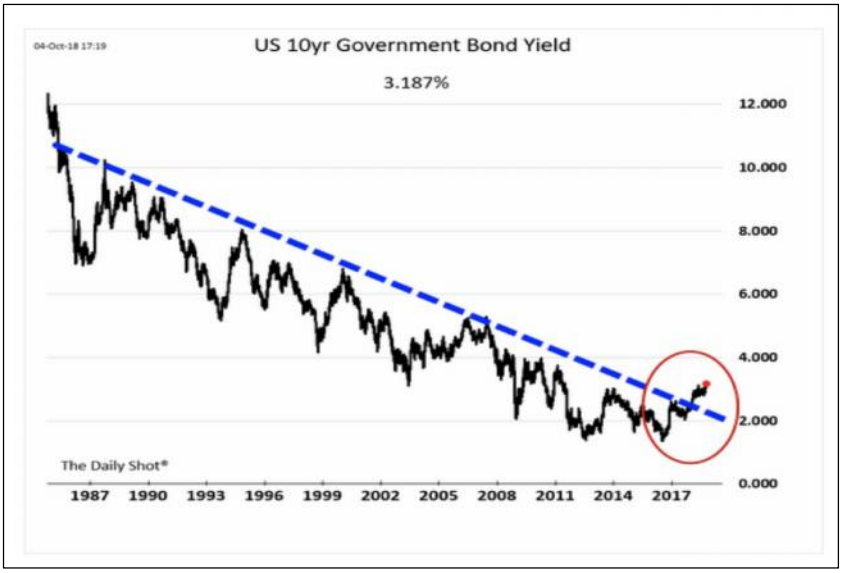
On October 16, 1929, Yale economist Irving Fisher wrote in the New York Times that "Stock prices have reached what looks like a permanently high plateau." Eight days later, on October 24, 1929, the stock market began a four-day crash on what became known as Black Thursday. This crash cost investors more than World War I and was one of the catalysts for the Great Depression. Irving Fisher's declaration went down as the worst stock market prediction of all time.

Hindsight is always 20/20 but in the Roaring Twenties, ***optimism and affluence had risen like never before****. The economy grew by 42%… average income rose by about $1,500 and* ***unemployment stayed below 4%…*** *Investing in stocks became like baseball – a national pastime. As newspaper headlines trumpeted stories about teachers, chauffeurs and maids making millions in the stock market,* ***concerns about risk evaporated****.*

Everyone wanted to get in on the action and credit was readily available. In particular, ***businesses and individuals borrowed money to buy stocks "on margin."*** *Buying on margin meant that an investor could put down 10-20% of their own money and borrow the rest from their stock broker… Economists and historians have long argued that the Federal Reserve's policy contributed to the crash. In 1928 and 1929, the* ***Fed raised interest rates*** *in an effort to limit securities speculation…*

During the period from August 1929 through March 1933… the S&P 500's total return was -74.6% and the 10-year Treasury's total return was +15.3%.

- *Business Insider; "A Brief History of the 1929 Stock Market Crash" April 8, 2018*



We readily admit that our reticence to be fully allocated to overvalued US equities has left short-term gains on the table. However, our understanding of and appreciation for market history suggests that our preference for a diversified, value-driven allocation strategy, as opposed to US-equity-heavy speculation, is likely to be rewarded over the full course of this market cycle.

Before closing this quarter's commentary, we would be remiss not to address the spike in yields at the long end of the Treasury curve that has taken place over the past week. As can be seen in the top left chart of 10yr US Treasury yields, the downward sloping trend line that has been in place since the late 1980's has broken, suggesting to many market analysts that much higher yields are to come. While the trendline on the 10yr yield has been broken, as of the date of this letter 30yr US Treasury yields are still within the 3.25-3.50% range that we highlighted in our April letter. We will continue monitoring the bond market closely to determine if a further reduction in the duration of our bond holdings is warranted.

With a respectful eye toward the lessons of market history, spikes in 10yr and 30yr US Treasury yields were precursors to the stock market peaks of 2000 and 2007. As was the case then and will likely be the case when the current bull market eventually ends, US Treasuries offer valuable portfolio diversification and can be a source of positive overall performance when investors flee overvalued equities for safe haven investments. More on this topic in our next letter when we have a clearer sense of the near-term direction of bond yields.

We appreciate your taking the time to read and consider our thoughts. Please feel free to share this newsletter and do not hesitate to call or email with any questions or comments or to schedule a face-to-face portfolio review.

Sincerely,

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"The individual investor should act consistently as an investor and not as a speculator."

- Ben Graham

**The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks representing all major industries. The Russell 2000 Index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index which is made up of 3,000 of the biggest us stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States. The Morgan Stanley Capital International All Country World Index Ex-US (MSCI ACWI Ex-US) is a market capitalization-weighted index designed to provide a broad measure of equity-market performance throughout the world, with the exception of US-based companies, and is comprised of stocks from both developed and emerging markets. The Dow Jones Industrial Average (Dow) is a price-weighted index of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. The Morgan Stanley Capital International All Country World Index (MSCI ACWI) is a market capitalization-weighted index designed to provide a broad measure of equity-market performance throughout the world and is comprised of stocks from both developed and emerging markets. Indices such as the S&P 500 Index, the Russell 2000, the Dow Jones Industrial Index and the MSCI ACWI are unmanaged, and investors are not able to invest directly into any index. Past performance is no guarantee of future results.*

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