June 18, 2018

Dear Fellow Investor:

Events are playing out as one would expect if one subscribes to our view that reduced central bank liquidity coupled with increased deficit spending and Treasury issuance is straining economies and markets in a big way. The impact is broadly negative for credit risk as opposed to increasing inflation concerns. Because of that, it pushes the globe towards the deflation side of the equation. The landscape is simply not as "growthy" as we are told.

Things are breaking in markets, but don't cry for Argentina. It just got $50 billion from taxpayers through the IMF as its currency and bonds crashed. Brazil and Turkey are in trouble too. We expect more bailouts in other places. All the usual suspects act as if no one could have seen this drama coming. We suggest otherwise.

The Fed raised rates again last week, so it is trying to stay on course in the face of the multiple headwinds, particularly in the emerging markets and generally softer global economies. It is also still shrinking its balance sheet, so the overall amount of tightening is much more dramatic, particularly when rates are rising from such a low base.

The ECB also just announced it will end QE in December, though economic data in Europe has rolled over again. Japan is mildly tapering QE in a back-door manner. The Treasury curve remains flat as if to say central bank buying is not what is keeping the bid in the long end. Growth just ain't that great, Mr. Powell, Mr. Kuroda, and Mr. Draghi.

Reduced liquidity is forcing a significant re-pricing of numerous sectors and asset classes. Because there is no longer nearly as much central bank largesse being thrown into the system, investors are forced to pick and choose between winners and losers. This creates the growth versus value dynamic that has been so pronounced in recent quarters as participants chase a shrinking group of perceived winners. For instance, some consumer staples and utility stocks are down 20-30% as those are sold to buy things like Amazon and Facebook.

Overall positioning in many markets still seems to pay no heed to the reality that the monetary tide is ebbing although major "accidents" are happening across the planet. What is also taking place is a refusal of U.S. equity investors to head close to shore. In fact, just like past cycles, a strange desire to maintain exposures becomes most pronounced as holes in the bullish narrative begin to appear. Those late to the party want to catch up.

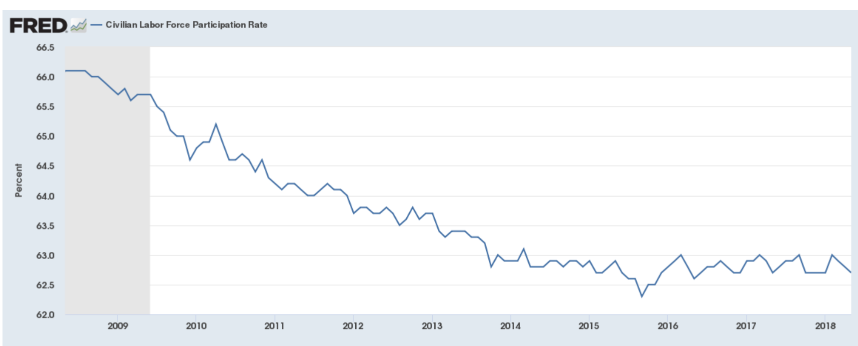
Small cap euphoria remains in place. The Russell 2000 trades at 89 times trailing earnings, but we guess investors take comfort in the notion that it "only" trades at 27 times forward estimates. Watching the Street bridge that gap between trailing and forward EPS numbers has always stood out as quite outrageous to us, but they have done it for years by removing negative earners and other trickery like non-GAAP accounting. Regardless, 27 times forward earnings ain't cheap even if we could hang our hats on the projected numbers!

It doesn't help to clarify matters when high frequency traders play elevator music all day in markets by making it seem as though good times will never end with trading tactics that ought to be regulated away in a forceful manner. The tape is a siren song.

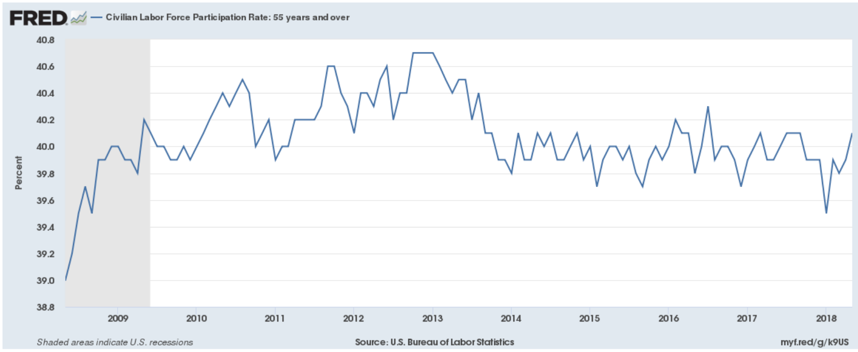
The idea of riding out a storm in the deeper waters of mega cap darlings and selling less liquid but cheaper stocks always seems to peak in popularity when investor cycle fatigue is high and the fear of missing out is most palpable. Of course, if a serious storm arrives, those supposedly liquid mega caps often become a source of cash when it becomes tough to sell anything else. This could be a problem if ETF holders turn net sellers.

U.S. GDP growth will come in better this quarter than the weak first quarter, but most of the global data is now running below expectations. For instance, South Korea is enduring slower growth and trade and that usually speaks volumes about world GDP. Industrial production in the U.S. fell 0.1% in May. We suspect those much stronger soft data manufacturing survey results might have more to do with the political preferences of the respondents than actual business prospects.

Employment numbers are getting a lot of accolades in the U.S., but they are lagging indicators and late-cycle peakers. Besides, the BLS headline numbers ignore millions of people not considered part of the labor force. We put together the graph below. It shows that we aren't back to labor force participation levels seen ten years ago, but few pundits dare to mention this.



We also don't believe the theory that low participation is caused by older people retiring. The opposite is likely true. The over-55 cohort is actually one of the few groups that has shown relative strength in recent years. This is likely tied to the inability for these folks to retire because zero-rate policy made it impossible for many to live off a fixed-income. Their living costs are rising faster than government-manipulated inflation numbers as well.



Payroll growth may be a bit better in recent months, but it's not a lot to get excited about either when one looks at the big picture. It isn't even as strong as the period before Mr. Trump came to town. This flies in the face of a lot of hype.

A rolling bear market is taking place in the S&P 500. Every sector in that index has now been down roughly 10-20% at some point in 2018. Market breadth remains challenged as fewer stocks are remaining robust. Many of the stocks that are most beaten-up are the very dividend payers the pundits portrayed as no-lose propositions during QE. Many are down 20-30%. A ratio of market moves on down days versus up days has it historically high levels after last year's extreme complacency.

Major stresses are appearing regularly. Deutsche Bank is once again enduring intense difficulties. Italian government bonds and stocks came under enormous pressure as populist, Euro-skeptic leadership takes control there. Contrary to the narrative, Italy has been left out of the supposedly strong economic upturn, so outsiders were put in power by disgruntled younger voters. Spain and Germany are also facing less stable political situations.

It seemed everyone had piled into emerging markets. Now those are cratering. Currencies, bonds, and stocks in places like Argentina, Brazil and Turkey have been in turmoil for months because their dollar borrowings are proving painful as the greenback rises in response to the dollar shortage we often discuss. China is showing corporate credit strains and slower growth.

As if these issues were not enough, Trump's trade policies are a big wild card that should not be ignored by investors. Tariff tweets create uncertainty and worries about higher prices. Though we welcome it, leveling the trade playing field may not be stock friendly.

As if right on cue, we are not surprised by the massive outperformance of growth stocks versus value stocks. We have witnessed the same activity near the end of the last two cycles. As the Wall Street Journal recently wrote:

> *"Hunting for cheap stocks has been out of favor for so long that some self-proclaimed "value" investors are embracing a broader mandate, a potentially costly move in the later stages of an economic cycle.*
>
> *Many such buyers have drifted away from the hallmark of value investing championed by the likes of Benjamin Graham and Warren Buffett : actively picking stocks the market has overlooked. Those legendary investors assessed what they called a company's intrinsic value and compared it with metrics such as its cash flow and price-to-book ratio, a measure of net worth.*
>
> *Value stocks—traditionally shares of consumer-staples companies, basic materials firms and big manufacturers, among others—have been stuck in a rut for most of the nine-year rally in U.S. stocks. The Russell index of 1,000 of the biggest value stocks in the market has fallen 2.1% in 2018, the fifth straight year—and the 10th of the past 11 years—that the index has lagged behind its growth counterpart, which is up 6.9%......*
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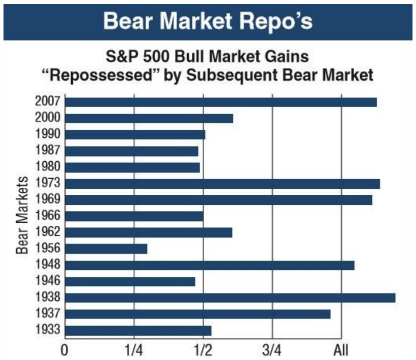
> *Eddie Perkin, chief equity investment officer at Eaton_Vance , said value funds that have ignored the hugely popular FANG stocks— Facebook Inc., Amazon, Netflix and Google parent Alphabet Inc. —run the risk of being left behind in the market.*
>
> *"The FANG stocks are so dominant in those benchmarks that to not own them, you got really hurt the last few years," he said. So you had to have those in your portfolio to keep up with other growth managers."*

Indeed! Never mind that trillions of dollars of market cap in FANG stocks rests on mobile ad pricing and an already mature smartphone market. This same sort of thing could have been written in 2000 or 2007. Anybody still use a Blackberry? Not long after those points, investors re-discovered the notion that there is nothing new under the investment sun. Value matters because investment success comes from buying securities when free cash flow yields are high or price-to-books low. That ultimately works much better than chasing the current market darlings whose margins may prove unsustainable.

Maybe this time will be different, but based on valuations, one is not paid to participate on an unhedged based. Meanwhile, insiders at numerous highfliers are quite busy selling even as retail investors pile into the names. The new head of the SEC has sounded a warning on this.

As we often discuss, we have been amazed from early in our career that so few participants undertake strategies that account for the fact that a large portion of any cycle's gains are lost to inevitable bear markets. We found this on UPFINA and think James Stack originated it.



We partially base our strategies on the concept that about half the gains are surrendered. This always seems so out of place when everyone acts like they bought at the absolute low and will hold on through thick and thin. We know otherwise. Most investors buy high and sell low.

Market structure issues cannot be dismissed. Algo trading is confusing matters, likely enticing major holders of stocks to refrain from checking where the bid for institutional size for many of their holdings really is. The transformation of the market structure to one dominated by high frequency traders (HFT's) and ETF buyers remains on our list of top concerns. The liquidity, if you can call it that, provided by the HFT crowd disappears when needed most. Even some of the big broker dealers now write about this.

We suspect ETF and index fund buyers have been late to the party and will likely become net sellers when turmoil erupts. The value crowd that normally takes the other side of pronounced selling, has shrunk dramatically given the dynamics of the dominance of passive investing that we have discussed. Specialists are just no longer situated on trading floors ready to step in when one side of a trade is crowded. Instead, HFT's mostly front run investor trading while committing limited capital. Who thought we'd miss the specialists?

Market gaming has gone on for decades, but now it is dominant as real money investors have become so much less important and computers seeking short-term profits take over. Those bids that come in at regular points throughout the day should not be depended upon for significant liquidity. We started talking about this chicanery years ago and it has only gotten more pronounced. It makes no sense that those Swiss clock-like bids are not pounded when everyone knows when they will arrive.

Emerging market bourses seem to function with less manipulation these days than U.S. trading activities. It's weird, really weird. Our point is that liquidity is not what it is portrayed to be, yet major players are positioned way out the risk curve as if large amounts of securities can be readily bought and sold without moving the "market" in a big way. It is another reason we remain hedged.

We are now 119% long and 75% short with a 3% net equity exposure. Closed-end bond fund holdings comprise a 41% total position (11% municipals, 3% TIP's, 6% mortgages, and the remaining 21% in diverse sectors). We are using options to increase short equity bets. We have been able to purchase numerous equities at much better valuations in recent months simply by having waited for these better opportunities. We strongly favor value over growth.

One can drive a large truck through the gap between the normalized free cash flow yields of our longs relative to our short positions. Our bet is simply that equities at 10-15 times this metric are very inexpensive relative to those with multiples over 20. Also, our bond and income-oriented investments are quite cheap to most stocks.

Valuations drive our exposures. However, based on what we see, it looks like many cracks are being exposed in the narrative that somehow it does not matter that an unprecedented central bank experiment is being reversed by Quantitative Tightening. The rising dollar and interest rates are proving quite troublesome for economies and markets. The Fed will likely be pushed into an easier stance, but maybe not before the damage is more obvious.

We love hearing pundits place central bank policy error at the top of their current worries list. They think Quantitative Tightening, higher rates, and less QE may push markets over the edge. We beg to differ that trying to return to normal is the blunder. The mistake was pursuing ridiculously easy and irresponsible strategies for ten years to the point that current markets and economies are unrecognizable to anyone with a knowledge of history.

The current paradigm is like a doctor, after having put patients on ever higher doses of steroids for years, deciding to no longer write the prescriptions. The weakest patients, like Brazil, Turkey, and Argentina or Deutsche Bank and Italy, are the simply the first to show that the patients' "recoveries" were a mirage. The central bankers worked no miracles!

Sincerely,

Scott E. Brown, CFA