October 18, 2018

Dear Fellow Investor:

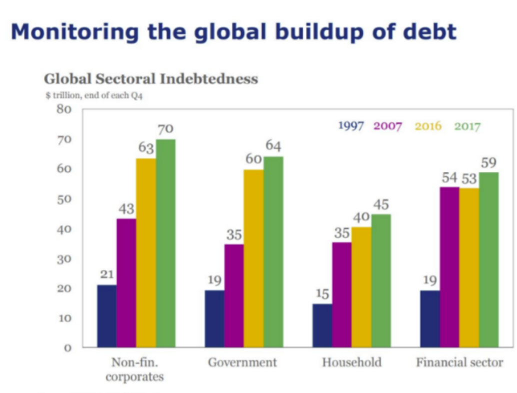
"Ain't it just like the night to play tricks when you're tryin' to be so quiet?
We sit here stranded, though we're all doin' our best to deny it"- Bob Dylan

The Fed is in the middle of increasing its balance sheet shrinkage pace to a massive $50 billion per month and raising rates in an unprecedented tightening process. Economists are overly optimistic regarding economic strength. Median equity valuations approach three times normal. The breadth of the equity market continues to deteriorate and suddenly even the U.S. indices are getting more volatile.

Meantime, it seems like many are "denying" that Quantitative Tightening may cause problems. Nothing to see here, folks, as day turns to night. Increasingly unfriendly markets are playing "tricks" on the Fed as it tries to quietly back away from its insane activities of recent years. The economy and investors are "stranded" in a no-man's land, stuck between the more real economy of yesteryear and the make-believe one concocted by Bernanke, Yellen & Co. to cover up for the popping of the prior bubbles they created.

Once you addict the globe to free money, and lots of it, it's tough to go back to the good old days. But they must try to contain the bubble before it gets more obvious. Also, if this dependence on QE madness and holding real rates below zero is not ended soon, the dollar will join other once-dominant fiat currencies like the British pound in "the dustbin of history." All fiat currencies eventually fail. Even the dollar was devalued in the 1930's.

Since the Great Recession, the deciders did more of the same and expected different results. They have one playbook with only one play in it: debase currencies and encourage the creation of massive amounts of debt because the global economic engine demands it since organic growth has been fading for years due to demographics and over-indebtedness.



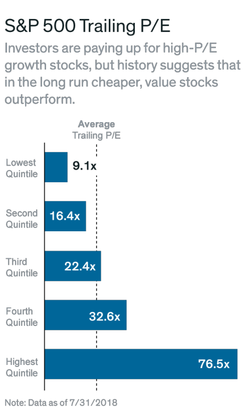
This obvious replay of what got the world into trouble last time is to be ignored say the talking heads. Dutifully, investors followed right along like 2008 was an unpredictable outlier. It seems as though blind buying of stocks has been declared by edict to be a no-lose proposition, just like buying houses supposedly was in that earlier period. Only a fool would not have a preponderance of assets in an index ETF. We do wonder how many of those making that recommendation are currently doing as they say.

The central bankers promised it was going to be like "watching paint dry" when their policies were reversed. We knew it was never going to be easy. Any time was going to be a tough time for central bankers to behave more rationally by normalizing policy after ten years of outright monetary malpractice that was portrayed as a typical economic recovery brought about by the wonders of QE magic.

Bizarre devotion to ultra-easy monetary policy became normalized and considered business as usual by a new generation of investors.   Now, with real interest rates still close to zero, numerous politicians and pundits are already clamoring that the Fed is acting irresponsibly by tightening. However, if you took a current snapshot, it would be impossible to find an historical picture showing when the Fed was more dovish other than when QE was still going strong a few years ago.

The reality is that normalization must take place if we are to have any hope of escaping the current economy dominated not by production, but by financialization. Speculation has been confused for investment. It has gotten to the point where fundamental analysis of stocks has been deemed old-fashioned and quaint. Some of the best minds in the investment business have closed-up shop and even the bearishly leaning have mostly gone silent and timid.

When 83% of IPO's are unprofitable, there might be a problem. That is the highest level ever. When the 100 priciest stocks in the S&P 500 trade at 77 times trailing earnings on average while the least expensive trade at 9 as discussed in a recent Barron's piece, perhaps index investing and momentum chasing have gone too far.



For years, a lot of economic activity took place simply because every business idea made sense when the hurdle rate was zero. Companies that used to go bankrupt were able to hang on because it was so easy to borrow. After all, the concept of creative destruction is so old-fashioned. Corporate stock buybacks to create earnings growth was also made easy with short rates held near zero.

While we have always favored a less reckless monetary policy and a return to some semblance of prudence, that will be quite trying, if not impossible. Look at how abnormal the buildup of bank reserves was and how little they have contracted.

However, liquidity is already clearly drying up. It is becoming impossible for financial assets to all move higher together and many have begun a downward trend. It started with cryptocurrencies and the emerging markets, but it is spreading for sure. About 1,600 out of 2,800 or close to 60% of stocks in the MSCI ACWI global index are in a bear market (down more than 20%). Small caps in the U.S. fell over 10% from their highs in a matter of weeks.

The decline in central bank-provided support seems to hit a different market each day. U.S. stocks and Italian bonds are the latest to suffer a dislocation. Treasuries, mortgages, and corporate bonds have all come under pressure too. Many cyclical stocks in the U.S. have rolled over meaningfully. In addition, the slowing Chinese economy is impacting the rest of the world. Its currency and stocks are weakening to levels which suggest severe unraveling.

Importantly, most economists, including those at the Fed, may be overestimating the sustainability of growth. The economy is being led by inventory accumulation as companies try to get out ahead of increasing tariffs on Chinese goods. While we think it is a significant issue that will likely lead to lower activity in the future, many market participants are taking this growth spurt as mostly a tax cut response without thinking about an alternative genesis.

Rebuilds from the natural disasters of last year are also helping boost GDP, as is the sort of federal government deficit spending that Republicans used to complain about. The incumbents now want to substitute fiscal recklessness for monetary recklessness as the Fed grows less friendly.

Corporate tax cuts are not being largely directed towards increasing capital expenditures and wages. They are leading to a larger budget deficit at a time when the Fed is reducing its holdings of Treasuries and mortgages. That is crowding out borrowing in the private sector and thus slowing growth. Based on recent earnings reports, bank lending growth appears to be receding.

Higher rates are impacting growth and profitability. Those 0%-loan offers for auto purchases are a thing of the past, hurting sales. Mortgage rates, pushing a seven-year high of 5%, are combining with price unaffordability to negatively impact home sales and refi activity. Housing and autos both look to have peaked.

No talk of a downturn is permitted in the media, though historical economic data is a story of cycles. We suspect we are also at peak jet production, the peak pace of migration to cloud computing, and peak social media/digital ads growth. Globally, it seems that some of the frothiest real estate markets are rolling over in yet another signal that Quantitative Tightening is having an effect.

Greek banks are now getting a bailout because, despite the powers that be telling us that nation was fixed, it apparently is not. Greece was center stage several years ago for its debt woes and received help from all of the usual sources, but it has not been able to escape from its downward spiral. We bring up this example only because it points out that much of what we are told is no longer a worry should not be so easily dismissed as a concern.

Italy is not fixed either. We think its troubled banks and euro-skepticism are key issues along the same lines as the Greece situation. It is a much bigger problem because the Italian sovereign debt market ranks number three in the world in size. The new anti-establishment government wants to run a budget deficit of 2.4% of GDP to spur its lagging economy, but the European Commission wants it to keep that figure at 0.8%. That's a big difference. The problem is that Italy is hugely indebted with banks all over Europe holding large chunks of its bonds. Meanwhile, the ECB is set to end its purchases of all sovereign bonds in coming months. Stay tuned.

You would never know it listening to many in the media, but a lot of stocks are down much more from their highs than Treasury bonds. While some of our cyclical short positions have helped us by declining 20-40%, intermediate and long Treasuries have given back 5-10% from their highs of the past year. One might not expect this given how breathlessly pundits praise the equity market as a sign of a strong economy and warn about bonds. Numerous cyclical stocks do not see it that way.

Importantly, while indices hit new highs recently, the number of stocks hitting lows is outpacing the highs on many days. That is significant. This has not been a favorable harbinger in the past. Investors appear to be thrashing about looking for a safe place to hide in the stock market, refusing to broadly capitulate as of yet.

Rising interest rates, the stronger dollar, new tariffs, rising wages, and higher oil prices do not favor profit margins for many companies going forward. PPG had this to say last week:

> “In the third quarter, we continued to experience significant raw material and elevating logistics cost inflation, including the effects from higher epoxy resin and increasing oil prices,” Michael McGarry, PPG chairman and CEO said in a statement on Monday (10/8).
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> “These inflationary impacts increased during the quarter and, as a result, we experienced the highest level of cost inflation since the cycle began two years ago. Also, during the quarter, we saw overall demand in China soften, and we experienced weaker automotive refinish sales as several of our U.S. and European customers are carrying high inventory levels due to lower end-use market demand.
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> “Finally, the impact from weakening foreign currencies, primarily in emerging regions, has resulted in a year-over-year decrease in income of about $15 million. This lower demand, coupled with the currency effects, was impactful to our year-over-year earnings and is expected to continue for the balance of the year.”

With more earnings reports rolling in, it seems these themes are becoming more common.

We are now 116% long and 74% short with a flat net equity exposure. Closed-end bond fund holdings comprise a 38% total position (11% municipals, 3% TIP’s, 5% mortgages, and the remaining 19% in diverse sectors). We are using options to increase short equity bets. Bond funds and precious metals stocks have become quite inexpensive relative to the broader equities market, but we remain patient for now.

Why have many hedge funds produced 2-3% annual returns in recent years as indices rallied strongly? It is more about growth stocks outperforming value stocks in such an historically unusual fashion than it is about market direction. When the most expensive or lowest quality stocks continue to massively outpace those which are better value, it makes it difficult for funds like ours that base their strategies on the convergence of relative valuations to profit. We simply don’t expect the mania to continue with a tightening Fed and/or waning investor confidence. We do expect stock selection to return to being based on investment merit, not on popularity or index weighting.

Central bank liquidity will continue to be removed for now, causing market spasms that should grow more pronounced in coming months. That will likely cause a continuation of the current repricing of risk assets. While the Fed seems resolute in its tightening policy, we expect it to reverse course once global equities have suffered significant losses.

We may wish otherwise, but the world is now “stuck” with a system dominated by central bank/government intervention because the powers that be simply went too far. They did not let the opportunity to assume further control during the last crisis slip through their hands. There is little value in “denying” that central banks fundamentally damaged the workings of the free market system. That does not mean volatility won’t continue to re-assert itself. “Night” does follow day, and it will “play tricks” on the unprepared.

Sincerely,

Scott E. Brown, CFA