The Equus Report

—BY BARNABY LEVIN

T.G.I.F.

October 12, 2018

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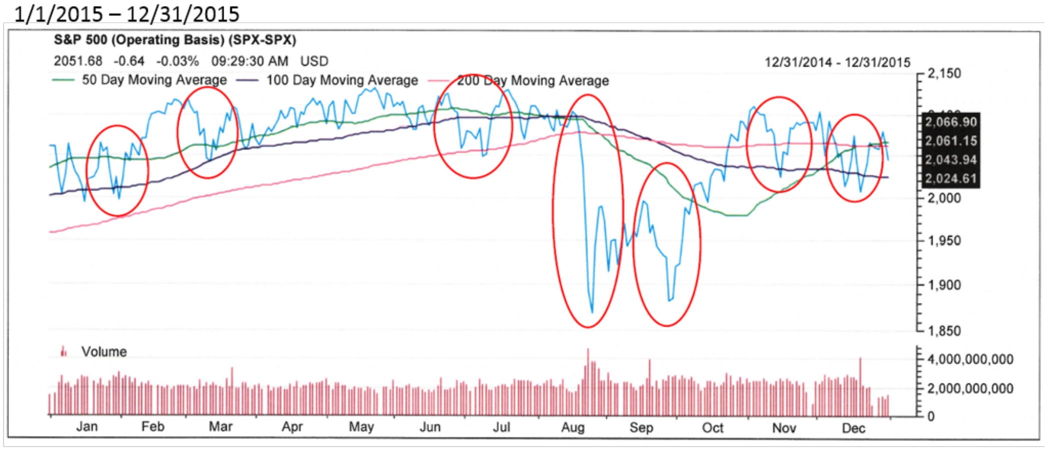
The purpose of these Articles is not only to share my Outlook and let clients know where things stand, but also to provide them the framework within which we are managing their money as that outlook will clearly influence our decisions. It gives us an opportunity to make sure (in this fast-changing world) that we remain philosophically aligned and, if not, open a dialogue so we can come up with ways to make sure that we *are* going forward.

Again, we serve our clients in many ways, from referring great CPAs and Estate Planning Attorneys; to annual Tax Planning and Charitable Giving; to discussions about Career in which we offer perspective about trends that might affect their direction or choice. We help them determine how to fund their children's College Education and, sometimes, deal with issues regarding their Parents. And, of course, there's always Real Estate. We do all this to help them make sound, financial decisions while (like Howard Marks of Oaktree Capital) constantly worrying, ourselves, about everything we *don't* know!

That said, we have predicted for some time that Quantitative Easing, Zero Interest Rates and taking on massive amounts of Debt would not end well and leave, not only Japan, but also the EU and US in untenable positions unless something (as with the environment) is done soon. In our case, this certainly won't happen until *after* (*if* then) the November elections, but the challenge of reversing course – knowing it will be a painful process, given the necessary cutbacks in Entitlement Spending and cost of servicing our enormous Debt as interest rates rise – will have a potentially serious impact on the markets and result in Unintended Consequences that will affect us all in profound ways.

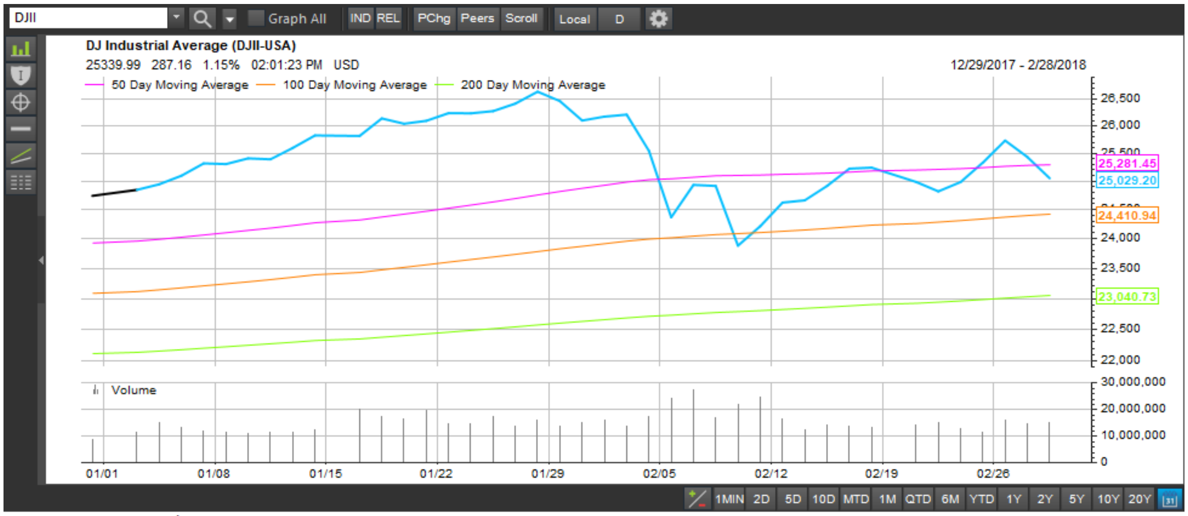
In recent articles, I have also warned that we should now ***expect*** and be *prepared for* more of these periodic sell-offs in which, after taking the Escalator up, we take the Elevator down as some "***un***expected" event roils the markets like they did in 2011 and, more recently, 2015.

1/1/2015 – 12/31/2015



Source: FactSet

Last February, soon after the Fed had transitioned from Janet Yellen to Jay Powell as Chair, it was the sudden spike in "Volatility" caused by the January jobs report that showed wage growth up 2.9%. This stoked fear of inflation and, in turn, concerns the Fed might raise rates more rapidly than anticipated.



Source: FactSet Research Systems, Inc.
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But what made the fall so violent (as the Dow dropped 1,600 points above) was that, *last* year, the VIX (or "Fear Index") remained so ***low*** for so long that more than $2.6 Billion in highly-leveraged, Arbitrage-related, mutual funds[1] and ETFs positioned themselves on the premise that volatility would ***remain*** that low "forever" and, when this "trade" suddenly reversed, there was no one willing to take the other side of their "bet" as they stampeded for the exits and many imploded.

Source: FactSet Research Systems, Inc.
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[1] "Volatility Returns: Exploring the Reasons and What Happens Next," Sean Hanlon, Advisor Intelligence, Feb 6, 2018

Over time, things calmed down and the dust settled until the end of September, when Chair Powell made Hawkish comments, removing the word "accommodative" from the FOMC's Minutes and suggested that things are <u>so</u> good, in fact, the Fed might, *indeed,* raise rates faster than expected[2] and, thereby, *fulfilled* the fears the market had back in *February*.

Source: FactSet Research Systems, Inc.
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As a result, markets began to fall and, as they broke through various, Technical support levels, the selling accelerated, as can be seen in the following chart of the S&P

Source: FactSet Research Systems, Inc.
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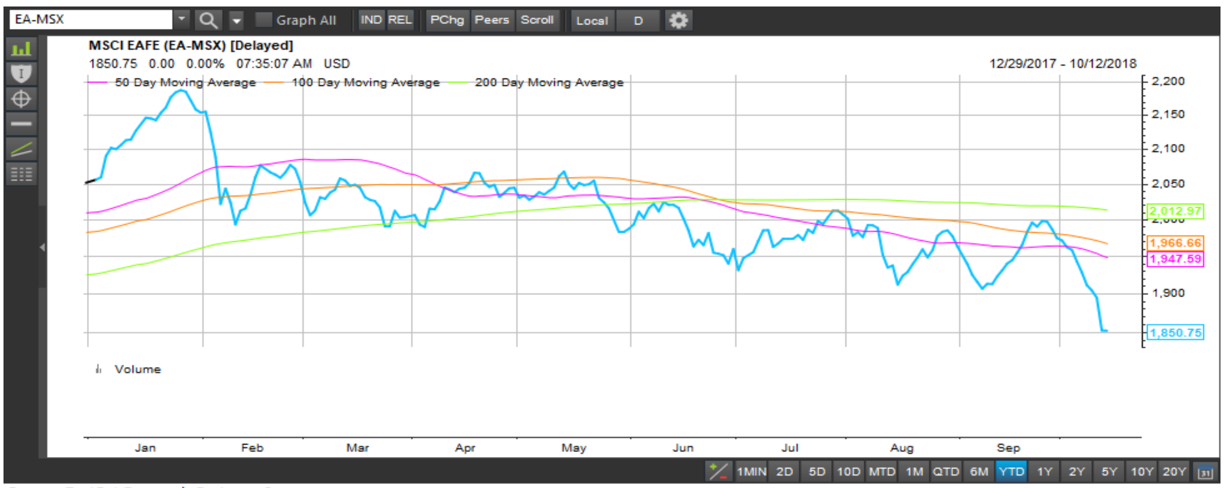
[2] FOMC Press Conference, September 26, 2018

THE EQUUS REPORT

—BY BARNABY LEVIN

Over the last few years, markets have been like a bathtub, with the "water" constantly washing from side to side, which is why most pundits recommend diversification and periodically rotating into undervalued assets, like Commodities and Emerging Market equities seemed to be earlier this year. But only if one had the foresight to *buck* Consensus (and simply buy the S&P) did they do better than most active Managers who tried to balance risk through thoughtful, Asset Allocation that consisted of *more* than "just" stock. *This* year, most *other* major markets have done poorly with, for example, the MSCI EAFE down -7.1% and the MSCI Emerging Market index down -17.6% year-to-date...



Source: FactSet Research Systems, Inc.

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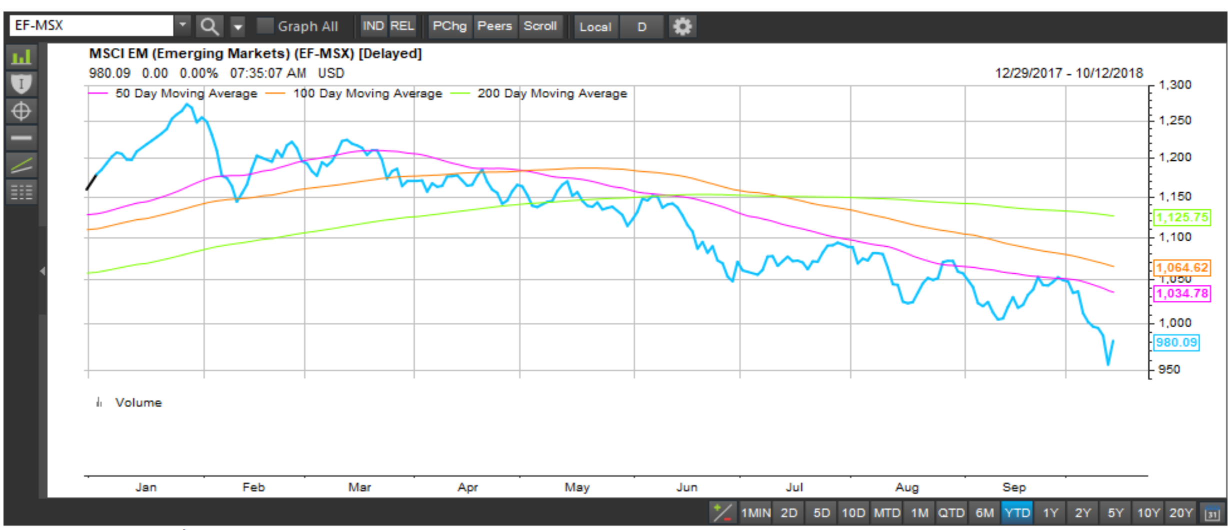

Source: FactSet Research Systems, Inc.

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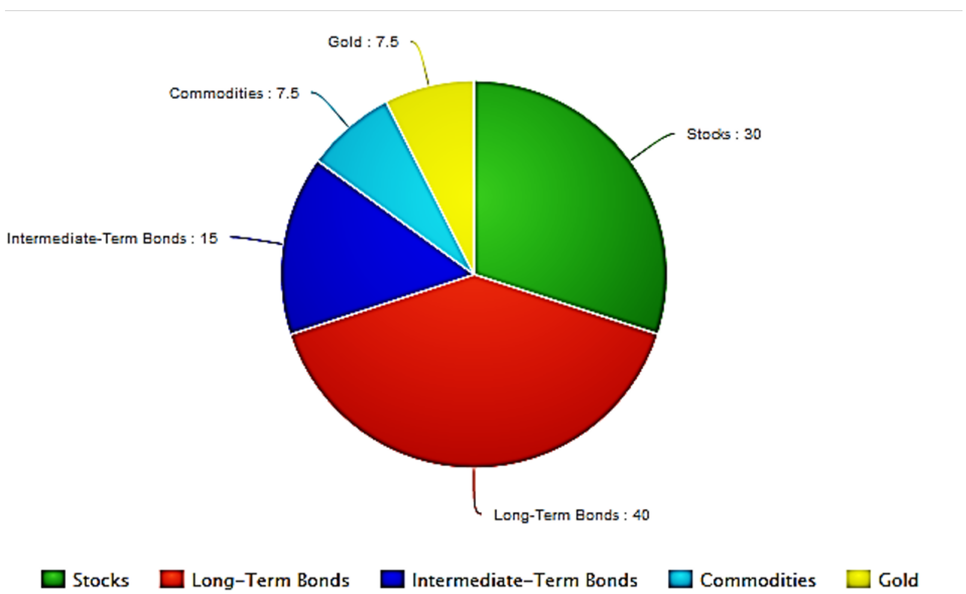
…while the ***Yield*** on the 10-year Treasury – typically considered a "Safe Haven" in times of stress – has risen from 2.41% to 3.25% as people sold bonds; bond prices *fell*; and the Barclay's Aggregate Bond index is now down -7.6%, while Gold (after being up nearly 8% in 2017) is down -6.6% as well.

Source: FactSet Research Systems, Inc.

In 2014, in his book "Money: Master the Game," Tony Robbins asked Ray Dalio (Founder of the world's largest hedge fund, Bridgewater Associates) to recommend the "ideal" Asset Allocation, which Ray chose to dub his "All Weather" portfolio as follows:

Ray Dalio's All Weather Asset Allocation



Source: Robbins, Anthony, *MONEY: Master the Game*, New York, Simon & Schuster, 2014

Unfortunately, with 55% in bonds, this Allocation hasn't fared so well this year and it seems that "all weather" *ain't* necessarily so…

So, again -- until a few weeks ago -- US stocks were the only “game in town” and the heck with “Diversification.” It sounds easy enough – except for the fact that markets have, for so long, been lulled by an accommodative Fed and other Central Banks have all been using the same monetary tools that, now, are coming to an end. One by one, they are removing the “back-stop” or “Put” of “Quantitative Easing,” designed to hold interest rates down while forcing investors into more aggressive (often inappropriate) assets in the hope this would stimulate growth. *This* time however – with easy Monetary Policy close to an end -- Hedge Funds may not feel quite so emboldened to pile back in the first chance they get, as they have in past years. We’ll have to wait and see.

And the question -- if one ***does*** want a “Balanced Portfolio”— remains: how does one avoid or cushion the impact of these periodic falls without sitting in Cash and facing the headwind of a 0% return, like some have done, and when highly-regarded folks – from Ray Dalio to Jeff Gundlach, David Tepper and Stan Druckenmiller – have shifted to a more “Risk-Off Posture” as war with China is no longer out of the question. This has been an ongoing challenge and conundrum for most Money Managers since bonds haven’t been the answer and, this year, have fallen along with a lot of other assets, including REITS.

Geopolitics are clearly playing a greater role in driving both economies and markets than at any time, perhaps, over the past 50 years and conflicts are increasing *between* and *within* countries as the number of “populists” from the right *and* left are increasing relative to more-moderate people who may be inclined to find compromise in a spirit of unity. The most critical conflict, of course, is the one between us and China and, by now, it should be clear that it is more than a simple “trade war.” There are deep schisms developing between our two Nations, ranging from theft of intellectual property to rules of ownership; from influencing elections to embedding microchips to spy on and, one day perhaps, take control of machines and systems; from near-collisions in the South China Sea (which China believes to be its Sovereign territory, along with Taiwan) to currency manipulation, with the yuan down nearly 10% versus the dollar over the past nine months. And, while a world free of tariffs and trade barriers certainly sounds nice, it will probably never happen because China – as the second largest economy in the world – clearly aims to be number one and is led by a strong Leader who is serving for life and the only hope in this stand-off is that both sides will ultimately sit down at the table because it is in their mutual interests to find a middle ground. One cautiously optimistic note in this regard recently came from Don Luskin (Chief Investment Officer at Trend Macro) who wrote about “Our Knife at China’s Throat”[3] in which he speculates that, given our success with Mexico, Canada, South Korea and soon (fingers crossed) the EU, the pressure is building on China and, as they become more and more isolated, the odds of a deal are actually getting *better*: “Remember,” he says, “China doesn’t *want* to change voluntarily. It takes pressure and China will only negotiate for peace when it looks like war is inevitable.”

Again, with interest rates so low, it has been difficult to be bullish on bonds. But we have felt uncomfortable being so far from “Consensus,” which believes people should always have 10-15% (or more) of their portfolio in them, regardless of yield. So, it’s fortunate we recently found a Manager who specializes in Direct Lending to smaller companies where there’s an untapped need, through a broad, portfolio approach, with short-term, *floating*-rate loans; strong covenants; and warrants that, in the event of a merger, offer some upside to an otherwise fixed-income approach and an average 3- /

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[3] Trend Macro “Macrocosm,” October 8, 2018

maximum 5-year duration. This is interesting for clients who can tolerate illiquidity for a meaningful time and meet Accredited Investor criteria. I also think we must continue to maintain a significant Cash position to serve as an Opportunity Reserve as it gives us the ability to take advantage of any sell-offs in our concentrated portfolio of Blue Chip, Global Gorillas. And, while it has performed poorly year-to-date, I think we should maintain our 5-10% allocation to Gold and Silver, in line with what Dalio recommends. Instead of his allocation to *long*-term bonds, however, I feel more confident maintaining our current, 40-50% *equity* exposure – in Operating Companies that pay Dividends, which typically increase each year – for now, while continuing to look for other, "non-correlated" assets like the Fixed Income manager above; Real Estate; and Best-in-Breed Hedge Funds like Millennium. None of these will hedge our exposure to equity itself, but they should provide a counter-balance and protection for that part of our portfolio if things start to unravel.

Regarding Hedge Funds in general, we found in February that it requires *truly* great talent, resources and a stringent, institutionally-embedded, risk- control discipline and, no matter how much research you do, "you never know who's swimming naked until the tide goes out."[4] With more "Liquid Alternatives" (i.e. mutual funds), it's now clear you can only push liquidity and the threat of daily redemptions so far before a Manager loses his or her ability to deliver "alpha," regardless of strategy and, this year, they *all* took a beating with most having yet to recover. Of course, even the "Best" can and do stumble, but they always seem to recover quickly and the bottom line is that our only reason to own ***any*** of them is the expectation that, when the market falls – for *whatever* reason – they hold up *better* than the market and, if they can't, we should step aside and sell, which we did.

So, in my opinion, here's where things stand. Again, we're currently in a strong, economic expansion here in the U.S. due to the tailwinds of Tax Cuts, Repatriation and Decreased Regulation and, at least until the middle of next year, it seems that strength should continue unless things with China really unravel. Overall, therefore, we're still constructive and will be looking to add to positions that hold up best or, after falling, recover most quickly to indicate that Demand is still in control. It feels like interest rates – having broken "Resistance" – will continue to ratchet higher, which will be a headwind for stocks and we won't be in *too* big a hurry to add, at least not until we see a change for the better with China. If China agrees to any sort of meaningful reform, we'll be back and "all in." If things continue to unravel, we'll continue to raise cash to keep more of our money in reserve. And, in the meantime, here's what we'll look for in this Expansion that many believe is already long-in-the-tooth:

Step One: TRADE IMBALANCE. This starts with people, companies and governments living beyond their means and taking on debt; production costs escalating; industries moving offshore; leading to trade deficits and unsustainable, national debt. We've already gone through and passed this phase.

Step Two: FINANCIAL CRISIS. When debt levels reach a tipping point, financial systems destabilize; companies and individuals can no longer borrow money; and bankruptcies and unemployment soar. This happened in 2007 and -08 and we may be on the verge of a similar situation today if things fall through with the EU or deteriorate further with China.

Step Three: CURRENCY WAR. Governments print money to pay debts and devalue their currency, which temporarily promotes exports; discourages imports; but, ultimately, leads to a "beggar thy neighbor" outcome in which *nobody* wins. Foreign governments seem to have done this already by no longer

[4] Warren Buffett

supporting their currencies relative to the Dollar (which remains the "Global, Reserve Currency") to maintain their competitiveness in a world of tariffs and trade barriers.

Step Four: TRADE WAR. As they endeavor to steal trade from one another, governments enact more (not less) tariffs, taxes and subsidies to support their own companies and industries and global trade plunges, exacerbating the financial crisis and unemployment begins, once more, to rise. So far so good with Canada and Mexico, which was key, but we'll have to wait and see with the EU and China.

Step Five: WAR.

It feels like we're somewhere between Steps Three and Four, to which we say, **Thank God It's Friday!**

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