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The Fundamental Investor

A QUARTERLY INVESTMENT NEWSLETTER

FASTEN SEATBELTS?

Over the past few weeks cracks have begun to appear in U.S. equity markets. The question on investors' minds: Is this the beginning of a bear market or is this just a bump in the ongoing bull?

Global Divergences Cause for Caution
Global markets have diverged greatly since the start of 2018. The U.S. markets have made new record highs, albeit marginally, while other markets have struggled. Emerging markets have been hit particularly hard and developed markets, the TSX included, have had negative price performance. As a matter of fact, the TSX is at roughly the same level today as it was in June 2008.

Fiscal stimulus in America (tax cuts) has propelled an already strong economy, creating record profits and margins for corporations. While the rest of the world economy was slowing down, the U.S. has been accelerating, partly due to this fiscal boost.

Leading indicators however are telling me that the American economy maybe slowing down: housing and automobile sales, two major drivers of economic activity, are rolling over. While it is possible that other factors are influencing these two important economic indicators, it is certainly a warning sign that bears watching.

Central Banks Still Key
However, I believe the most important issue facing financial markets is monetary policy. In particular, what the Federal Reserve is doing and is planning to do.

Since the financial crisis, the Fed has been supporting financial markets, both through reducing and keeping interest rates extremely low and by performing "Quantitative Easing" (basically flooding the financial system with money). All this is now being put into reverse. Interest rates are being raised and money is being drained from the system. It is as if the Federal Reserve is slowly chocking the financial system.

These changes in policy are being done for good reason in my view. They are raising rates in order to get ahead of inflation which they see as a an oncoming threat. In fact, wage inflation statistics from the most recent employment report, confirm an acceleration in average hourly earnings, a key metric. At the same time, they need to raise rates now, while the economy is strong, so they can lower them again during the next crisis. Furthermore, they are worried that the abundance of cheap and plentiful money will cause asset bubbles, misallocation of capital which will fuel another problem in the future.

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FIXED INCOME: Death of the Bond Bull Confirmed

In our Winter'17 issue, we called the end of the bond bull shortly after the 10 year US treasury bond hit an all time low yield-to-maturity of 1.3%.

A Technical Break

The very long term trend line that bond investors have been surfing for decades was recently broken by 2018's rise in rates—see chart below. Since 1981, bond investors have ridden the steadily declining rate environment to capture well above average returns on longer dated maturities. Not too difficult a task given the strong persistence of this trend supported by aggressive central bank policy over the past 37 years.

Technical analysts are now sounding the alarm given that these broken trend lines appear to confirm that an important inflection point was hit during the lows of 2016. Furthermore, they view this break in trend as not only confirming the secular low in rates, but more importantly, that the long term secular trend has shifted (reversed) to an upward bias. Rest assured that all of the 30 and 40 something bond fund managers out there, who have seen nothing but declining rates (higher bond prices) for their entire career, will end up dazed and confused.

Technical Voodoo Aside

While many might dismiss technical analysis as a *dark art*, if we study the chart below of the10 year US treasury bond yield, intuitively it does look like rates bounced around their lows for several years and have turn upwards decisively enough to be in the process of establishing a new long term trend with an upward bias.

However, I will maintain there's still a chance that come the next recession, central bankers will respond in the only way they know how, by cutting short rates back to zero and flushing the system with more freshly printed dollars (aka quantitative easing-QE). In my mind this keeps the possibility open for new record low yields on the 10 year US treasury bond. It wouldn't surprise me to see rates below 1% or even going negative—heaven help us all—as we've seen in Europe this cycle.

Whether this can happen will depend entirely on the willingness of bond market participants to accept this *rinse & repeat* response of central banks. If the bond vigilantes take back control of the bond market, essentially taking the printing press away from central banks, which I have no doubt they can easily do, then the technicians are probably right, and we've seen the secular lows for rates.

Indeed, some believe that market participants are now back in control of bond markets. This may be true in America, but I'm not convinced that's the case in Europe or Japan just yet. I get the feeling that we will find out whose really in control of rates in 2019. If the bond markets revolt, central bankers beware!

Bond Strategy Update

For a long time we have suggested that the optimal part of the yield curve for investors has been in the 3 to 7 year range, avoiding the near zero rates paid on very short term bonds. Given that the short end of the curve has moved up substantially over the past couple of years, narrowing the spread between the 2 and 10 year bonds (i.e. yield curve flattening), we would suggest investors tighten up their maturity ladder to focus on the 1 to 5 year range. Apart from providing fewer opportunities for re-investment, longer dated bonds will continue to be negatively affected (more sensitive) as rates continue to creep higher. Indeed, to the end of October, longer dated Canadian bond indices are down 1% on a total return basis, while shorter bond indices are flat. We would expect this outperformance by the short end to continue in the coming years.

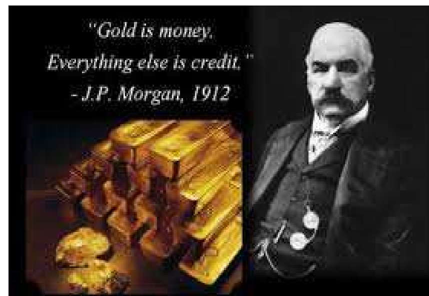
Beware of central bankers bearing gifts. Sincerely, Mark.

PORTFOLIO MANAGER: Pet Rock

Currently there is probably no more hated, and I would add, misunderstood asset class than precious metals. From a contrarian, value investor's point of view, bullion and producers, which have been in a bear market for roughly six years, represent a compelling opportunity at a moment in time when scant value can be found elsewhere and the portfolio insurance optionality they offer is virtually free.

Millennials and Gen-Z*ers* have embraced Bitcoin as their alternative to traditional fiat currency—Bitcoin is *only* down 70% from its January peak! However, I fail to see how a virtual currency is any better than a paper currency? For the children of the digital age, history lessons yet learned, gold is nothing more than a shinny pet rock. I guess every generation of investors must live through their own bubble to learn the harsh lessons of greed and mass delusion.

Buffett is Mistaken
Warren Buffett, no doubt one of the greatest investors of our time, says he doesn't *invest* in gold because it has no cash flows: it is a non-productive asset, simply a commodity. While that is true, his fundamental error is thinking of gold as an 'investment' in the first place. Gold bullion is money, an immutable store of wealth. Furthermore, other forms of money, namely the fiat currencies of the world, don't produce cash flows either: consider a large stack of $100 bills left on your kitchen table for a year.



Misconception of Money
The conventional counter argument to the above is that it would be irresponsible to leave a large stack of money lying around in such an unproductive fashion: we should simply make a deposit to a savings account at the bank to at least earn some modest return. While many would still like to believe their deposit to be money, it is not. Deposits are a liability of your bank. They are nothing more than a promise to pay. Don't believe me? Then check any bank's financial statements, you will find deposits listed under the liabilities section—the *we promise to pay section*. In fact, a bank deposit is no different than a government bond or GIC. You have exchanged your 'money' for a promise of repayment. You can also exchange your money for ownership (equity) rather than a promise to repay (debt), but neither of these items represent money. People count these things as money everyday, they are not.

Properties of Real Money
Having cash or money on the sidelines should reduce uncertainty and provide liquidity for opportunities. However, today's monetary system actually adds considerably to uncertainty. Today's money is false money. It is created at the whim of central banks and is backed by nothing more than a hope that it will continue to be a medium of exchange in the future. Central banks do not hide the fact that their aim is constant price inflation, that is, continous dilution of the money supply. It has always been difficult to define exactly what money is, other than what we all agree is to be money. However, for money to be liquid savings, a true reserve component of one's balance sheet, it must have other important properties. Portability and divisibility are pre-requisites, however these are less important in my view than Anthony Deden's (chairman of Edelweiss Holdings) criteria. He suggests that the essential characteristics of a true reserve asset must include scarcity, permanence and independence.

Today's fiat currencies do not pass the test of scarcity. They cannot be used as a long term store of value, since central banks consistently and purposefully debase them and have the power to produce an infinite quantity. In the universe, gold occurs as 0.004 parts per billion, scarce indeed. Furthermore, it is difficult to find and expensive to extract, adding to its scarcity value. Finally, it cannot be conjured out of thin air at the key stroke of a central banker's computer. As for permanence, no medium of exchange has withstood the test of time as has gold (and silver). It keeps coming back when all others fail: over 5000 government issued currencies have failed over time. What happened to the life savings of those who held this so called money when it finally failed?

Paper money eventually returns to its intrinsic value—zero", Voltaire.

Gold Miners Are Not Money
Bullion is money, miners of the stuff are not. They are leveraged plays on the bullion. While holding bullion will help preserve your purchasing power over the long term, that is all it may do. Gold miners however, have the potential for substantive gains during a crisis of confidence. Investors should own both.

Your Intuition is Not Deceiving You
Even without intimate knowledge of the minutia of monetary policy. Many of us feel that all is not quite right within our economic landscape. Was papering over the debt problems of the last crisis with more debt really the solution? How are negative interest rates even possible? How will we fund all the retirement and healthcare promises made to an aging demographic? How can house prices in Australia be 9x median household income?

Owning some gold over the next few years, prior to the next economic downturn is the right gambit. Sincerely, Mark.

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Good Intentions

While I have no doubt Chairman Powell has good intentions, these policies have negative implications around the globe. The fact that the U.S. dollar is the world's reserve currency and that much of the world's trade is conducted in dollars is not to be overlooked.

By having the world's strongest economy and hence being in a position to raise rates, Chairman Powell is inadvertently raising the value of the dollar vis-a-vis other currencies. This in turn is putting further pressure on emerging markets and their economies. In addition, by withdrawing dollars from the global financial system, additional stress is being applied to global economic activity.

The American central bank is in a tough spot, its responsibility is the American economy, however its actions affect the world. This situation is exacerbated presently by the divergence in global economic conditions. Chairman Powell has made it clear that he is serious about continuing down this path. Recent comments suggest it would take a large shock (big market decline) for him to take his foot off the pedal.

Tensions

Another irritant to market participants is the trade tariff situation. While I believe that Mr. Trump has a legitimate argument with the Chinese and some of their unfair practices, markets see trade tensions as bad for business. It looks like tensions may continue to rise before we see a meaningful resolution.

For the stock market, the timing of these various events is not great. If in fact the U.S. economy is slowing down at the same time that rates are rising, liquidity is declining and a trade war between the world's two largest economies is ratchetting higher, then you have the conditions for a drop in equity prices. Bond investors don't get much of a break either. Rising rates are bad for fixed income investments. As I wrote in this publication a few months ago "If the reason for the stock market's decline is rising rates, then there is nowhere to hide". This is a difficult time for investors.

We have always advocated being long term investors, recognizing that it is difficult, if not impossible, to time the market. We believe in buying great companies at reasonable prices and holding them over the long term. We have written in the past about the danger of trying to be too clever (trying to time the market) and how that can come back to bite you. However, if we feel there is a potential storm on the horizon, we will take action. For this reason we sold some positions recently, raising the cash portion within accounts. Portfolios are now generally positioned more defensively. Reductions were made in the more economically sensitive components, as well as securities whose valuations appear to be at or near historical peaks. Less cyclical areas such as consumer staples and health care have been maintained. Historically these sectors have proven to be more resilient during turbulent times. Despite potential short term volatility, our long term holdings in Canadian banks and pipelines, as well as large U.S. technology companies remain unchanged.

We've never claimed to posses a crystal ball, I do not know for sure what markets will do over the next 3-6 months. However, I am a portfolio manager partly because I always knew that I wanted the responsibility of these difficult decisions.

Historically bear markets occur six to nine months before the onset of a recession. At the moment, other than housing and autos there are no real signs that a recession is coming. The good news (yes, there is good news), there will be another upcycle. Either we are not going into a downturn and markets will continue higher or, there will be a decline followed by a recovery.

There are many assets whose market prices have already declined materially. Assets like emerging market indices, individual companies as well as some housing related businesses in America. Buying these assets at depressed prices will be the fuel to generate handsome returns in years to come. Some of the cash proceeds from the securities sold recently will likely be used to purchase these inexpensive assets.

It's good idea to fasten seat belts with potential turbulence ahead!...Al

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