BRAVE ASSET MANAGEMENT

Quarterly Review

October 2018

Dear Clients and Friends,

During the third quarter, the performance of individual markets again reflected their specific fundamental conditions as opposed to a global risk-on or risk-off theme. The U.S. financial markets continued to reflect the impact of strong domestic economic and profit growth with the S&P 500 index posting a total return of 7.7%, while the U.S. fixed income market was flat (as measured by the Bloomberg Barclays US Aggregate Bond Index). Emerging markets were buffeted by currency fluctuations, tightening global liquidity conditions, and slowing growth in China which resulted in the MSCI Emerging Market exchanged traded fund posting a loss of about 1.0%. Stock markets in developed countries other than the U.S. were caught in between these opposing influences and in some cases, such as Japan, posted even better performance than the S&P 500 while in other cases, such as Italy, suffered meaningful declines. The S&P Goldman Sachs Commodity Index returned 1.3% on the back of a strong recovery in energy markets during the second half of the quarter.

Market Outlook

Our market outlook remains very similar to what it was three months ago with the primary changes being that conditions in place then have generally gotten more stretched. There are many reasons to suspect that the U.S. stock market and economy are in the late innings of the current expansion, but we are still challenged in trying to determine whether it is the top of the 7th or the bottom of the 9th. At this time, nothing suggests that a bear market or a recession is imminent and we firmly believe that equities will remain the best place to invest to build long-term wealth. However, our late-cycle view does inform our equity sector weightings and fixed income credit-quality and duration exposures.

There are a number of factors influencing the U.S. and global markets.

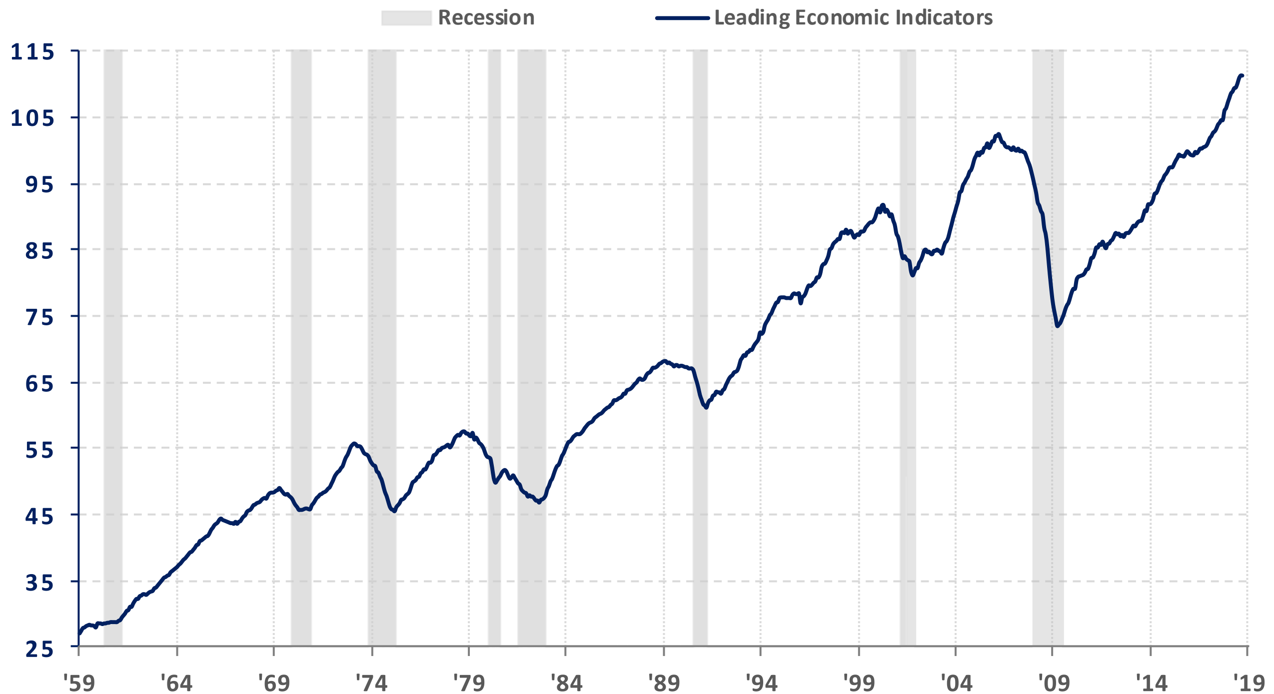
- The primary positive influence is the strong economic and profit growth in the U.S. that has been boosted this year by the significant fiscal stimulus from tax reductions and increased government spending. This has served to boost GDP growth to 3-4% from its prior level of around 2% and S&P 500 earnings growth to an estimated 23% in 2018, the best since the initial recovery from the 2008-09 financial crisis. The concern is that this pace is not sustainable and that the waning impact of fiscal stimulus, tightening monetary conditions, and rising input costs could result in a greater than expected slowdown in 2019 or 2020. However, forward looking indicators that typically signal a future recession are suggesting nothing of the sort in the near term (**Chart 1**).

- We believe the most challenging underlying financial issue in the coming months will be the growing monetary tightening by an increasing number of major central banks. The upward move in official interest rates and the reduction of liquidity at the margin will have a depressing impact on growth and valuations, everything else being equal. We are already seeing the impact in certain emerging market economies and interest-rate sensitive sectors of the U.S. economy.

Headquarters: 47 Summit Ave, Summit, NJ | (908) 522-8822 ▪ **Rhode Island Office**: 3913 Main Road, Tiverton, RI | (917) 392-9268

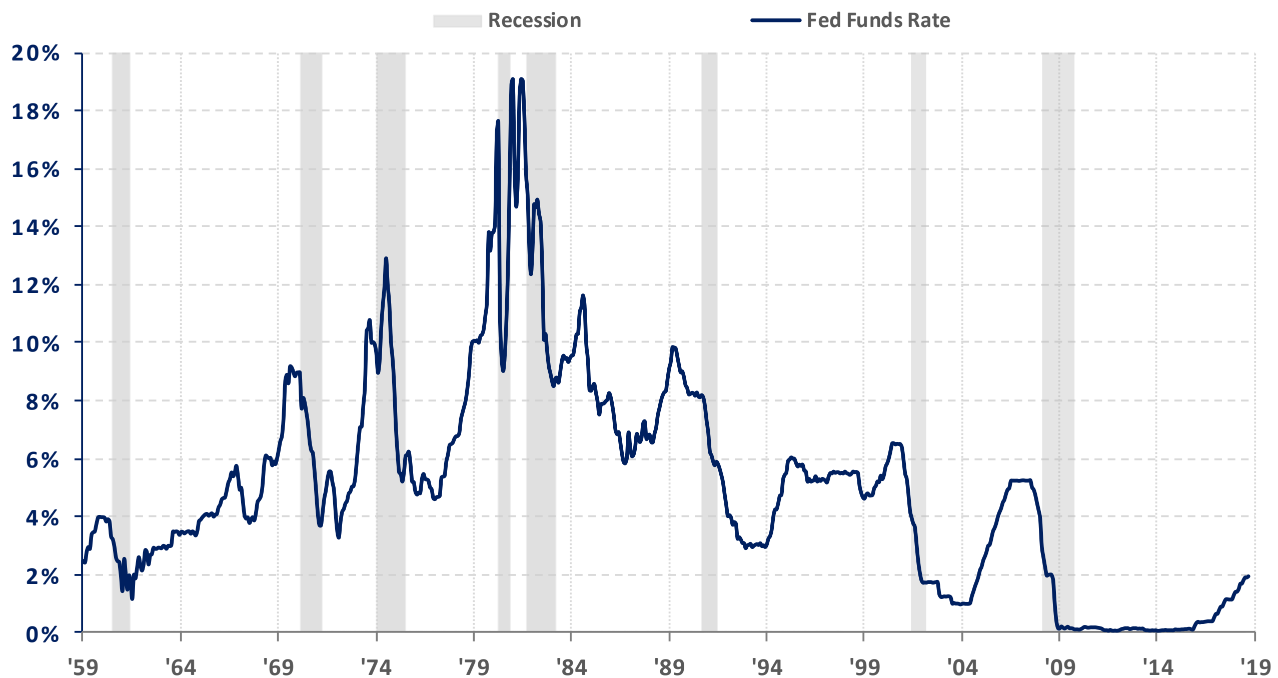
Brett Haire: bhaire@braveasset.com ▪ **David Bunting**: dbunting@braveasset.com ▪ **Scott Morrison**: smorrison@braveasset.com

Chart 1: Commerce Board's Index of Leading Economic Indicators with Recessions



As a refresher, the Federal Reserve shifted its monetary stance to tightening in December 2015, when it increased the Federal Funds rate for the first time in almost ten years. The interest rate increases to date total 200 basis points. Current expectations are for an additional 100 basis points of tightening through the end of next year. The Fed has also been shrinking its balance sheet for the last year with the pace set to accelerate to $50 billion per month this month. Some economists estimate that the effect of these two policies will equate to total tightening of approximately 500 basis points, which would be the most since the early 1980s when Paul Volcker was trying to lick runaway inflation. As you can see on **Chart 2**, this magnitude of tightening has always brought on a recession.

Chart 2: Historical Federal Funds Rate with Recessions



Several other central banks have or are expected to join the Federal Reserve in beginning to tighten monetary policy conditions. The Bank of Canada has raised rates four times since the middle of 2017. The Bank of England raised interest rates this summer for the first time this cycle. The largest central bank providers of liquidity, the Bank of Japan and the European Central Bank, have reduced their pace of bond buying and the latter is expected to end its program altogether in December of this year.

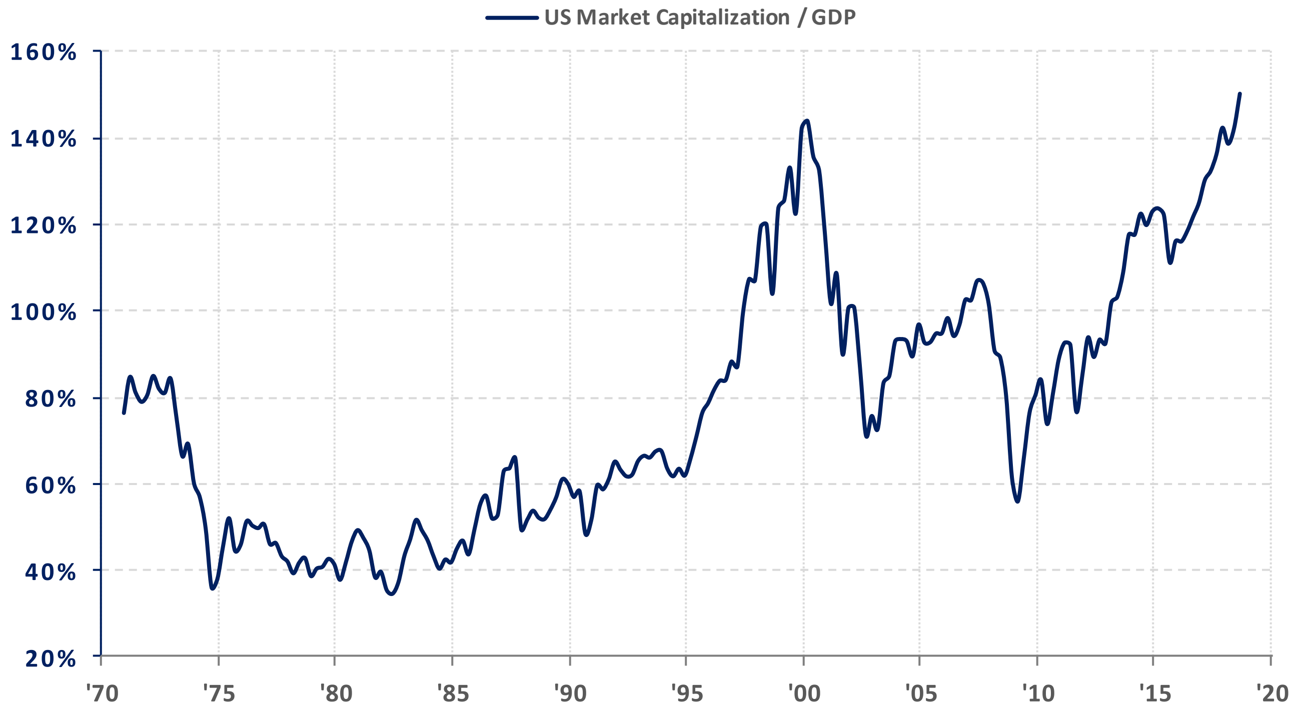
- In the area of politics, trade and the mid-term elections are potential wildcards. President Trump has been successful in getting to new trade agreements with Canada, Mexico and South Korea, and the odds seem to favor a constructive resolution to negotiations with the EU. The situation with China, though, appears unlikely to be headed for a quick solution and is a greater risk to global and U.S. growth depending on how things play out.

The outcome of the upcoming mid-term elections seems increasingly to favor a Democratic House and a Republican Senate. Despite ushering in an even more rancorous atmosphere in Washington, a split Congress would likely be viewed by markets as a relatively benign outcome as current economic policies would remain in place. The surprises would be Democrats taking both houses, which would likely be viewed bearishly by markets, or Republicans retaining both houses, which would likely be seen as bullish.

- Market valuations are mixed. The S&P 500 is currently trading at roughly 17.9 times estimated 2018 earnings, which is only slightly above the historical average. However, there continues to be an argument that on some other measures, markets are at historically rich levels and euphoria has begun to appear. The percentage of companies going public this year that are losing money is at the highest level since the dot-com peak. The spread between the yield on high-yield bonds and Treasuries is at the narrowest level since 2007. **Chart 3** shows the updated CAPE price to earnings multiple relative to the last 100 years of history. This measure attempts to account for inflation and compares current prices to a multi-year measure of earnings. On this basis, the market is about as expensive as it was in 1929 and is only surpassed by the time around the 2000 peak. **Chart 4** shows an updated picture of the value of the stock market relative to the total economic output of the country as measured by Gross Domestic Product (one of Warren Buffett's favorite valuation indicators). With the strong performance of the stock market last quarter, this measure has now surpassed the highs from the internet bubble.

Chart 3: Long-term Historical Cyclically Adjusted PE Ratio with Recessions

Chart 4: Wilshire 5000 Total Market Capitalization to Annual Nominal GDP



Current Portfolio Themes

Our portfolio themes remain focused on shifting exposures to investment opportunities that outperform during slowing economic growth and/or offer compelling valuations relative to some of the more expensive areas of the markets. We recognize that those changes could cost some near-term relative performance as the bull market continues, but we believe gradually moving to a more defensive posture is the correct thing to do for the intermediate term given our late cycle view of markets and the economy.

There are several themes that we think offer opportunity in the environment we envision over the next couple of years. The first is to favor value stocks over growth stocks in our equity portfolios. In recent decades growth and value stocks have tended to enjoy long periods of relative outperformance (**Chart 5**). Growth outperformed value from mid-1988 until early 2000; value then outperformed until mid-2006. Since mid-2006, growth has enjoyed a period of outperformance that is now several months longer than the 1988-2000 period. There is nothing to say that the recent underperformance of the FANG stocks and growth stocks more generally is the start of a major trend, but we believe that the opportunities in the universe of value stocks have become very compelling relative to growth stocks.

Headquarters: 47 Summit Ave, Summit, NJ | (908) 522-8822 ▪ **Rhode Island Office**: 3913 Main Road, Tiverton, RI | (917) 392-9268

Brett Haire: bhaire@braveasset.com ▪ **David Bunting**: dbunting@braveasset.com ▪ **Scott Morrison**: smorrison@braveasset.com

Chart 5: Russell 1000 Value Index Relative to Russell 1000 Growth Index

We continue to look for opportunities to increase exposure to stable, high-dividend stocks. We believe that in many cases they represent attractive value compared to other parts of the market and are not dependent on strong economic growth to maintain their earnings growth and dividends. Examples include the Consumer Staples (which is comprised of companies in industries such as food, beverage, household products, and food/drug retailers) and Utilities sectors. Both of these groups have been significant underperformers in recent years (**Charts 6 and 7**).

Chart 6: Consumer Staples Sector Weight as a Percent of the Total S&P 500

Chart 7: Utilities Sector Weight as a Percent of the Total S&P 500

Commodities are attractively valued relative to equities as they remain near multi-decade lows on a relative basis (**Chart 8**). This is against a current commodity market backdrop of steady global demand growth and limited supply increases which should translate into higher prices. Commodities have also tended to enjoy strong late cycle performance.

Chart 8: S&P GSCI Total Return CME Index / S&P 500 Total Return Index

A final theme is to remain alert for opportunities to extend the duration of a portion of our fixed income exposures. Keeping minimal exposure to duration and credit risk continues to be our primary fixed income strategy, but as economic growth peaks the risk of further significant declines in the bond market diminishes. We still do not see value in the long end of the Treasury market, but we view some other areas of the fixed income world as becoming increasingly more attractive. One such candidate is preferred stocks, which are a hybrid equity/fixed income security that offer relatively high yields (currently in the neighborhood of 6%) and favorable tax treatment.

Headquarters: 47 Summit Ave, Summit, NJ | (908) 522-8822 ▪ **Rhode Island Office**: 3913 Main Road, Tiverton, RI | (917) 392-9268
Brett Haire: bhaire@braveasset.com ▪ **David Bunting**: dbunting@braveasset.com ▪ **Scott Morrison**: smorrison@braveasset.com

Other Services

BAM is happy to help you get a better understanding of any life insurance policies owned by you or your family members. Life insurance can serve some important roles in the financial life of a family: it can provide security to surviving family members in the event of an untimely passing of a caregiver and/or breadwinner; it can be part of a financial legacy for survivors; and it can provide an efficient answer for estate tax issues. However, life insurance is often a complicated and opaque financial product that is usually not well understood by most people, including the owners of the policies.

We have insurance brokers in our network who understand these policies. We are not licensed to sell life insurance and do not receive any compensation, but we are able to get you a second opinion on your current coverages at no additional cost to you. A review will include an opinion on whether you have the appropriate type, whether the premiums are too high, and whether you are over or underinsured. It will be totally up to you whether you want to make any changes to your coverages after enjoying the information learned in the review.

Clients are sometimes pleasantly surprised by what these reviews reveal as there are often cost savings or additional features that are available. One client was able to exchange a $350,000 whole life policy for a new $500,000 policy with an added long-term care rider (which allows the insured to tap into the tax-free death benefit to pay for qualified services related to a disability, chronic illness, or old age) at no additional cost. Another couple discovered that they could exchange whole life policies that they had purchased for their children which required annual premiums until the children turned 65 years of age for new policies with twice the death benefit but required only ten years of premium payments.

Company Developments

We are happy to announce that Lisa Campanelli joined us on October 1 in the Summit office as a part-time administrative assistant. She will be working closely with Suzie and the rest of the team to help us provide even better service for our clients.

We are proud to report that Yiorgos learned in September that he passed the third and final exam to earn the Chartered Financial Analyst (CFA) designation. Earning the CFA is a very rigorous process that consists of extensive learning and studying and three six-hour exams. Only about 20% of people who embark on seeking the CFA end up finishing it and there are only about 150,000 CFA charter holders globally.

We are working on upgrading a couple major aspects of our technology over the balance of the year. One project, moving our data from servers to the cloud, should be invisible to you. The other should provide an enhanced client experience: we will be transitioning from our legacy reporting software system to a new system called Envestnet Tamarac. Among the improved features will be a client portal that will be accessible from your computer, iPad, or smart phone. Stay tuned for further information on this in early 2019!

Administrative Items

We will be mailing out IRA distribution paperwork for those clients who have not taken their 2018 RMDs as of September 30, 2018. When you receive the paperwork, please review, make any necessary changes and then return to our office for further processing.

As a reminder you can access your account using NetXInvestor or the NetXInvestor app. NetXInvestor will provide you with daily account balances and your realized gains and loss reporting to date. If you would like to access your account using NetXInvestor please call the office and we will help you get set up with login information.

As always, we welcome your comments and questions. Please don't hesitate to call, visit or email at any time.

Scott, Brett, & Dave

Headquarters: 47 Summit Ave, Summit, NJ | (908) 522-8822 ▪ **Rhode Island Office**: 3913 Main Road, Tiverton, RI | (917) 392-9268

Brett Haire: bhaire@braveasset.com ▪ **David Bunting**: dbunting@braveasset.com ▪ **Scott Morrison**: smorrison@braveasset.com