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January 31, 2019

To Our Clients and Friends:

The Monthly Letter covers three topics this month. First, we provide our Global Economic Overview. With Global Rebalancing accelerating against a backdrop of troughing global growth, global relationships are poised for rearrangement as the realities of the global economy steamroll all opposition. Second, the stock markets bounced mightily from their fall swoon. However, the environment resembles more and more the late 1960s, with its ups and downs going nowhere. In addition, investors are likely to feel the hangover from technology valuations that resemble the late 1990s. This combination could deliver a one-two punch to investors over the next few years. And Third, as always, we close with brief comments of interest to our readers.

Dragon Recessions, The Setting Sun, Elephants Politics, The Lion in Stride, A Real Beat, The Old Man Stumbling, and The Summit Approaches

Global rebalancing continues to accelerate. For now, this represents only an assault on the economic relationships set up under the WTO (World Trade Organization). Ultimately, this will lead to a wholesale rearrangement of the global political order. This latter will occur as the economic and political order set up by the victors of World War II and the Cold War continues to crumble under the reality of a world in which the Emerging Markets represent the majority of world economic output. This reality stands in contrast to the assumptions behind many of the rules under the WTO as well as the World Bank which still provides Emerging Market Countries significant advantages compared to Developed Countries. For example, China continues to benefit from rules under the World Bank which consider it an Emerging Economy. As the second largest or perhaps the largest economy in the world, depending how it is measured, such special status stands inappropriate in light of the size and development status of its economy. Given economic reality, there stand numerous outdated rules, institutions, and relationships that will break under this weight.

China, which stands at the epicenter of these changes, will face the full gale force of this coming storm as the United States and other Western economies respond, for the first time, to the economic warfare waged against them over the past 20 years. With just the limited actions the US took over the past year, China's economy took a blow as the strategy it followed over the past 30 years to grow its economy came under assault. And with the US and other Western countries viewing Made in China 2025 as a significant economic and strategic threat, actions to stymy its success and limit its reach will accelerate. While the US and other countries began to move against Chinese technology companies over the past year, such as ZTE and Huawei, more actions will occur as Developed Economies move to protect their intellectual property and shut Chinese firms out of their markets. The most likely scenario sees Chinese

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technology products systematically shut out from Western markets and manufacturing, that does not find itself re-domesticated for National Security reasons, moved to other nations. While these developments will not occur overnight, they will produce a long term drag on China's economy, reducing its growth significantly. (For more details, please see *The Great Game of Power: Trade Networks & The Rise of Mercantilism, The Re-Emergence of the Cold War, & The Return of the Yellow Peril* originally published on December 31, 2017.)

With long term growth slowing due just to its rivalry with the US, China's economy faces two other massive problems in its Debt to GDP and its Industrial Overcapacity. They are both intimately linked to each other. Since the 2008 – 2009 Recession, China stepped on the Investment lever whenever its growth slowed. This ensured the country met its growth targets. However, this left China with massive overcapacity, as it built plants when the economics said not to do so. Reflecting this reality, China's Productivity Growth stands at less than 1% according to several major banks and less than 0% according to several well-respected private economics firms, such as The Conference Board. Whichever is correct, growing the economy at over 6% with no population growth, little to no productivity growth, and no internal demand to absorb the production creates assets unable to produce a return. Due to this, China funded over 100% of its growth through debt guaranteed either implicitly or explicitly by the government. This meant that Debt to GDP rose massively despite the country's rapid reported GDP growth, currently sitting at over 260% of GDP. This style of growth stands similar to the Potemkin Villages that Soviet Russia built to meet its growth targets. A couple of examples will make this clear. With auto sales in China running ~28 million in 2018, including both passenger and commercial vehicles, overall capacity in China stands at almost 60 million units. Despite this, China continues to build new auto plants. In steel, despite US tariffs and European safeguard quotas, China's production of steel rose 10% in 2018. In addition, according to government forecasts, Chinese steel capacity, despite pledges to rationalize its massive production, will rise in 2019 by almost 10%.

Given China's growth targets, changing its behavior to address this major economic issue will not come easy. Most analysts of Chinese debt estimate that 25% to 35% of the debt is non-performing. As a result, China possesses numerous Zombie Banks and Zombie Companies starring in a modern reprise of Night of the Living Dead. Were international accounting standards applied to Chinese banks and companies, a significant portion of the banking system would be declared insolvent and a significant number of companies would be declared bankrupt and liquidated. To admit to this, would require a major recapitalization of the banking system as well as shuttering a significant portion of the Chinese economy. Neither of these appears palatable to a Chinese leadership focused on social stability.

To understand the costs of addressing just the banking system, a quick look at what occurred in other Asian countries can prove illuminating. When South Korea faced a similar crisis, the recapitalization of the banking system ultimately cost the government 31% of GDP. When Indonesia faced a similar crisis,

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the recapitalization of its banking system ultimately cost the government 57% of GDP. With China a $14 - $15 trillion economy and debt at $39+ trillion, whatever the number, it will prove massive. To prop up the banks today, without recapitalizing them, and to fund the loan growth in 2019 to underpin more Investment spending, as China sits in a recession despite reporting more than 6% growth, the regulators authorized insurance companies to buy perpetual debt of the Chinese banks. This will provide the banks liquidity. And to make this regulatory asset palatable and not bankrupt the insurance industry, the Chinese regulators declared that the insurance companies can use these perpetual bonds as collateral with the central bank. While this may provide liquidity to fund short term growth, this does not address the cost of rationalizing the systemic overcapacity in the economy. While China continues to build out industries where it is not yet self-sufficient, such as medical devices, China will complete their buildout by the early 2020s. At that time, with no more industries to build out, growth should slow massively, putting huge pressure on the country.

Despite this future, China's leaders once more stepped on the Investment lever over the past few months to counteract what would be called, anywhere else, a recession. These measures included cutting Required Reserve Requirements, lowering taxes, authorizing more Local Government Debt, increasing infrastructure spending, and more. All told this stimulus adds up to more than 5.5% of GDP, with more expected. This should, by the second half of 2019 at the latest, exhibit a positive impact on the economy. However, the true government budget deficit will rise to over 11% of GDP. And, despite hitting some growth target of 6% or more, Debt to GDP will continue to rise. While it may push out the day of reckoning, it does not mean that it does not rapidly approach. And with a global recession likely in the early 2020s, just in time for China to finish building out every industry, growth will come under massive pressure creating huge issues in the banking system. And this will occur on top of economic pressure from the US and other Western countries. With China attempting to stave off the inevitable, Dragon Recessions will produce more and more pain as the heat of the Dragon's flame approaches.

For Japan, which hitched its export growth to China over the past decade, the benefits of this relationship may no longer outweigh the costs. In the short term, companies such as Nidec reported a collapse in orders in Q4, feeling the full brunt of China's recession. As Chinese stimulus begins to impact its economy this year, Japanese companies should benefit from the turn. However, as China matures in the early 2020s, there exists insufficient demand elsewhere to take up the slack. In addition, the move by China to a more militaristic posture with aggressive moves against Japanese held islands in the East China Sea will force Japan to underwrite an expansion of its military. This will put further strain on its government budget and its Debt to GDP. At the end of 2017, Japan's Government Debt to GDP stood at 236%. By the end of Q1 2019, it is expected to hit 254%. While the Japanese Central Bank continues to monetize the debt, eventually such a strategy will create issues for the economy. For example, the VAT, which stood at 5% in 2013, will reach 10% in 2019. Inflation, which currently stands close to zero, will eventually rise to reflect all the pieces of paper being printed by the

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government. Lots of other good things like this will occur. And should interest rates ever rise, the ability of Japan to service its debt will come into question. For Japan, the Setting Sun will bring a night with potential nightmares for the average Japanese citizens.

In India, which sits where China stood two decades ago, fundamental growth drivers stand abundant. And thus, India's reported economic growth of over 7% appears realistic unlike China's growth numbers. Reflecting this growth, areas such as air conditioners, water heaters, capital spending, manufacturing orders, and retail sales continue to exhibit strong growth. However, with a national election ahead and the ruling party under pressure, politicians will act like politicians unable to resist the temptation to meddle with the economy to goose growth, despite its positive fundamentals, to boost their election prospects. Thus, government pressure on the Monetary Policy Committee led to a 25 basis point cut in interest rates with more expected in 2019. In addition, the government engineered an 8% trade weighted depreciation of the rupee in 2018. When it comes to the levers the government directly controls, the F20 budget moves to hand out largess to voters by providing cash transfers to farmers. This stands similar to actions by numerous African democracies, whereby the government hands out cash in an election year. Of course, at some level, there exists a government budget with revenues and expenses. For India, the official budget deficit stands at a mere 3.5% of GDP and looks quite reasonable. But that number belies the true deficit as it does not include "Off Balance Sheet" borrowing. Somehow, if the government borrows money but does not include it in its balance sheet, it does not count. When the budget includes this debt, the countries budget deficit rises to 8.5% of GDP. And even that number understates reality. In order to get to this number, the budget assumes tax growth well in excess of recent trends. For example, GST collection grew less than 7% over the past six months, yet the government assumes it will grow 25% over the next year. And while personal taxes grew 16% this year due to increased tax enforcement against the underground economy and the currency changeover, the government assumes 20% growth next year. Lastly, the 8.5% of GDP deficit excludes SOEs. With Elephant Politics in ascendance, Indian growth should remain strong in 2019, with the unpleasant consequences of these actions put off to some future year that does not include national elections.

African growth continues to chug along. With $2.2 trillion in stated GDP and over $6 trillion using PPP (Purchasing Power Parity) growing overall at 3% to 5%, depending on the year, the continent's impact on global growth continues to rise, especially given its 1.25 billion population. Numerous countries, such as Tanzania, Senegal, Ethiopia, Ghana, Kenya, …, are expected to grow above 5% in 2019 and even Nigeria is expected to grow above 3%, despite the drop in oil prices. And while a number of economies remain resource focused, quite a few have diversified away from these areas in order to create a more sustainable growth platform. By 2030, a number of countries, assuming they maintain their growth, will reach middle income status, putting them on a path to create the same type of growth

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that China experienced over the past 20 years and India currently experiences. With The Lion In Stride, this continent bears careful watching for the future.

While official data look great one month and mediocre the next in Brazil, on the ground data indicate a fundamental recovery of the economy. Carrefour, the large French hypermarket company, possesses significant operations in Brazil. These stores just reported an acceleration to over 10% same store sales growth in Brazil for the fourth quarter. America Movil, the Mexican wireless company, reported growth of 1.2 million post-paid subscribers here while mobile ARPU increased over 10% year over year. They commented that even pre-paid subscribers rose, indicating a broadening out of the economic recovery. Brazilian farm equipment sales continue to soar. January tractor sales rose 73%. Combine sales rose 66%. Even if the numbers are adjusted for the 20% drop in the prior year, assuming it did not occur, sales for both tractors and combines stand ~35% above their January 2017 level. Given the massive drop in the Brazilian currency, making Brazil's soybeans hypercompetitive globally, such economic statistics make sense. In addition, Foreign Direct Investment (FDI) remains strong, which should come as no surprise due to the currency move. Underpinning this fundamental growth stands a new government focused on reforming the excesses of the government and adopting more pro-business and pro-economic growth policies. For Brazil, the music grows stronger as the economy exhibits A Real Beat.

For the Old World, economic growth continues to disappoint, as the shackles of the Euro coupled with the slowdown in China prevent the Continent from sustainably growing. Italian GDP shrank in Q4 with no better outcome expected in Q1. Germany's Industrial Production (IP) fell year over year in Q4 at a 4% to 5% rate. While the official political excuse points to the auto changeover testing to meet emission standards after the diesel emission scandal, the real culprit hides a continent away, in Asia. Foreign Manufacturing Orders fell almost 5% in November with December no better. With German IP comprising almost 25% of the country's GDP, German growth likely turned negative in Q4 as well despite reporting 0% growth. Combined with a negative Q3 GDP report, Germany likely experienced a recession. While the French can maintain their elan under almost any circumstances, their economic growth took a hit from the difficulties in Italy and Germany coupled with Brexit. French IP turned negative year over year in September and never looked back. French Q4 GDP grew less than 1%. And if one wishes to understand the Mouvement des Gilets Jaunes (Yellow Vests), one need look no further than the economic numbers. This type of economic result for the major European economies on top of the "robust" results of the past five years will continue to put increasing strain on the political bonds in the EU.

And with the EU attempting to impose its will on countries over their national governments, the breaking point appears close. Already, Britain headed to the exits. The next most likely attendee to leave the movie theater is Italy. With Italian growth worse than that during the Great Depression, the

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populace continues to grow restless. And the latest actions of the EU will only increase their restlessness. The EU treated Italy harshly on their budget deficit while giving France a pass. This differential treatment did not go unnoticed by the citizenry. At the opposite corner of the EU, Poland stands aghast as the actions of the European Commission on electricity exhibit gross insensitivity to the nation's electric market. For those unaware, the EU created CO2 Permits in order to push electric production towards non-carbon, green energy sources. For whatever reason, CO2 Permit prices rose over 70% in 2018. For Poland, this created a disaster. Over 80% of Poland's electricity comes from coal/lignite and Poland's electric companies needed to buy these permits at any price. To prevent Poland's citizens from bearing the cost of these EU permits, the government capped electricity prices and provided compensation to electric producers so they did not lose money. This seems a reasonable approach in light of a market discontinuity. The European Commission does not agree with this and appears ready to challenge these actions as illegal state aid. Whether the Italian budget deficit or the Polish electricity market, frictions within the bloc continue to grow as the EU attempts to impose its decisions on countries and those decisions infringe on basic national sovereignty. With the Old Man Stumbling both economically and politically, the EU comes closer and closer to flying apart.

For the US, the actions of the Federal Reserve coupled with the slowdown abroad, in Asia and Europe, represent a significant challenge to the economy, much as occurred in 1998. Numerous economic data points to underlying weakness in the economy. And while observers point to the Trump Administration pressure on the Federal Reserve for a change of heart in monetary policy in January, the early look at the actual data, prior to their publication, likely skewed the Federal Reserve to the side of caution, as the data undermined their case for continued tightening in monetary policy. These data include Housing, Exports, Manufacturing, and Unemployment or, more simply put, almost every area of the US economy. And while some of this can be laid at the feet of the government shutdown, much of it finds origin in either the tightening by the Federal Reserve or the economic turmoil outside the US. The following chart on Existing Home Sales makes clear this point:

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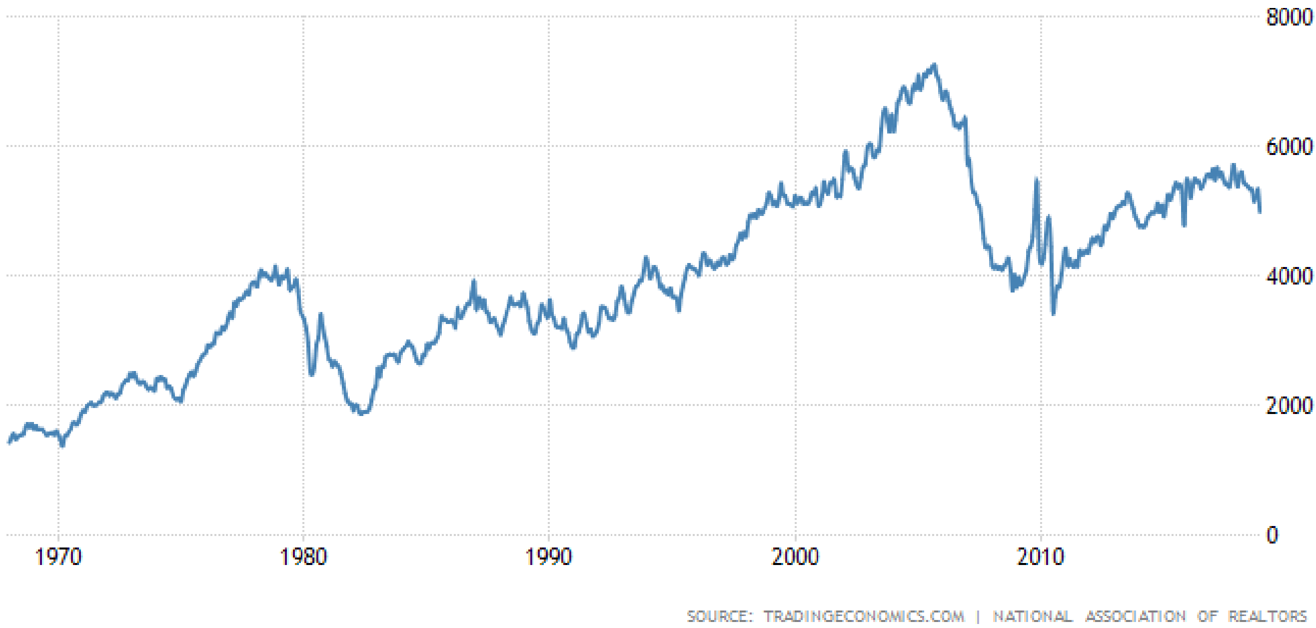

Chart courtesy of tradingeconomics.com.

As the chart makes clear, Existing Home Sales appear to have peaked for this economic cycle. And while the recent pullback in mortgage rates may cause a short term pickup in home sales, as first time buyers are very sensitive to mortgage rates, Existing Home Sales will remain under pressure as limitations on the mortgage interest deductions as well as the State and Local Tax (SALT) deduction for federal tax purposes impact the economics of housing on the two coasts as well as in other select markets.

And while the US will benefit from the massive stimulus in China, with its spillover effects globally, as well as a more accommodative central bank, the sequence of economic events in 2019 looks more and more like 1967, 1988, and 1999. In those years, the US economic cycle, after bear markets triggered by Federal Reserve tightening, went on extension. However, the extension was brief, lasting 2 ½ Years on average. After which, the inevitable plunge into the deep freeze occurred. While there are many reasons why this length of time occurs, it generally comes down to the lag between cause and effect. There are a number of economic cycles within the economy. And, when enough of these cycles crest and move into the downcycle together without other parts of the economy to offset them, the economy shrinks in what is more commonly called a recession. As the above chart indicates, Housing has moved into a late cycle position, where, at best, it will move sideways. In addition, autos appear in a similar position, whereby they will not add to economic growth as the following chart indicates:

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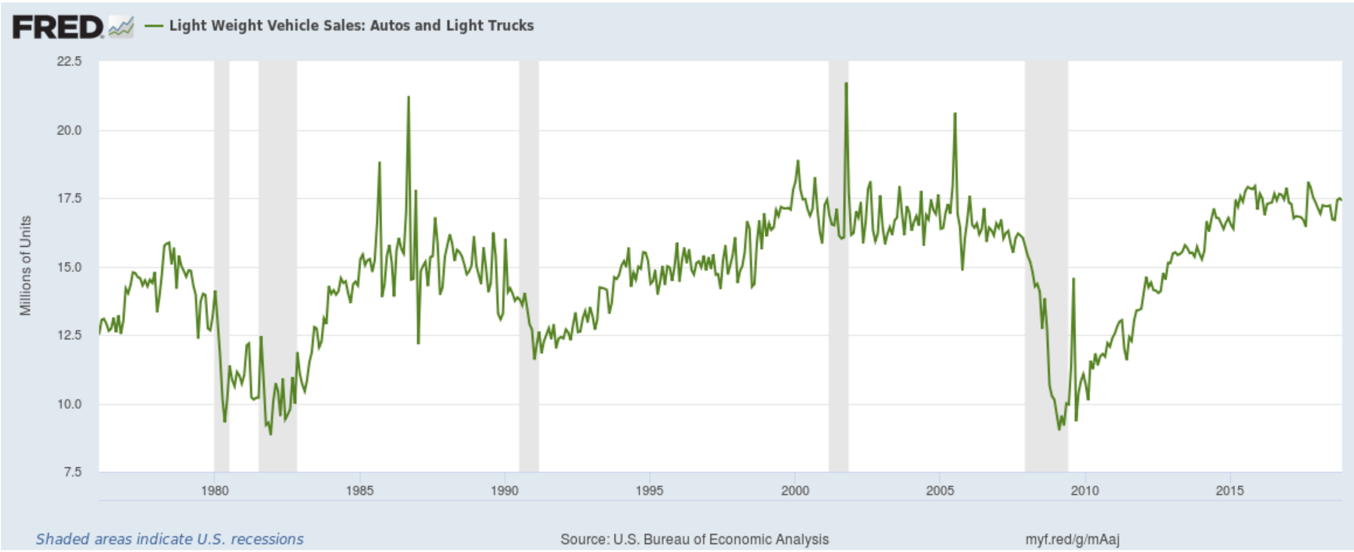

Another area that typically adds to late cycle growth, but appears near its peak, is Commercial Real Estate Construction. As the following chart from the Federal Senior Loan Officer Survey in January 2019 indicates, loan demand for CRE Loans, has peaked:

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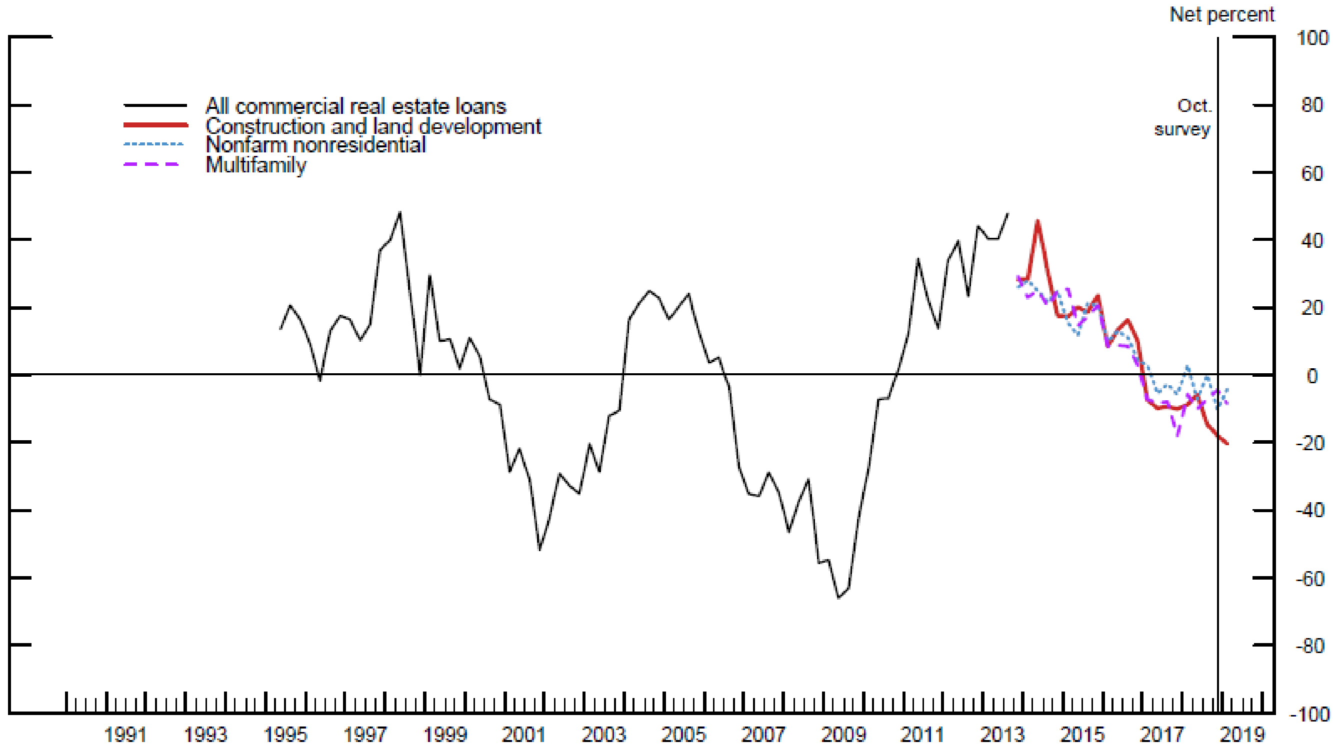
Net Percent of Domestic Respondents Reporting Stronger Demand for Commercial Real Estate Loans



With Real Estate and Autos done for the cycle, this leaves only a few areas to maintain economic growth. They include Government spending, Corporate Capital Investment, and Consumer Spending. With the tax cut for the Consumer coupled with the typical late cycle increases in real incomes, Consumer Spending will stay strong as long as Employment grows. For Corporations, Capital Spending remained inordinately low this cycle. While some spending by certain sectors, such as Defense or Steel is in the works, in general this area has not driven growth at all. The following chart shows Real Investment into Manufacturing Structures:

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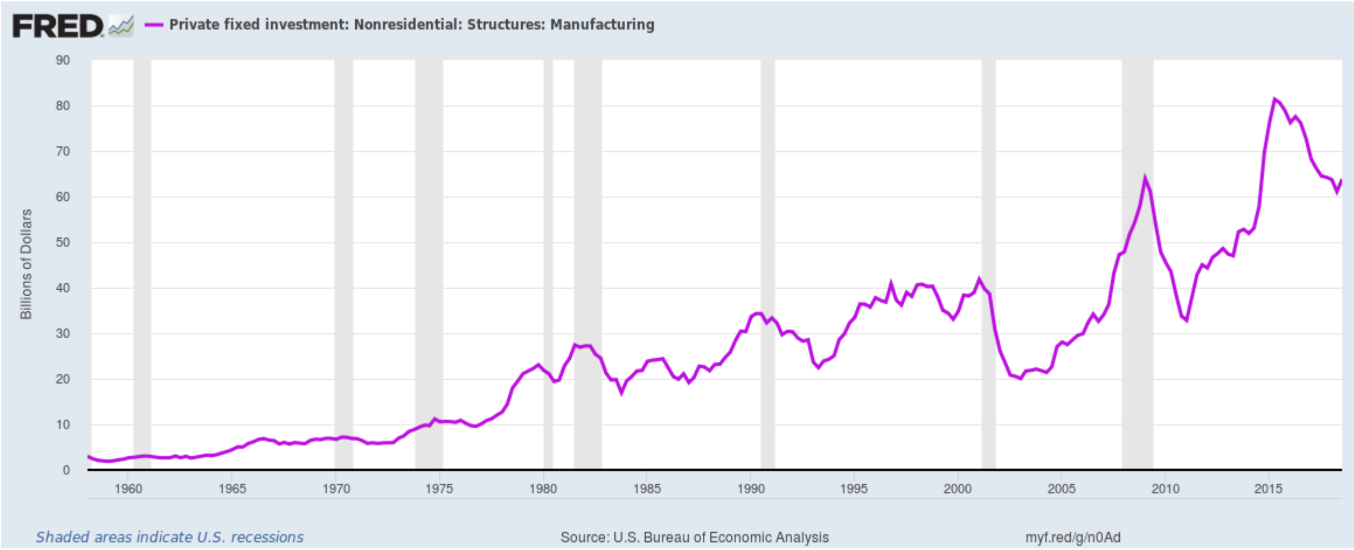

As the chart unfortunately demonstrates, Real Corporate Manufacturing Investment stands no higher than in early 2009, almost a decade ago. (While nominal spending has risen, it merely rose in line with inflation.) Given the growth in the economy, this is a disappointing result. And, given the massive tax cuts large corporations received to foster investment in the economy, this decision by the Fortune 1000 to buy back stock and not invest into plant and equipment, as Congress intended, is even more disappointing and will have real world consequences. But that is for another day. In addition to the lack of Manufacturing Investment, other Investment Cycles, such as heavy duty trucks, appear to have peaked while technology spending on areas such as the cloud appears to be experiencing decelerating growth based on company reports. This leaves the Federal Government and the Consumer to carry the baton for the economy. Federal spending will head higher for now, as automatic payments under Social Programs rise with the number of retirees and the significant increase in Defense spending continues through 2021. However, should there be a changing of the guard in 2020, there likely will be a change in direction starting with the Fiscal 2022 Budget, with less defense and higher taxes. Thus, this leaves the Consumer carrying the load. As long as corporate profits hold together, employment should continue its upward course. But, once the Federal Reserve begins to raise rates again to slow the economy, the slowdown will likely lead to the classic late cycle margin squeeze. In response, corporations will cut back spending and cut back people. This will put an end to the Consumer, leaving the economy one direction to follow.

With the US economy moving into extra innings, the countdown clock has begun. However, there still remains time before the buzzer sounds, likely in 2021. With the Government and Consumer carrying the baton for the final laps, the economy should make it through the normal late cycle extension despite

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the international noise and the lack of corporate capital spending. Beyond the end of this cycle stands a brave new world that likely will look different than the past two decades. But, until then, the US should make The Climb To The Top. (Data from US Census Bureau, Federal Reserve, OECD, Eurostat, company reports, and public sources coupled with Green Drake Advisors analysis.)

The Equity Markets: A Visit to the 1990s and A 1960s Springtime At The Bourses

> "*Every great crisis reveals the excessive speculations of many houses which no one before suspected, and which commonly indeed had not begun or had not carried very far those speculations, till they were tempted by the daily rise of price and the surrounding fever. The case is worse, because at most periods of great commercial excitement there is some mixture of the older and simpler kind of investing mania. Though the money of saving persons is in the hands of banks, and though, by offering interest, banks retain the command of much of it, yet they do not retain the command of the whole, or anything near the whole; all of it can be used, and much of it is used, by its owners. They speculate with it in bubble companies and in worthless shares, just as they did in the time of the South Sea mania, when there were no banks, and as they would again in England supposing that banks ceased to exist. The mania of 1825 and the mania of 1866 were striking examples of this; in their case to a great extent, as in most similar modern periods to a less extent, the delirium of ancient gambling co-operated with the milder madness of modern overtrading. At the very beginning of the adversity, the counters in the gambling mania, the shares in the companies created to feed the mania, are discovered to be worthless; down they all go, and with them much of credit.*
> *The good times too of high prices almost always engender much fraud. All people are most credulous when they are most happy; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity. Almost everything will be believed for a little while, and long before discovery the worst and most adroit deceivers are geographically or legally beyond the reach of punishment. But the harm they have done diffuses harm, for it weakens credit still further.*
> *When we understand that Lombard Street is subject to severe alternations of opposite causes, we should cease to be surprised at its seeming cycles. We should cease too to be surprised at the sudden panics. During the period of reaction and adversity, just even at the last instant of prosperity, the whole structure is delicate. The peculiar essence of our banking system is an unprecedented trust between man and man; and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it.*"

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Chapter VI: Why Lombard Street Is Often Dull, And Sometimes Excited
Lombard Street: A Description of the Money Market
By Walter Baghot, 1873

For those who missed the period from late September to mid January, little changed in the stock markets. Stocks declined marginally, but not out of line with the deterioration in fundamentals. Earnings projections remain positive for 2019 and valuations have slightly compressed. However, for investors who lived through this period, the markets took them on a wild ride, more reminiscent of a roller coaster at Six Flags than a placid pond. Most investors probably reached for the Dramamine more than once or twice and left feeling somewhat nauseous.

However relatively flat the performance of the markets over the past 5 months, appearances can be deceiving, as underneath the surface of the markets, all is not well. Margins compressed for the market as a whole, as cost pressures began to rise. International economies slowed or shrank, impacting the 50% of earnings that are sourced outside the US. And revenue growth slowed with more to come. While the Fed change in policy direction from tightening to neutral in January was viewed positively by the markets, the Federal Reserve does not move away from tightening for no reason. Leading indicators show further deceleration ahead with recent economic data providing harbingers of what may come. And the US Dollar, coupled with foreign economic weakness will likely put pressure on corporate earnings projections. The issue for the 2019 expected earnings growth for the US markets can easily be shown via the following chart:

	S&P 500	*MSCI EAFE*	*MSCI Emerging*
Expected EPS Growth Vs. Expected Nominal GDP Growth	*1x – 2x*	*<0.5x*	*<0.4x*

Data from Bloomberg.

In other words, US Markets appear to price into the average stock a relatively optimistic outcome. This is despite a slowing economy. And this is despite currency issues, as the US Dollar continues to rise against the Emerging Market Currencies. The easiest way to see this is the drop in EM currency values against the US Dollar:

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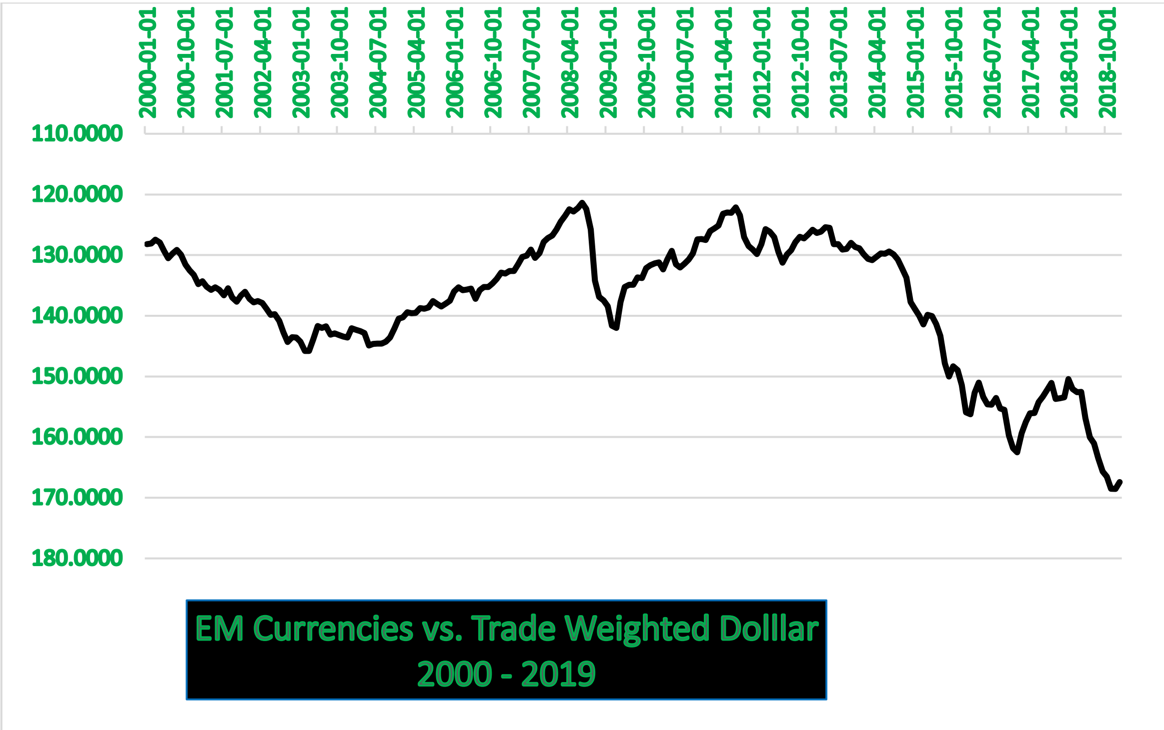

Data Courtesy of Federal Reserve Economic Database, St. Louis Federal Reserve Bank.

And while it is true that the currencies of Europe, Japan, and Canada remain within their traditional long term bands, almost 60% of trade occurs with the Emerging Markets. Thus, to discount their impact would be inappropriate.

In addition, to the above short term issues, there is the longer term issue of valuation. The easiest way to view this issue is Robert Shiller's CAPE Ratio (Cyclically Adjusted Price Earnings Ratio). The CAPE along with numerous other indicators, such as Equity Market Value to GDP, the Buffet Indicator, or Tobin's Q, continue to flash Red, based on long term valuation:

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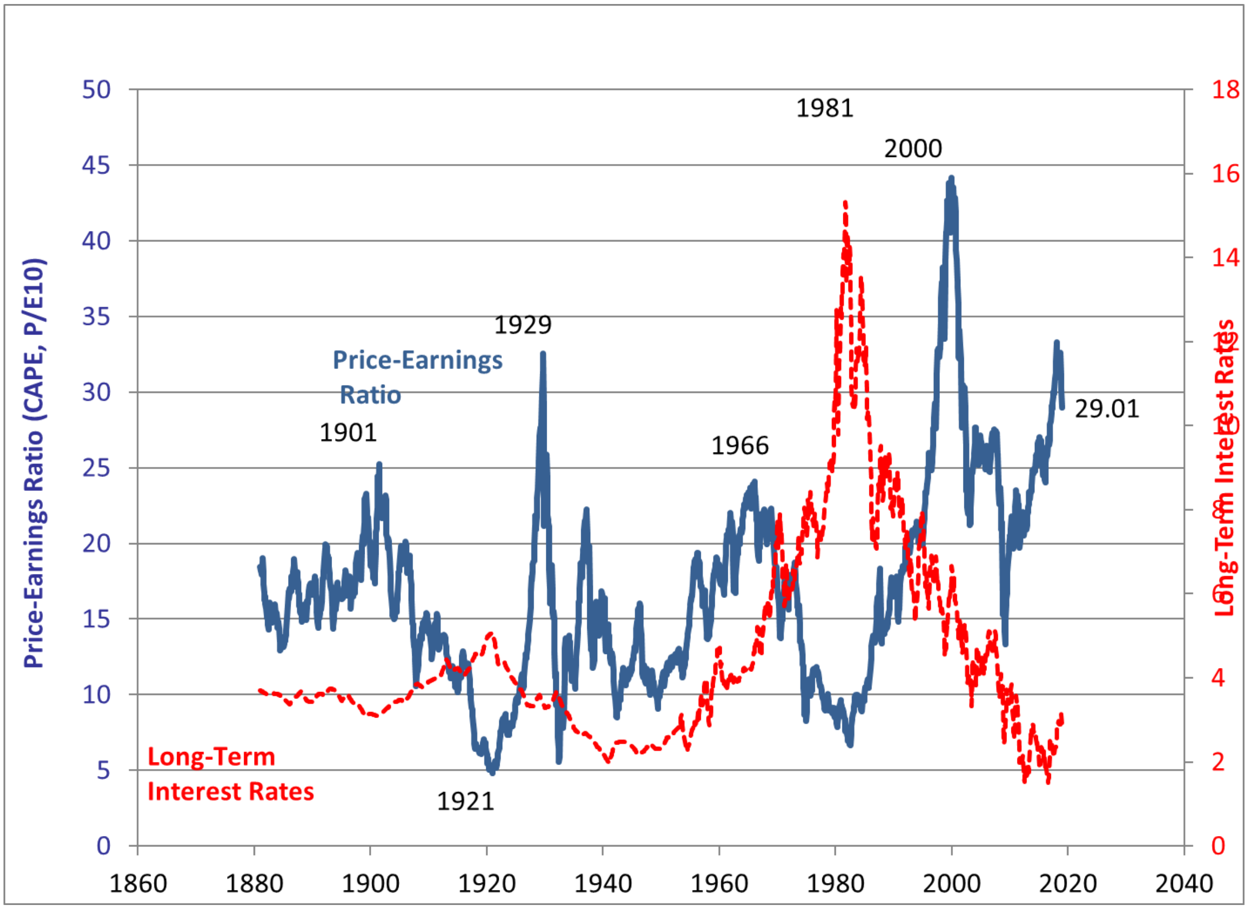

Chart Courtesy of Robert Shiller, Yale University.

Readings, such as these, correlate with very low to no increase in the markets over a decade. So, buy and hold investors can expect compound returns, including dividends, of 3% - 5% over the next 10 years. This, of course, will come with significant volatility, as the markets typically volatility is 15% over the long term. With the majority of the public having now indexed to the market via Index Funds and ETFs, the public stands positioned in just the right manner for the past 10 years, but likely in just the wrong manner for the investing environment ahead over the next decade. (Please see *Everyone In The Pool: Indexing, ETFs, Smart Beta, and Quant Strategies* from July 31, 2017 and *The Cult of Indexing: All Hands on Deck, 1960s Ahead* from January 31, 2018.) This would be similar to their move into mutual funds in the late 1990s, when those products came to dominate the investment scene.

In addition to this, the stocks of the growth companies, that have led the market upward over the past decade, bear eerie similarities to those of an earlier growth stock era in the 1990s. The easiest way to see

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this is by looking at Amazon. It, like Cisco in the 1990s, led the market over the past decade, providing outsized returns to investors with its stock reaching over 100x forward earnings at its peak last year. Today, that is down to a mere 70x to 80x forward estimates depending on the earnings assumed. This is similar to the path that Cisco demonstrated. Cisco came public at a split adjusted price of $0.06 per share in 1990 and reached $1.87 by 1995 with a market cap of $9.5 billion. The company then went on a 5 Year acquisition spree that drove its stock upward. Eventually, the value of the company peaked at $588 billion in March of 2000 or $78.22 a share. Of note, actual earnings in 2000 were $0.50 per share. So, the stock traded at almost 160x forward earnings. Of course, the stock then crashed spectacularly in the ensuing bear market. The following chart shows this incredible ride for investors and the aftermath:

Chart Courtesy of Yahoo Finance, www.finance.yahoo.com .

Not surprisingly, earnings crashed as well, with the company earning just $0.10 per share in 2001. Below is the chart of Amazon's stock:

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Chart Courtesy of Yahoo Finance, www.finance.yahoo.com .

What is striking is how this chart resembles the Cisco chart from 1990 – 2000. One can note how Amazon's stock, in just six short years from 2012 – 2018, went up over 8x. This is similar to the rise in Cisco from 1997 – 2000, when it rose over 8x as well. With Amazon's fundamental growth slowing, it appears a correction in the stock has begun as the stock now must wait for earnings to catch up. This would be similar to the problem that Cisco experienced back in 2001, when Cisco's growth slowed and the stock crashed. The stock spent over a decade waiting for earnings to catch up before moving sustainably higher. Despite this catch up by corporate earnings and the sustained move upward since 2016, Cisco's stock price remains below its 2000 peak. (For those who wish to view a major technology company that exceeded its 2000 peak, the long term chart of Microsoft would illustrate this. It took the company a mere 16 years to exceed its 2000 peak.) For Amazon today, its stock appears in a similar position, as a number of years must pass before earnings can catch up to the stock price. The only question is how long. Other current market favorites, such as Facebook, appear to be tracing out similar paths. Given the performance of the market leaders, it appears the markets are making a Visit to the Late 1990s with an early 2000s reprise ahead.

Despite the historical valuation data noted above; the real questions about future earnings for the market; and a potential peak in the growth stock prices of the market leaders of this bull market, the US markets appear to be taking a nostalgic ride back into the 1960s with the ups and downs of the markets and the vicissitudes of global Central Banks following a similar path to those years. A quick review of the

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historical record will illustrate this point. After tightening in 1966, the US Federal Reserve panicked due to the 21% drop in the stock market. As a result, it ended its tightening and actually eased policy starting in late 1966 and continuing through the first part of 1967. Of course, the markets responded by undoing their drop of 1966 and going to new heights. However, in a classic stop-start pattern, the Federal Reserve started to tighten again in late 1967 and continued to squeeze through 1968, this time going too far and producing the 1969 – 1970 Recession. As a result, the markets traced out the following pattern:

Chart courtesy of Yahoo Finance, www.finance.yahoo.com.

As is clear from the above chart, the markets stood at the same place in 1970 as they did in late 1965. And while the markets did go briefly to new heights in late 1968, this proved unsustainable in the face of Federal Reserve actions.

In 2018, the markets dropped almost 21%, a similar amount to 1966. With the Fed putting its tightening on hold early this year, the markets have basically recouped most of their losses. Should the Fed continue this policy or possibly ease, Chinese stimulus prove effective, a deal on trade occur, and Europe act to stimulate its economy, the markets could potentially rise back to their prior highs or even exceed them over the next eighteen months as global economic growth reaccelerates, in a similar fashion to 1967 – 1968. However, with low US unemployment and wages accelerating, the Federal Reserve likely would resume tightening sometime in 2020, assuming growth reaccelerates bringing along higher inflation, just as occurred in the back half of 1968. This time, as in other prior episodes, the Fed would likely go too far, precipitating a recession. This would create the inevitable bear market. Thus, the market level in

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2022 might look like the market level in 2017. This would be similar to the period from 1965 – 1970, whereby the market provided a 0% price return over 5 Years and all return came from dividends. For investors who have indexed their futures to the markets, this would come as a shock. If, in addition, inflation picked up, the markets could end up providing them a Negative Real Return, as occurred from 1965 to 1970, with the potential for a decade to follow like the 1970s. Not quite what the Indexing Doctors ordered. With the current Federal Reserve appearing to follow a similar pattern of stop-start policy and inflation once more starting to pick up, it appears to be A 1960s Springtime for the Bourses once again. (Data from Robert Shiller at Yale University, Federal Reserve of St. Louis, Yahoo Finance, Bloomberg, and company reports coupled with Green Drake Advisors analysis.)

Those Golden Years, No Place Like Home, and Iron Man To The Rescue

Finally, we close with brief comments on Those Golden Years, The Portable Home, and Iron Man To The Rescue. First, the Baby Boomers continue to age into retirement. From only 48 million people in the US 65 years or older in 2015, this number is expected to increase 52% by 2030 and reach 73 million people. For businesses catering to the elderly, it will be Those Golden Years. Second, despite the pullback in Home Sales in the US, Manufactured Home Sales continue to grow. That is due to their relatively modest price point at just half of a single family home. In 2018, it is estimated the industry shipped over 100,000 units for the first time in over a decade, making up over 15% of the estimated New Homes Sold in 2018. For manufactured home companies, there is No Place Like Home. And, in the realm of science fiction visits the real world, Gravity Industries of the UK appears to have developed a powered armor suit. This suit allows the user to fly through the air in controlled flight using a heads up display. Given this development, it soon will be Iron Man To The Rescue.

In Closing

Should you have any questions on how the above issues or the items discussed in our accompanying cover letter impact your family's financial position or your business's future as well as the potential actions you could take in response, please do not hesitate to contact us. We welcome the opportunity to discuss this with you.

Yours Truly,

Paul L. Sloate
Chief Executive Officer
& Senior Advisor

Steve Rodia
President
& Senior Advisor