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February 15, 2020

The Monthly Letter covers three topics this month. First, we provide our Quarterly Global Economic Overview. The Global Economy stands in a late cycle position. The spectre of Coronavirus stands over the globe. However, standing athwart the ship is the end to the Global Inventory Correction. This coupled with global Central Bank stimulus, an upturn in the U.S. Housing Cycle, and increased spending in China, should enable the Global Economy to weather the virus and to reaccelerate in the second half of the year. Second, we review the Equity Markets. The Equity Markets look more and more like a cross between the 1999 – 2000 Tech Bubble and the Late 1960s Nifty 50. Various historical data indicate these types of valuation starting points typically lead to poor long term returns. And Third, as always, we close with brief comments of interest to our readers.

The Beginning of the End

For the Global Economy, Late Cycle stands as a euphemism. The Global Economy sits in Extra Innings, as governments attempt to prevent the inevitable back half of the cycle. Each side continues to bring in their relief corps of pitchers. However, the ability of the pitchers to handle the batters coming to the plate continues to deteriorate. And the likelihood of one of them hitting it out of the park continues to rise. In China, despite multiple rounds of required reserve cuts and additional fiscal stimulus, economic growth continues to slow. The economy then took it on the chin from the Coronavirus, in what appears a boxer's Standing 8 Count. While the economy will bounce back once the quarantines are lifted, as the Chinese government likely will do whatever it takes, with the boxer already woozy, the next blow likely will lead to a knockout. In the US, the Federal Reserve reversed course from its policy of raising rates and pulling money out of the economy, as it became clear that continuing down this path would cause a recession in an election year. However, with unemployment low and resources tight in the economy, typical negative late cycle issues have shown early signs of rising from the mud, where they have lain dormant. As they continue to come into view, the Federal Reserve likely will reverse course once more. And, unfortunately, this likely will occur at the same time as many of the natural economic cycles roll over after a long expansion. In Europe, nationalism continues to rise as the European experiment continues to produce economic goose eggs. The latest elections from Ireland and Germany continue this trend. And with the EU beginning to disintegrate, economic issues will continue to come to the fore. Despite the appointment of Madame Lagarde to head the ECB, the populace continues to grow restless with the pitchforks getting sharpened. For the Emerging Markets, troubles in China will create troubles at home. With many EM economies betting their futures on China, the long term problems there coupled with a secular growth slowdown will reverberate across the EM globe. While in the near term, post-virus, the Global Economy will mount a snapback, creating strong global growth in H2 after a weak Q1 followed by a mediocre Q2, these forces,

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already set in motion, represent the Beginning of the End for the Global Economic Cycle, with the short trip to the summit ahead followed by the long trip back down the mountain.

Dragon Sickness & Recovery & Dragon Sickness Again

For China, the Coronavirus illustrates the competing demands on the government. Initially, the government attempted to hide the virus outbreak and keep it quiet. But, as the virus spread, containing the virus became a national health emergency. By not addressing this early on, the crisis forced China to effectively shut down the economy in order to manage the spreading disease and panic. And while the draconian measures appear to enable those fighting the disease to make progress and the Chinese government shows early signs of trying to get the country back to work, quarantines remain in many major metropolitan areas due to the highly contagious nature of the virus. (Due to the refusal of China to allow Western scientists into the country to track down the origin of the virus, many speculate that this virus originated from the bio-weapons facility in Wuhan, as a mutated bat coronavirus. This is due to the 14 day incubation period and the highly contagious nature of the virus, allowing it to spread without any outward sign. Typical bat coronavirus is not contagious and not easily transmitted from the bat to humans without physical contact.) Recent economic data indicate the severity of the problem. Chinese consumption stands 40% below normal. Freight traffic dropped 45% year over year. Air traffic stands down almost 80%. Oil consumption and natural gas consumption collapsed domestically, leading China to declare Force Majeure on imports. According to the International Energy Agency, due to the collapse in demand in China and the spillover from the Chinese economy, global crude oil consumption will drop 435,000 barrels per day in Q1 instead of growing 1.2 million barrels per day, a swing of over 1.5 million barrels a day. February Industrial Production in China appears down 15% or more. Whatever statistics the Chinese government prints, reality indicates the economy shrank in Q1 for the first time in decades.

While the bad news sits on the front page of the newspaper, the Chinese economy likely will trace the typical economic pathway seen by economies after severe, short term contractions. After the rubber band is pulled taught, once it releases, it snaps back rapidly to normal and beyond to make up for the tension. In China's case, this likely means economic growth explodes upward exiting Q2 as the normal snapback occurs coupled with additional stimulus, to ensure economic growth heading into China's once very 5 year meeting of the Chinese Communist Party in 2021. Thus, Chinese growth could approach double digits in Q3. Of course, if the Coronavirus crisis drags on, Chinese growth will continue to suffer during Q2 with the snapback not occurring until late Q3.

For China, while COVID-19, as the virus is known to the WHO, will dictate the short term swings in the economy, the longer term malaise and clear secular growth slowdown will not disappear. Chinese Investment stands at almost 45% of GDP. For an economy with much of industry already built out, an

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in place highway and rail system, export share of global trade having peaked, the labor force shrinking, and labor income levels rising into middle income status, such Investment stands well above sustainable levels. For China, Investment to GDP will shrink rapidly over the next decade as its economy must adjust to these factors coupled with a world less willing to take its goods and the inevitable conflict with Developed Market economies as it attempts to steal share from their core industrial and technology industries. For the DM looking to protect their economies and recapture their economic growth, the likely end game appears a world divided into a Chinese and DM spheres with some EM economies dealing with both, but most forced to choose sides, due to the fight over technology. Should Investment to GDP shrink to 25% or less, a reasonable target for a more mature economy, Chinese growth will face a 2% of GDP per annum headwind. And with Investment to GDP falling coupled with a shrinking labor force, Chinese growth could rapidly slow to 3% or less per annum over the next 5 years. And, in fact, some data, prior to the virus, indicated that real Chinese economic growth might stand closer to 3% than the 6% number the government publishes. For China, unfortunately, Dragon Sickness & Recovery will quickly lead to Dragon Sickness Again, likely starting in the 2022 – 2024 time frame.

A Setting Sun

Japan continues to face both short term and secular issues. As recent data show, the Japanese economy shrank 1.6% in Q4 compared to Q3 and over 1% on a year-over-year basis. This decline stems from the increase in the consumption tax implemented in the fall coupled with the global inventory correction. And this comes before any impact from the Coronavirus this quarter. Given the economic dislocations in China, leading to reduced exports from Japan and a collapse in tourism from China, Japanese GDP will likely fall again in Q1 both sequentially and year-over-year. This will produce another recession in Japan despite the implementation of Abenomics. For Japan, this represents a second recession in just five years.

With a recession in the background, a series of difficult decisions lies ahead. From a cyclical perspective, the government must deal with the recession. Fortunately, the global inventory cycle stands near a bottom. And should Chinese actions to contain the Coronavirus succeed, as appears possible, then the Japanese economy would begin a cyclical rebound in Q2. However, this does not solve the longer term issues for Japan. The country must increase spending on defense, to meet the challenge from China, at the same time as it must provide social benefits to an aging population, to meet social program requirements, at the same time as it must raise tax revenue, to fund its needs. Furthermore, Government Debt to GDP continues to rise and already crossed the 200% threshold and demographics forecast a shrinking population. In addition, with the Made in China 2025, exports of high value goods to China continues to come under pressure. This comes on top of a United States looking to localize more production. The only out will fall to government spending and spurring domestic consumption. In

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addition, the government will likely move to monetize the government's debt via the Bank of Japan, using some form of Modern Monetary Theory. For Japan, A Setting Sun will dominate its future.

Tiger Taming

Southeast Asia's Tigers continue their investment led growth, despite the issues emanating from the virus in China and the looming longer term adjustment for the global economy. Malaysia is expected to grow 4.0%, Indonesia 5.0%, and Vietnam 6.0%+. The Philippines joined this growth club over the past few years by tripling Investment spending by the government, driving its growth rate to 6%+. However, as a significant portion of these countries' growth comes from exports to China for reexport as processed or final goods product to Developed Markets, estimated at 35%+ of their exports, the disruption from the virus will weigh on Q1 growth. In addition, with China's export led growth strategy starting to take on water, tying their economies to China's industrial growth may turn into a double edged sword. And this will occur prior to the United States seriously focusing on redomesticating manufacturing for global strategic reasons. Furthermore, certain Southeast Asian economies already have begun to exhibit the limits to these types of growth plans. Thailand and Singapore experienced secular growth slowdowns over the past decade. And Malaysia's growth slowed as well despite its actions.

This growth slowdown occurred despite the significant depreciation engineered in their currencies over the past few years. As the below chart indicates, the EM countries engineered a 25% rise in the value of the US Dollar against their currencies over the past 5 years:

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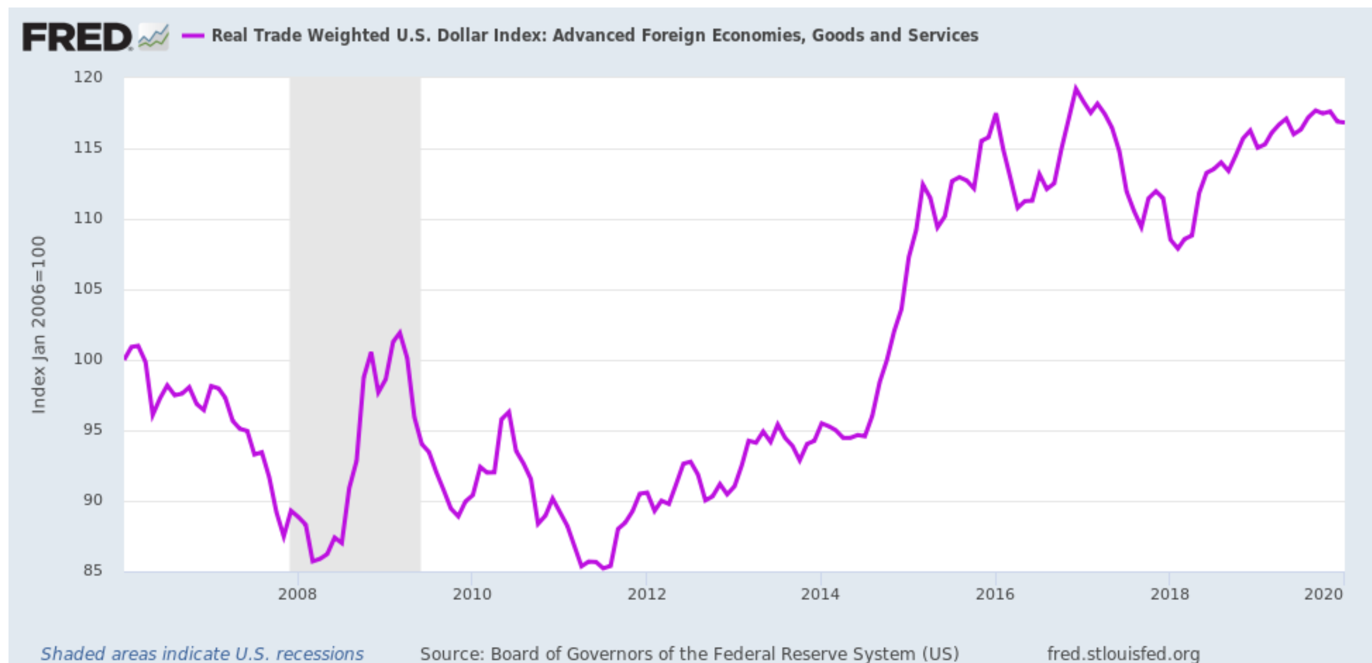
While the United States has yet to enter the currency markets to reverse the levitation of its currency and the associated growth hit due to EM depreciations, political pressures are rising to address this issue. And once they come to the fore, the United States could move aggressively to address this issue. Already the US Dollar appears to have peaked against the Major Currencies:



This comes as the U.S. Federal Reserve engineers a mini-QE and interest rate cuts. With the likely outcome of the next U.S. recession being a reprise of the 1940s, with both money growth and inflation accelerating, the natural direction of the US Dollar will become downward. And, from a long term perspective, the currency possesses a long way to move on the down side against the EM Currencies, as the following chart demonstrates:

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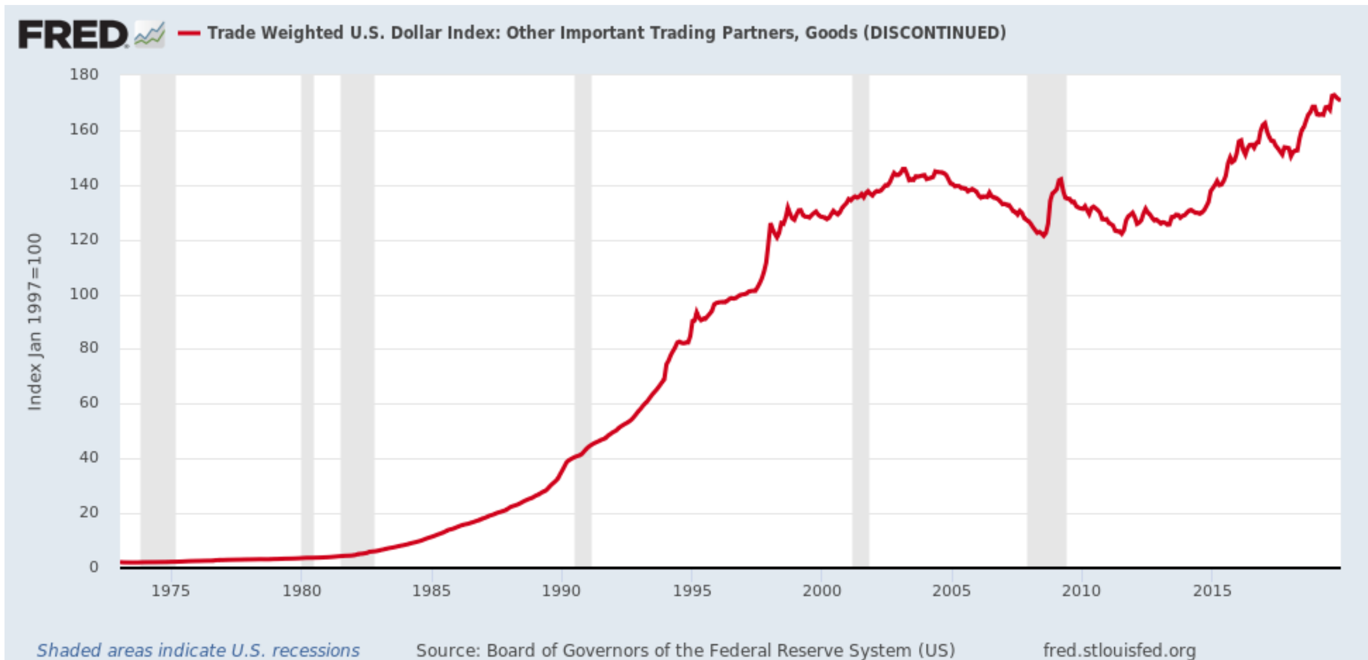

Should the US move in this direction, then the Asian Tigers would find additional drag on their economies on top of their maturing economic positions. And Tiger Taming would become the norm not the exception, providing a jolt to a way of doing business over the past 50 years.

Elephant Credit

The fallout from the collapse of the Non-Bank Financial Sector (NBFS) continues. India grew only 4.5% in 2019, Q4 over Q4. This represents the slowest growth in years. Both the auto sector and housing shrank in 2019 as credit became cut off. India now possesses between 150 and 200 major housing projects that stand in limbo, without access to credit. And while India will benefit somewhat from the end to the Global Inventory Cycle, its economy stands less open than many of its brethren. Although, it will take a hit in Q1 as the Coronavirus impacts intermediate goods it receives from China for export in final goods. The key to a true growth acceleration lies with the government rescuing numerous NBFS institutions that stand just one foot from the grave. And while the true survivors have begun to receive access to the capital markets, the walking wounded need an immediate blood transfusion followed by major surgery to return them to the line of duty. Today's status looks like the typical aftermath of a credit induced binge, much as in the US in 2009. And while the agricultural

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sector continues to recover from last year's massive rains, the country will need Elephant Credit, in the form of rescues, from the government, in order to truly restart growth.

The Beat Goes On

Despite the issues in China and the obvious hit to Brazil's commodity sector, the Brazilian economy stands ready to accelerate as the economy benefits from the massive currency depreciation of the past three years. With the undervalued currency cut by a further one third, leaving it valued at one half its fair value according to the OECD, using Brazil as a base for manufacturing becomes a logical outcome. Foreign Direct Investment numbers over the past 12 months indicate theory matches reality as the country received $78.3 billion in FDI or 4.3% of GDP. Other economic statistics indicate that Brazilian growth continues apace despite the headline noise about the economy. Unemployment fell to 11% in December. And multi-national corporations continue to report reasonable growth for the country whether in the hypermarkets or in cellular demand. The only place the growth appears missing stands in the GDP statistics, which indicate the economy grew only 1.1% in 2019. Notwithstanding such a headline number, it remains clear that The Beat Goes On and likely will accelerate once the global Coronavirus impact passes.

Old Man Reality

For Europe, especially Germany, global trade stands as an important driver of economic growth. And any moves in global manufacturing produce a magnified impact. The Global Inventory Correction over the past two years coupled with a slowdown in global trade disproportionately impacted Germany, sending its economy effectively into a recession, with ripple effects on the remainder of Europe. With the downward move close to an end, it appeared that Europe stood poised to benefit from a turn in the Global Inventory Cycle. Semiconductors already turned upward in 2019 and manufacturing appeared poised to follow in H1 2020. The Orders to Inventory Ratio for the Purchasing Managers Index (PMI) turned upward, signally an imminent turn in manufacturing production. Then along came the Coronavirus, hitting China's economy. This may push out the turn by a few months, depending on the virus's spread, but likely will not derail the cycle. For Europe, this will come as welcome relief after Brexit.

However, the turn upward in Global Manufacturing will not make the underlying economic issues go away. For Europe, a day of reckoning lies ahead as economic reality rears its ugly head. For the Economic Reality for Europe indicates the EU, as constructed, only benefits select countries, leaving other countries behind with little to no real growth and flat to declining living standards for their citizens. Should any politician stand up in front of the electorate and state that they will deliver lower real earnings and higher unemployment, they would become the recipients of boos and rotten tomatoes

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and need to scamper off the stage. They also might not have a job waiting for them. With the inevitable result of the economic policies adopted by the EU on full display after 20 years, the electorates in those countries left behind now understand the consequences of these policies. And they continue to search for alternatives that would restore the growth they enjoyed prior to the Euro coming into existence and their local currencies disappearing. Unfortunately, the obvious solution, a breakup of the EU and a return to the European Common Market, stands anathema to the countries that benefitted from the current situation. However, with the United Kingdom showing the path to exit and the reality of limited consequences to such an exit, other countries will feel the pull to follow the Brits down this pathway. The obvious candidates stand Italy and Spain. With Italy already having one foot out the door, the EU put Madame Lagarde, the former French Finance Minister, in charge of the ECB, as a last ditch attempt to keep Italy in the EU. However, how much power Madame Lagarde really possesses to change the institutional inertia at the ECB remains to be seen. Should the ECB not adopt a significantly more proactive economic policy and push for significant fiscal stimulus, especially by Germany, to drive economic growth upward, the path of least resistance for the laggards in Europe becomes another messy exit. In other words, should the ECB continue to play the fiddle while Rome burns, the world likely will witness the premier of the Italian soap opera Itexit followed by the Spanish soap opera Espexit. With this Old Man Reality ahead, there stand no easy answers for the EU.

The Climb To The Top

For the United States, the economy continues to track the late cycle bounces seen in the late 1990s and late 1960s that concluded those economic cycles. The January PMI Indices for both manufacturing and services indicate a similar economic reacceleration to those seen in 1999 and 1967. And while the Coronavirus likely will impact February and March and much of Q2, the Global Inventory Cycle, a snapback in China, additional global central bank stimulus, and the domestic Housing Cycle should underpin economic growth.

The Housing Cycle continues onward, much as in the late 1990s. As the following chart demonstrates, single family starts recently exploded to the upside as interest rates fell:

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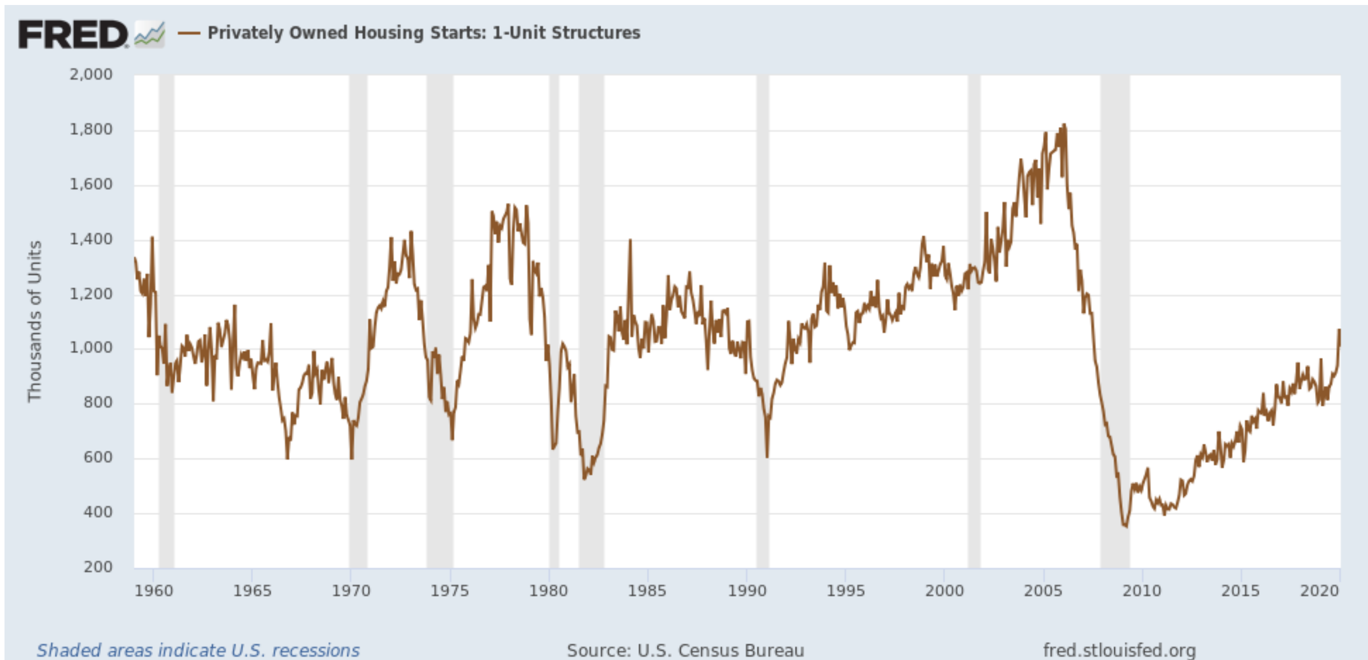

This rise mirrors what occurred in 1998, which should come as no surprise. Multi-Family Starts exploded upward as well recently, to their highest levels since the 1980s, as capital continues to flow into the commercial rental sector:

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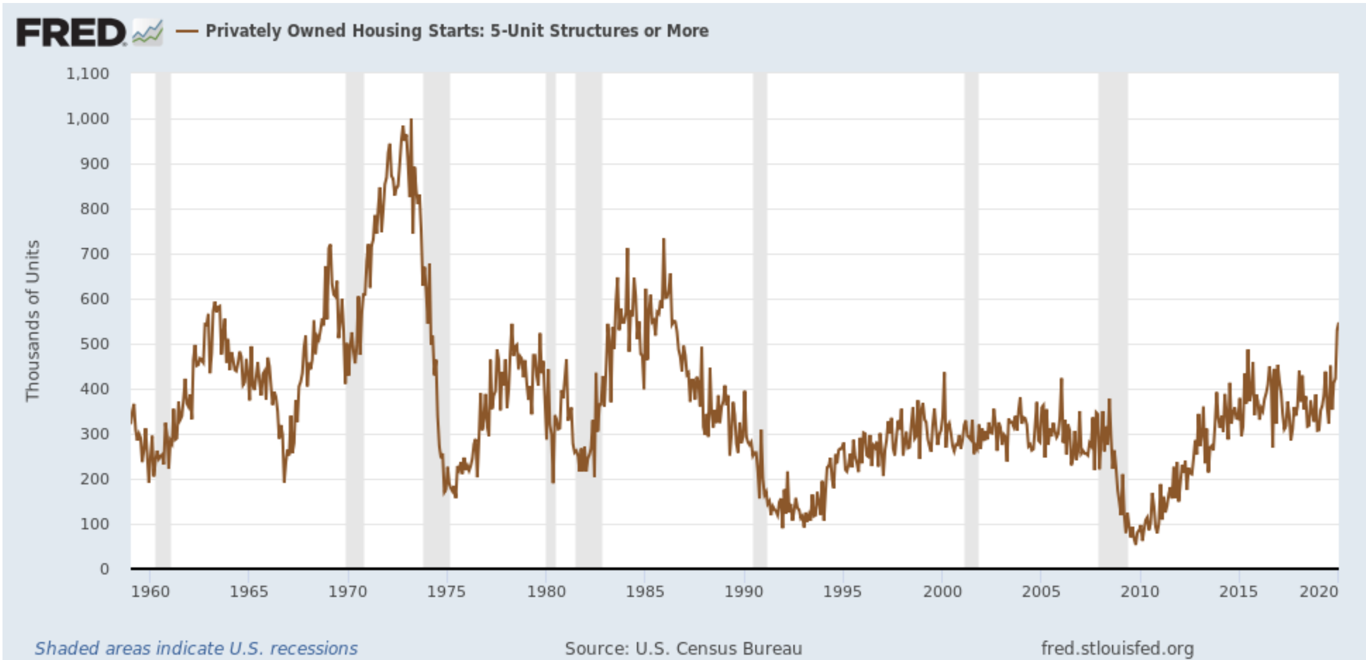

And with the explosion upward in starts, Residential Fixed Investment spending headed upward once more:

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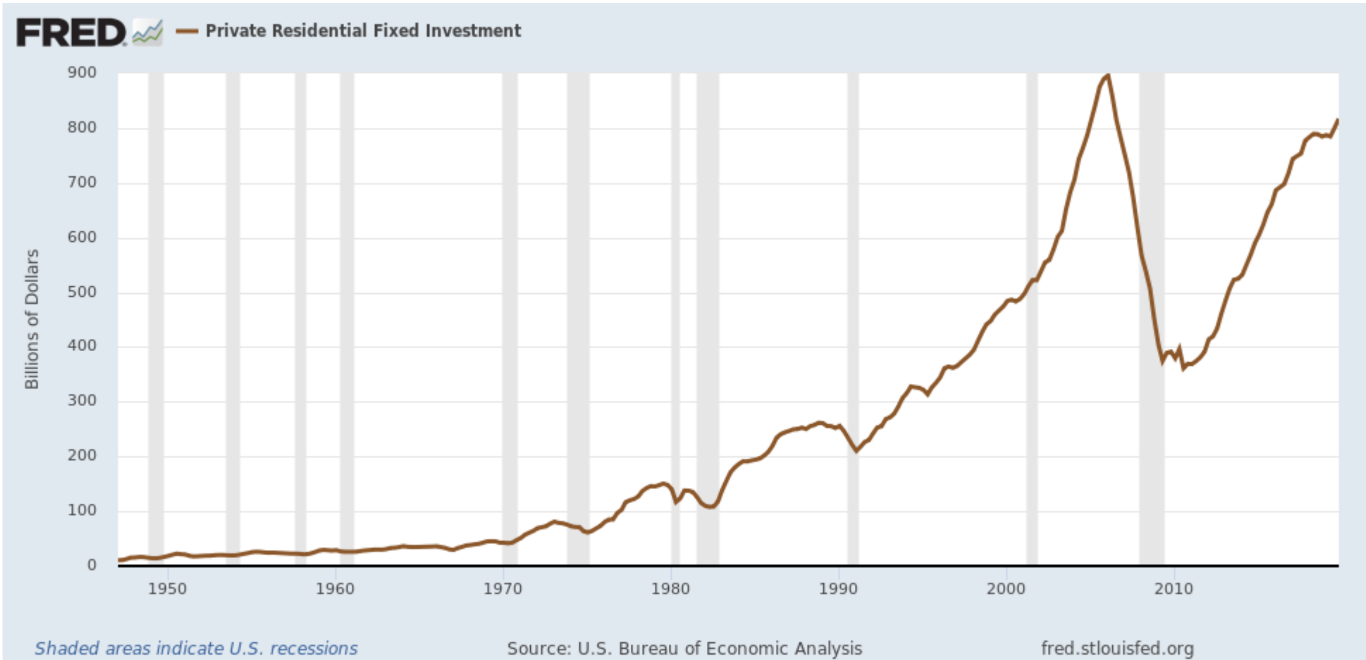

And began to accelerate on a year-over-year basis:

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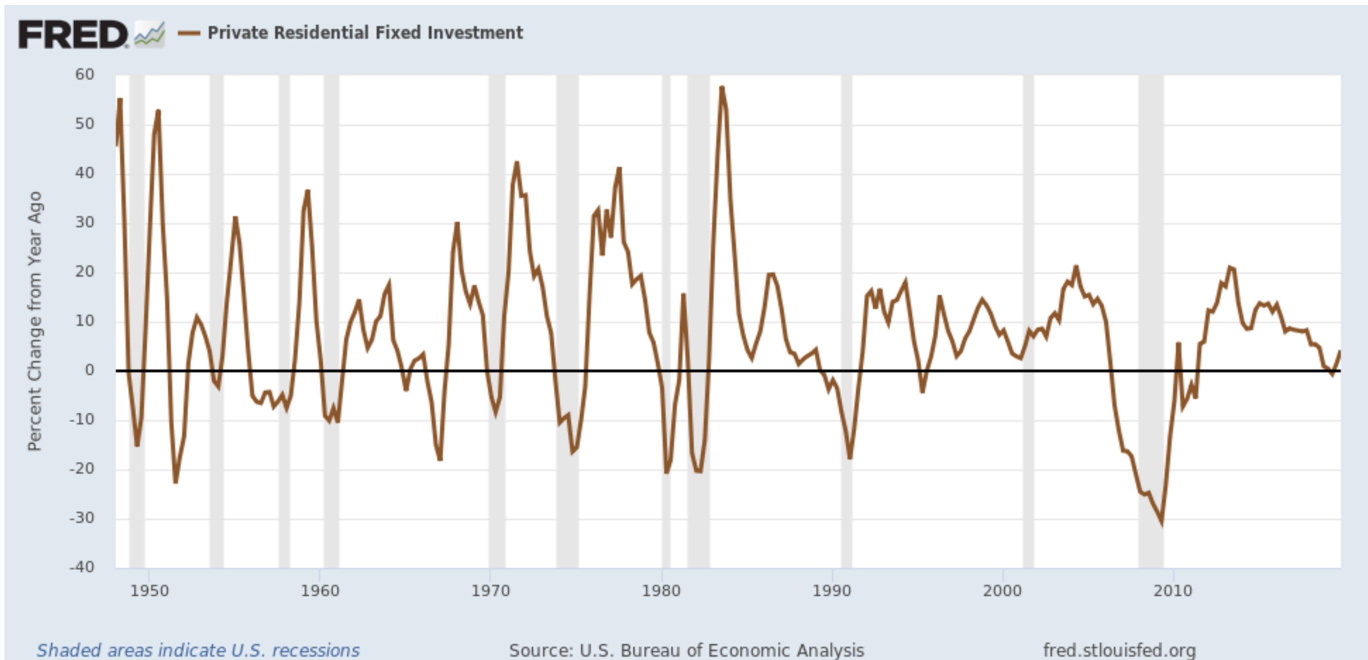

As Housing permeates everything in the economy from copper usage to plastic to manufacturing to labor to banking to insurance to consumer spending, it should produce a salutary impact on economic growth.

This bounce in Housing will come just in time to offset an issue on the industrial side of the economy. Besides the impact of the Global Inventory Correction, the US suffered from the Boeing woes, leading the company to shut down airplane production temporarily. Estimates put this growth impact at 0.5% of GDP for Q1 and potentially a similar impact in Q2. As the following chart shows, Industrial Production turned slightly negative on a year-over-year basis recently, but not nearly to the extent it did in the 2014 – 2016 time frame:

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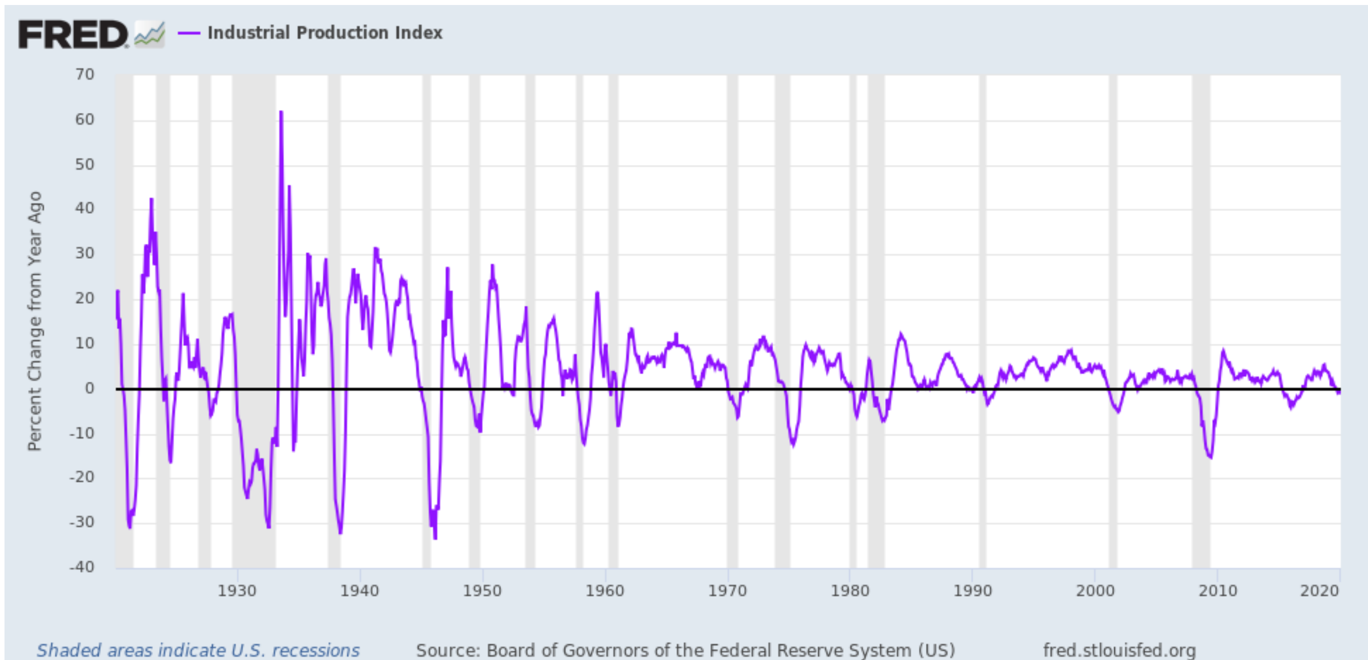

The pullback, to date, looks more like 1998 than 2015. With the looming snapback in China's industry and Boeing likely to resume production shortly, as its plane finally receives the green light from the FAA, US Industrial Production will likely turn upward again, reinforcing the growth impetus from Housing.

However, all is not coming up roses in the economy. Fundamentals for Commercial Real Estate continue to erode. Defaults on commercial properties, such as hotels, turned upward over the last year, a fact not lost on Senior Loan Officers at commercial banks. The Federal Reserve's Senior Loan Officer Survey shows a clear tightening trend for Commercial Real Estate. In addition, areas such as Self Storage continue to add significant amounts of capacity leading to revenue growth but no income growth from facilities, as margins come under pressure. Despite what appears a potential top in Commercial Real Estate, Non-Residential Construction rose 3% in 2019. However, that belies the underlying reality. Private Non-Residential Construction actually fell 2.7%. Only a 7.3% rise in Public Construction masked this weakness. Furthermore, ratings agencies began to reexamine corporate debt ratings. As previously documented, U.S. corporate debt remains an accident waiting to happen.

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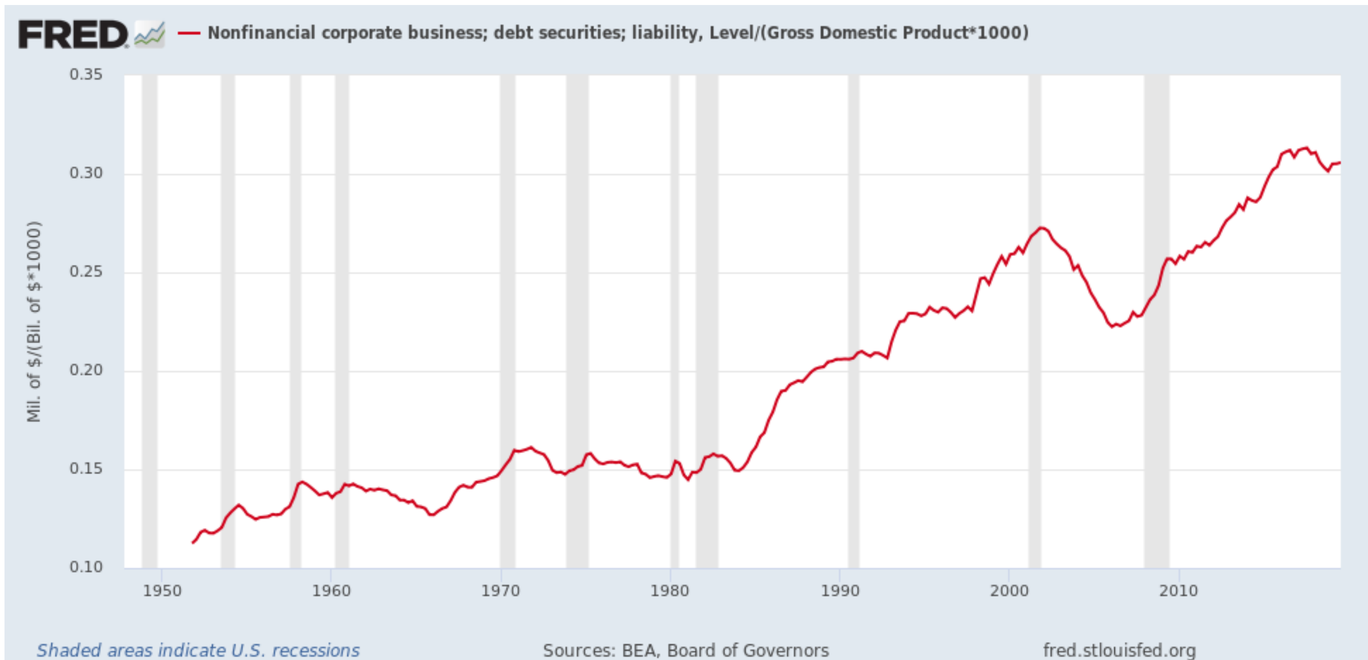

The recent downgrade of Kraft to junk status illustrates this risk. The bonds dropped almost 10% the day the downgrade occurred to junk status. And this was during a bull market for bonds. Should the economy hit a real soft spot, such as a recession, a large number of bonds could find themselves no longer investment grade leading to a stampede for the exits, with deleterious economic impact to the companies and the economy.

With the US economy standing in a late cycle position, various props for the economy continue to slowly disappear. However, with the Housing Sector heading upward and Industrial Production likely to follow later this year, the economy should provide one last move upward. And with Consumer Spending continuing to grow and Government following the typical election year script, the economy should continue onward and upward. This would stand as the classic Final Hurrah for the economy before the inevitable plunge as the US makes The Climb To The Top.

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Equity Markets: 1999 – 2000 Again or The New Nifty 50

"*John Bull can't stand two percent.*"

Old Wall Street Saying

"*My fifth point is performance contains the seeds of its own destruction. As more and more institutions get into the act, the more likely it becomes that performance will go the way of all previous investment fads. The first practitioners at least were trading in and out of high-grade, readily marketable, seasoned growth companies. As others joined the parade, the emphasis moved along to secondary securities. Now, with everybody jumping on the bandwagon, the trend is toward highly speculative issues of fledgling companies with very limited marketability. With many of these stocks selling at 50 to 100 times earnings and 10 to 15 times sales, performance may already be running its string.*"

David L. Babson
First Annual Institutional Investor Conference, January 31, 1968
Institutional Investor Inc.
As Quoted by:
Classics: An Investors Anthology
Edited by Charles D. Ellis, 1989

Nothing new ever occurs in investing. Economies rise and fall and with them interest rates and growth. Companies pile on debt in good times, only to find them anchors pulling them under the water in bad times. And company valuations move from the depths of despair during recessions to the heights of exuberance during economic booms. And whether one reads Common Stocks as Long Term Investments, written by Edgar Lawrence Smith in 1928, or Ben Graham's and David Dodd's critical comments on Smith in their 1934 classic, Security Analysis, little changes in investing.

To illustrate this point, one need only examine the current valuation on the Equity Markets. And one of the best long term valuation methodologies continues to be Robert Shiller's CAPE, Cyclically Adjusted Price Earnings Ratio. While the CAPE does not predict short term movements in the markets, the valuations provide a reasonable read on 10 year forward Equity Returns, with strong statistical support. The current chart looks as follows:

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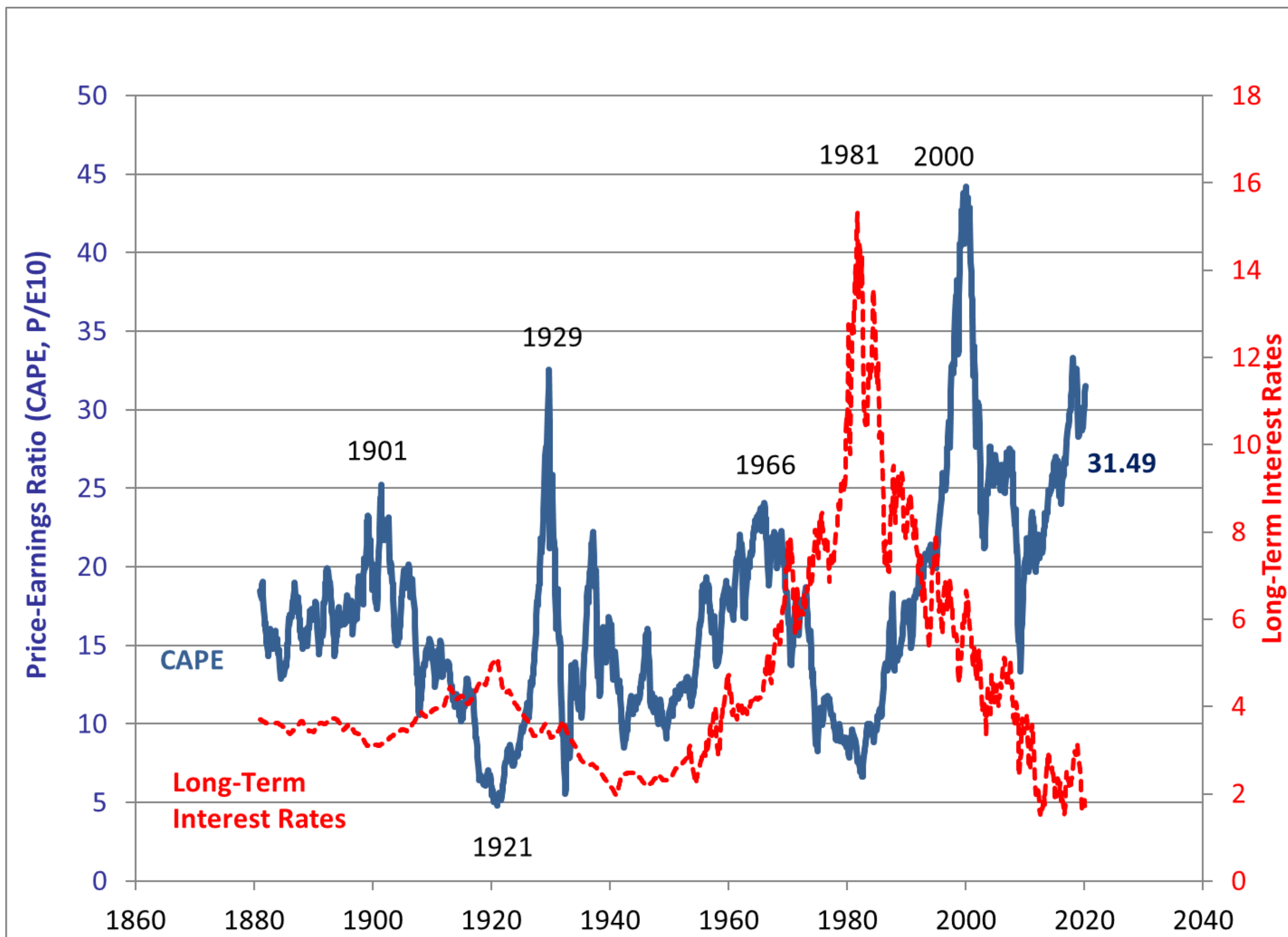

Chart courtesy of Robert Shiller, Yale University and can be found at: http://www.econ.yale.edu/~shiller/data.htm

As the latest data shows, the current CAPE Valuation equals 31.49. This is the same value as in August, 1929 which, in that stock market bubble, only was exceeded in September, 1929 at 32.56. For points of reference, the 1901 peak valuation occurred at 25.24 and in 1966 at 24.06. And the ultimate mania in the past 150 years, the 1999 – 2000 Tech Bubble, reached a peak of 44.20 in December 1999. From these types of starting valuations, 10 Year Forward Returns typically produce zero or negative Nominal Returns and uniformly negative Real Returns. In other words, investors holdings decline in real value over the next decade. And this should come as no surprise. Overpaying for any investment, no matter how good the company, typically leads to poor returns. For example, if an investor sold her or his equity holdings in 1997 when the market hit its 1929 CAPE valuation, it would have taken until 2011

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for the value of the market in real terms, assuming an investor reinvested his or her dividends, to reach its 1997 level.

The CAPE graph also illustrates reversion to the mean in overall valuations. Within a decade of each peak in CAPE valuation at these types of levels, valuations drop over 50%. This type of valuation decline undermines the ability of investments to produce positive real returns. The impact of such a valuation decline can be shown in the following illustration. Imagine an investor owns a building that throws off $100 in Cash per Year. Assume the building is valued at 20x its cash flow today, similar to a 5% cap rate. (Please note: actual cap rates stand below this for a significant portion of the real estate market today.) That means the building is worth $2,000 today. If Cash Flow grows 5% per year for a decade, the building will produce $162.89 in Cash per Year in 10 years. Let's assume valuations fall to 12x cash flow or cap rates rise to 8.5%. This would equate to a drop of only 40% in valuations. This means the building valuation would only equal $1,955 in 10 years or a little over 2% below today's valuation. If inflation averages just 2% over the decade, the price level rises almost 22%. This means the real value of the building falls to just $1,603 and the investor suffers a real decline of almost 20% in their investment. If inflation averages 3%, then the price level rises over 34%. This would lower the real value of the building to $1,455 or by more than 27% compared to today's valuation. The following table illustrates this example:

	Current Year	***In 10 Years***
Cash Flow	*$100.00*	*$162.89*
Multiple	*20x*	*12x*
Value	*$2,000.00*	*$1,955.00*
Real Value:		
At 3% Inflation	---------	*$1,603.00*
At 4% Inflation	---------	*$1,455.00*

While investors always assume that valuations can continue at high levels in the midst of bull markets, history demonstrates a different lesson, a painful one that each generation of investors seemingly must learn over for themselves as its 1999 – 2000 Again.

If today's market valuation resembles 1999 – 2000 or the 1929 Market, the massive concentration of the market resembles the Nifty 50 of the late 1960s. The Nifty 50 stocks, on average, traded at 42x earnings

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with highflyers like McDonalds trading at 86x, Polaroid at 91x, and Avon Products at 65x. Of course, these stocks produced strong fundamental growth in the 1960s that led Morgan Guaranty Trust to issue its famous list of 50 stocks that also included names such as Disney, Dow Chemical, General Electric, and Phillip Morris. This worked until the 1973 – 1974 Bear Market, in which these stocks fell precipitously in a similar manner to the technology stocks in the 2001 – 2003 Bear Market. Today, numerous growth stocks trade at valuations similar to those of the late 1960's Nifty 50, effectively creating a New Nifty 50. The lowly valued growth stocks, such as Microsoft, trade at 27x – 30x earnings. The more highly valued trade at 70x 2020 estimated earnings or more. These include Amazon at 83x 2020, Netflix at 89x, Tesla at 285x, and Zoom Video at 400x. All of these companies have demonstrated growth over the past five years leading investors to provide them high valuations. Unfortunately, the history of these types of valuations tends to produce poor results over the long term in aggregate.

For investors, the Equity Markets stand in a late cycle position. Long term valuation measures, such as Shiller's CAPE, mimic those values seen at or near prior peaks. The S&P 500 looks much like 1999 – 2000, with the Top 5 Stocks by market cap all Technology companies (Microsoft, Apple, Amazon, Facebook, and Google) and Technology comprises the largest percentage of the market since then. Valuations resemble those last seen during the reign of the Nifty 50 in the late 1960s/ early 1970s, when a diversified crop of growth companies dominated the market. Given this backdrop, investors likely stand in a similar position to those in 1967 or 1999. While the market rose from those levels, ultimately the economic fundamentals eroded leading to a recession and bear market. With the fundamentals beginning to erode for the economy, investors must watch for the appropriate time to exit lest they get caught in the next downdraft. Until then, the New Nifty 50 will reign. (Data from public sources coupled with Green Drake Advisors analysis.)

Bye Cobalt, Robot Mining, and Whatever Happened to the Swiss Watch?

Finally, we close with brief comments on Bye Cobalt, Robot Mining, and Whatever Happened to the Swiss Watch? First, Tesla announced it will utilize a battery for its Cybertruck that will not use Cobalt. Due to the high cost of Cobalt, this will drive the price of the battery down over 15% and bring the cost of the vehicle closer than ever to an internal combustion engine driven vehicle. With this move, we see Tesla and potentially the industry saying: Bye Cobalt. Second, miners, such as Codelco, are adopting new methods for underground mining called Block Caving. This new method automates significant portions of the mining process reducing fuel consumption by 80% and increasing productivity by more than 40%. With these changes, Robot Mining appears set to dominate the future. And Third, Apple sold 30.7 million smartwatches in 2019 compared to the Swiss watch industry selling only 21.1 million

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watches. With technology marching on, future generations may say: Whatever Happened to the Swiss Watch?

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	Steve Rodia
Chief Executive Officer	President
& Senior Advisor	& Senior Advisor

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