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To: Our Clients
From: Peter Cavelti

Dear Client:

The Narrative Changes

One of the first things I learned when I started my investment career was to adjust each commentary for the known biases of its author. It's quite easy to do that. Subscribe to any newsletter and you'll soon learn that the publisher is perpetually bullish (or bearish) a given stock, commodity, or asset class. Listen to the talking heads on TV's financial shows and you'll quickly find out what preconceptions they're guided by. As a rule, most views rest on "confirmation bias". Even if the commentators know their subject well, they look for evidence that may confirm the view they already hold. That does not mean that their narrative isn't worth contemplating—every professionally articulated narrative holds its share of facts we weren't aware of, or perspectives that may change our own viewpoint. But, when considering the conclusions offered, we need to adjust them for discernible biases.

As I wrote three months ago, the stock market has for some time been a risky place to be. Yet, with few exceptions, financial columnists, the talking heads on television, and the major investment firms sang the same chorus—the economy, they chirped, is doing just great and a major correction is months, perhaps years, away. In confirmation bias terms: *we want to believe in perpetually good markets, and if we look hard enough we can spot the positives to support our case.* To be sure, in recent months favorable economic statistics did provide reassurance, but there were countless negatives you had to ignore to end up with a bullish view. Organizations like the International Monetary Fund and the Bank of International Settlements described the risks at hand in great detail, as did a number of prominent hedge fund managers and people like ourselves—but most of the financial media were deaf to messages of caution.

Now that the market is in correction mode, the tune has changed. We are told that 2019 will be a challenging year marked by uncertainty on virtually every front. There is also a lot of finger-pointing. The New York Times appears convinced that if only Trump weren't the President, all would be well. The Commander-in-Chief, meanwhile, blames the Federal Reserve for the stock market's sputters. He's partially right: it is largely the central bank's course of persistent rate hikes that's reversed the market's fortunes.

That, of course, is not to say that the Fed is doing the wrong thing. Stephen Roach, who once worked at the Federal Reserve, later became Chief Economist at Morgan Stanley and now teaches at Yale, believes that the central bank should be congratulated for its steadfast commitment to policy normalization.

“[The Fed] is finally confronting the beast that former Chairman Alan Greenspan unleashed over 30 years ago: the ‘Greenspan put’ that provided asymmetric support to financial markets by easing policy aggressively during periods of market distress while condoning froth during upswings.” I agree with Mr. Roach’s comments. Greenspan, Bernanke and Yellen all encouraged investors to count on the Fed’s unfailing support, which essentially penalized the financially prudent while encouraging the reckless.

Yet, the problems go far beyond those created by the central banks. Politicians have been equally complicit in creating what is now the most monstrous debt bubble in human history. Living it up today at tomorrow’s expense is no longer an abstract. For the first time, excessive and unaffordable consumption is the model that guides the life of the vast majority of those residing in the developed world. Individuals old and young, corporations large and small, company and government pension funds, and government itself—statistics show that all these groups consistently consume a lot more than they produce. It’s clear that the debt-fuelled consumerism the developed world has known for the past half century is unsustainable, but that doesn’t mean that we know when and how it will end. Will one of the many black swans currently circling the pond of prosperity act as the catalyst? Or will the bubble deflate incrementally? No one can know, but whichever way the adjustment unfolds, it will affect not only asset prices, but profoundly change the fabric of our social order and political landscape.

Where From Here?

To return to the present moment, here we are, in what is evidently a painful correction and may turn out to be the prelude to a protracted bear market. Equity indices are down 15% from their September high, which means that we’ll end the year in the negative. On the other hand, we have a cash reserve of more than 50%, which means we can take advantage of deflated prices when the time is right. When will that be? My assessment of financial markets remains cautious. For me to believe that an opportunity is at hand, valuations will have to become more compelling or the backdrop will have to improve.

For the time being, the economic, social and political landscape remains negative. Consider, for the moment, some of the game-changing issues:

> -International relations are quickly deteriorating, as the U.S. seeks to replace a global rules-based system with one where Washington gets to decide who trades or has friendly relations with whom. Global trade is likely to contract. Notably, this is occurring against a backdrop of an already weakening world economy.
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> -The unipolar political order that has been in place since the collapse of Communism is gradually giving way to a multi-polar construct, in which the U.S. is no longer the hegemon and the U.S. dollar gradually loses its place as the world’s reserve currency.
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> -What we’ve come to define as Liberal Democracy has lost its way and continues to lose support. Throughout the developed world, populism is on the rise. We don’t know whether the populism of the nationalistic right or the socialist left will become the lead ideology. Both are scary propositions.
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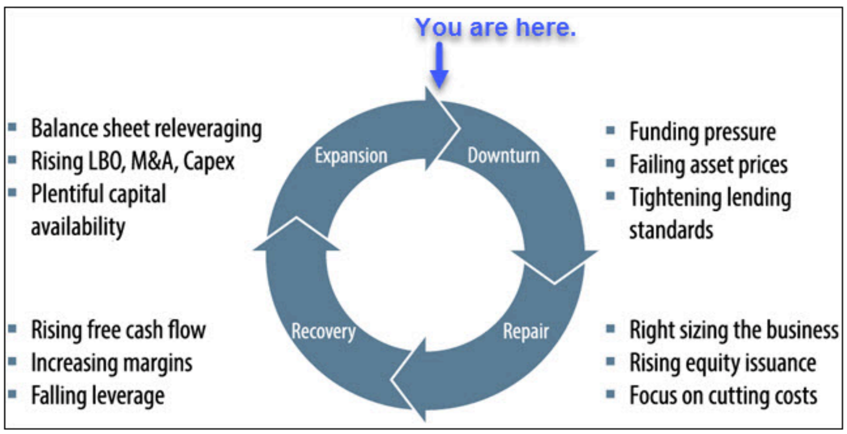
> -Debt is at unsustainable levels. Data analysis shows that economic growth would be deeply in subpar territory were it not for ever larger injections of debt. Worse, a sizeable portion of corporate and individual debt is of very low quality. No matter which way government and the monetary authorities deal with it, actions to rectify the problem or prolong the status quo will rock the social order.

-The demographic realities in almost all of the developed economies will add to the problem. We'll read a lot more about bankrupt pension funds, sky-high social security deficits and the like.

-The wealth disparity, particularly in the United States, has reached levels where a substantial portion of the population has an actual incentive to rebel against the status quo.

These are all game-changing structural issues. In terms of imminence, some are more tangible than others, but they all have the potential to create chaos at very short notice. There are many other uncertainties that could grow in importance: an attempt to impeach President Trump, further trouble in Euroland, incendiary developments in the Middle East, a spillover of U.S. – China trade tensions into military confrontation, terrorist problems, whatever.

What also worries me is how the investing public will react to the stock market correction itself. Having been told by their favorite media channels that things are on solid footing, and now seeing that narrative changed to "2019 will be a year of great uncertainty" doesn't inspire confidence. With global growth in clear slowdown mode, the problems mentioned above, and cyclical realities (see our chart) generating mostly negative headline noise, I suspect that any market recovery will be met with a wall of new sales orders from Main Street—no matter what spin Wall Street and its publicity machine may put on things. Don't forget: the retail investors pocket book is slim, and trust in institutions (media, financial or any other) is waning.



This is why, at least for the time being, we will continue to harness sizeable cash reserves. Cash, we continue to believe, is a highly useful asset class that, over time, can dramatically enhance returns.

I wish I could tell you that your assets appreciated during the past year. They didn't, but at least we did far better than a fully-invested, index-based portfolio would have done. I should also add that the 2018 drawdown follows a two-year period in which we managed an aggregate return of above 50%.

Some of you will ask, "Why hold any stocks?" It's a valid question and one that I've asked myself many times in recent months. The key reason to hold equities is that a stake in a well-operated corporation that has manageable debt and pays an attractive and sustainable dividend is still more appealing than most investment alternatives.

As we enter a new year, let me thank you for your continued trust and wish you a joyful, healthy and successful 2019!