Cavelti

Cavelti & Associates Ltd.
188 Eglinton Avenue East, Suite 706
Toronto, Ontario, Canada M4P 2X7
Phone 416 - 486 1900
Website: www.cavelti.com

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To: Our Clients
From: Peter Cavelti

An Important Change in Narrative

Dear Client:

When Melissa and I were first started working together, she boldly suggested that my professional skills acquired during the past five decades were of limited use. "Analysis is valuable," she said, "but of equal importance is the prevailing narrative." It took me a while to get there, but she was right: in today's media-centric world, it's vital to understand how the financial industry, the financial media and therefore the investment community see things. Quite often, their viewpoint is ridiculously off base, but that doesn't matter.

So, it usually pays off to 'go with the crowd', but always with a keen eye on potential changes in the narrative. There were numerous times during the past two years when we concluded that stock valuations were woefully stretched, but we stayed with the market because the narrative demanded it. As it turned out, it was the right thing to do—client portfolios tacked on a cumulative 52% during 2016 and 2017. Throughout that period, the narrative remained unchanged, reflecting the following belief system:

> Central banks won't allow a meaningful correction in equities,
> and there are few attractive places for money outside the stock market.
>
> **Therefore, the market's overvaluation is justified.**

Well, since the beginning of this year, that narrative has undergone two major changes. The first was when Congress passed a comprehensive tax reform package, just as the U.S. Federal Reserve made it clear that interest rates would keep rising. The good part was that fiscal relief will boost the economy, the offsetting negative that rising interest rates would push up borrowing costs for consumers and businesses and, perhaps most importantly, for a government saddled with an out-of-control federal debt (consider that the U.S. federal debt stood at $8 trillion ten years ago and is expected to reach $22 trillion this year). The bottom-line of these developments was that they introduced new uncertainties, which led to the nine-day long 10% market decline that started in late January. Key indices then briefly recovered but, as I write, are sharply falling again.

That is largely because a second change in narrative came along and firmly tipped the balance. Washington's tough rhetoric on global trade escalated into clearly articulated action. If Mr. Trump's tariffs on key imports to the U.S. are introduced as promised, costs on industrial and consumer goods will sharply rise, adding to inflation and, in turn, forcing the Fed to raise interest rates even more aggressively. This dynamic changes the narrative far more dramatically; after all, contractions in trade have historically led to severe economic setbacks.

Among informed investors, the prevailing story-board now looks like this:

> Fiscal relief will boost corporate earnings and make valuations less stretched,
> But higher borrowing costs will prevent lasting economic improvement,
> and trade protectionism will hurt consumers and boost inflation.
>
> **Therefore, the market's bull-run may soon end.**

What matters: inflection points in narrative are highly important markers. Technically, the stock market is still in a bull market and no one can know when a deeper correction will unfold. What is certain is that the reassuring storyline that's been with us for so long is dead. That doesn't mean the talking heads on financial TV channels and their followers will embrace the new reality immediately, but it makes a more defensive portfolio strategy imperative.

Here are some things investors can do to safeguard their portfolio:

-Reduce your overall market exposure. Recognize that cash is a critically important asset class; it reduces risk and gives you flexibility. Most importantly, it gives you peace of mind.

-Pay down debt. Debt leverage has brought huge rewards during the past many years; the future could look strikingly different.

-Be careful when holding other people's debt. A big slice of fixed income markets will be negatively impacted as long as interest rates continue to rise.

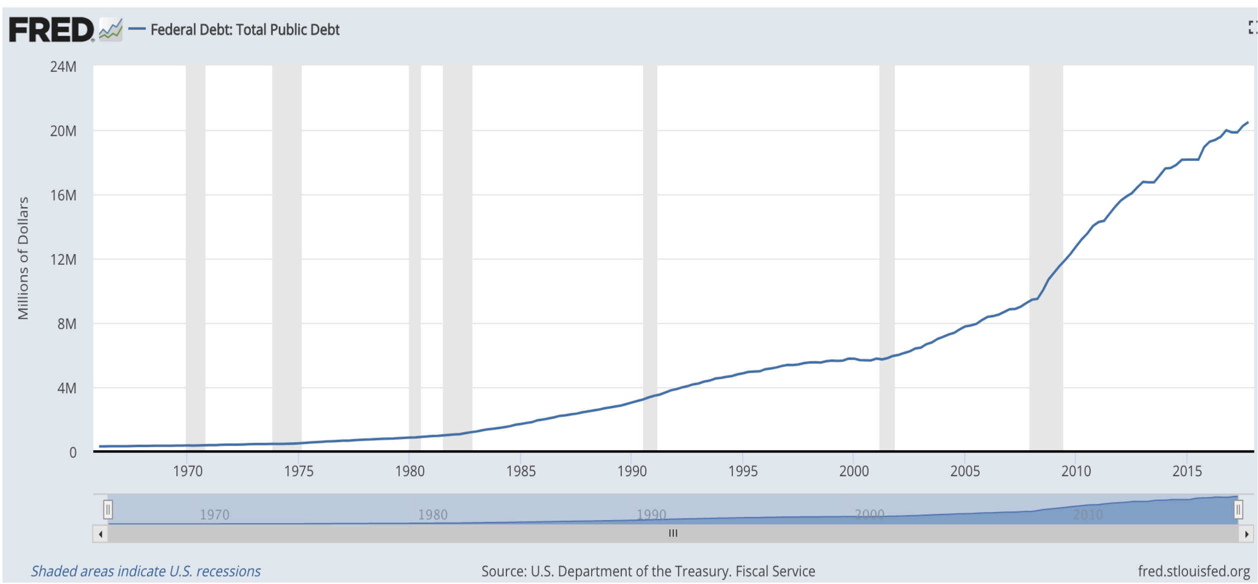
-Within your equity portfolio, diversify. Stress quality and liquidity, ideally coupled with attractive, secure dividends.

Trouble On Many Fronts

There are many things other than rising interest rates and the potential of a nasty trade war that concern me. To me, one of the greatest problems is the self-absorption and incompetence at virtually all levels of the American federal government. Many of my friends point to the fact that other countries' leadership is equally inept, but to North American investors that hardly matters—if Italy or the Philippines or Brazil are poorly governed it will affect those particular countries and perhaps their region, but it's hardly of global consequence. In contrast, when U.S. policies become erratic, the world's key power centers are affected.

During the past two decades, the American state has gradually, and in a perverse way most effectively, destabilized the world, and much more is yet to come. Most of my friends are obsessed with the inadequacies of Donald Trump, whose shortcomings are too numerous to list—but U.S. systemic problems that threaten global stability were engendered long before the Trump era began. I'll go even further: they were what led to the rise of populism that propelled President Trump into office. Apart from numerous policy-specific inadequacies, I worry about the meteoric rise of the U.S. intelligence services and the U.S. military complex, as well as the American legislature's rapid descent into corruption. I see little chance of improvement, at least not as long as America's mainstream media prefer partisan squabbling to discussing the major structural problems that are ruining their country.

I will, in a coming issue, deal with the deteriorating social policy construct and the geopolitical challenges that threaten our wellbeing, both in the U.S. and in the rest of the world. For now, let me conclude by saying that they have the potential to roil financial markets as vehemently as rising interest rates, frighteningly high debt levels, or stretched equity valuations.



Your Portfolio

Consistent with our belief that a critical change in financial markets narrative has occurred and that numerous non-financial issues may influence markets negatively, we aggressively cut back your stock market exposure. During the past two weeks, we raised cash reserves to over 50%. We made similar retreats in 1999 and in early 2008; on both occasions it allowed us to re-enter the market at sharply lower levels. Our intention is to reengage when justifiable valuations have been restored and when we have confidence that the environment for the economy and investment is improving.

Turning to performance, the value of your assets under our administration has declined roughly in line with market indices, during the first quarter. If our views are vindicated, we should considerably out-perform the indices in the coming reporting periods.

Thank you for your continued trust. Please let us know if you have any comments or questions.