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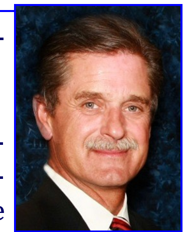
Scott's Thoughts —

INSIDE:



Scott Husband

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria" – Sir John Templeton

There is no pessimism, no skepticism, nor any euphoria. There is however, optimism. But we have not witnessed that short period of time that investers, mostly retail investors, buy equities "knowing" stocks always go up. We witnessed the euphoria in 1987, which was followed by a very short and dramatic bear market. The Dot.com craze ended in March of 2000 and was "euphoric" as it made its' last major push higher in late 1999. The Great Recession did not begin because the stock market had been euphoric, but rather as a consequence of the euphoria in the real estate market. Vast amounts of borrowing, backed by real estate, was created by the euphoric "knowledge" that in the **long run** real estate always goes higher. But the long run is comprised of many periods of (shorter) time. And in the short term, the prices placed on real estate were unsustainable. Housing prices collapsed and the scramble for liquidity began. The Great Recession was the consequence of a euphoria.

The valuations placed on the current stock market reflect the abundance of money and the extremely low interest rates. Money always has to go someplace and with interest rates near zero, the debt market offered little to no benefit (and in some cases a known certain loss-negative interest rates). While governments issued currency by purchasing vast amounts of debt, investors were left with little choice but to buy equities and (eventually) real estate. Equites have offered little in the way of value for years, and real estate prices now exceed those prior to the Great Recession. But there is no euphoria.

Taken from an article by Sam Ro published on March 12, 2016:

"On May 26, 2010, Warren Buffett was interviewed by the Financial Crisis Inquiry Commission (FCIC). Brad Bondi, then Deputy General Counsel of the FCIC, asked Buffett, "What do you think it was, if you were to point to one of the single driving causes behind this bubble?"

Buffett began his brilliant response by quoting his mentor Benjamin Graham. "…Ben Graham, made an observation, 50 or so years ago to me that it really stuck in my mind and now I've seen evidence of it. He said, 'You can get in a whole lot more trouble in investing with a sound premise than with a false premise.'"

When you have a sound premise, you may also have a "This can't go wrong" mentality. And when you add money to that equation, things quickly get out of hand.

As he offered examples, Buffett remembered a study that was published in 1924 that argued stocks always outperformed bonds.

"That became the underlying bulwark for the '29 bubble," Buffett said. "So after a while, the original premise, which becomes sort of the impetus for what later turns out to be a bubble, is forgotten and the price action takes over." Again, you start with a sound premise. But when people see the numbers go up, they pile on.

"The Internet was the same thing," Buffett said. "The Internet was going to change our lives. But it didn't mean that every company was worth $50 billion that could dream up a prospectus. And the price action becomes so important to people that it takes over the — it takes over their minds…"

Scott's Thoughts (continued)

And it happens over and over.

"It's a totally sound premise that houses will become worth more over time because the dollar becomes worth less," Buffett said. "It isn't because, you know, construction costs go up. So it isn't because houses are so wonderful.

"It's because the dollar becomes worth less, and that a house that was bought 40 years ago is worth more today than it was then. And since 66 or 67 percent of the people want to own their own home and because you can borrow money on it and you're dreaming of buying a home, if you really believe that houses are going to go up in value, you buy one as soon as you can. And that's a very sound premise."

"Soon the price action — or at some point the price action takes over, and you want to buy three houses and five houses and you want to buy it with nothing down and you want to agree to payments that you can't make and all of that sort of thing, because it doesn't make any difference: It's going to be worth more next year," Buffett said. The financial crisis triggered by the housing bubble was orders of magnitude worse than past stock market crashes. Buffett articulated: "…the price action becomes so important to people that it takes over the — it takes over their minds, and because housing was the largest single asset, around $22 trillion or something like that, not above household wealth of $50 trillion or $60 trillion or something like that in the United States. Such a huge asset. So understandable to the public — they might not understand stocks, they might not understand tulip bulbs. But they understood houses and they wanted to buy one anyway and the financing, and you could leverage up to the sky. It created a bubble like we've never seen."

Bubbles continue to be obvious only in hindsight, largely because something based on a "sound premise" surely couldn't be a bubble. Unfortunately, in the markets, a premise is sound until it isn't."

So how expensive are stocks? Investors buying US stocks at current prices are valuing the typical large-cap company at almost 35 years worth of free cash flow - from now until the year 2053. Essentially, the entire stock market is being valued as if they are all booming growth stocks (Geoffrey Caveney 8/26/2018). Gary Gordon wrote a piece titled, "When Will S&P 500 Valuations Matter Again?," In his first bullet point, he said "truth be told, valuations have not mattered for the public markets for three-and-a-half years." He then goes on to state that "on virtually any methodology one employs, the U.S. stock market is extremely overpriced."

In coming to this conclusion, he has reviewed price-to-free-cash-flow, price-to-sales, market-cap-to-GDP, and other valuation matrices. Yet, as he noted in his bullet point, these valuations have not mattered for the three and half years where the market added 50% to its price. Yes, that is a 50% return which cannot be supported by traditional valuation methodologies.

Goldman Sachs offered this chart.

Scott's Thoughts (continued)

A **Goldman Sachs Group** Inc. indicator designed to provide a "reasonable signal for future bear-market risk" has risen to the highest in almost 50 years. The firm's Bull/Bear Index, which is based on measures of equity valuation, growth momentum, unemployment, inflation and the yield curve, is now at levels last seen in 1969. While the gauge is at levels that have historically preceded a bear market, Goldman strategists including Peter Oppenheimer wrote last week that a long period of relatively low returns from stocks is a more likely alternative.

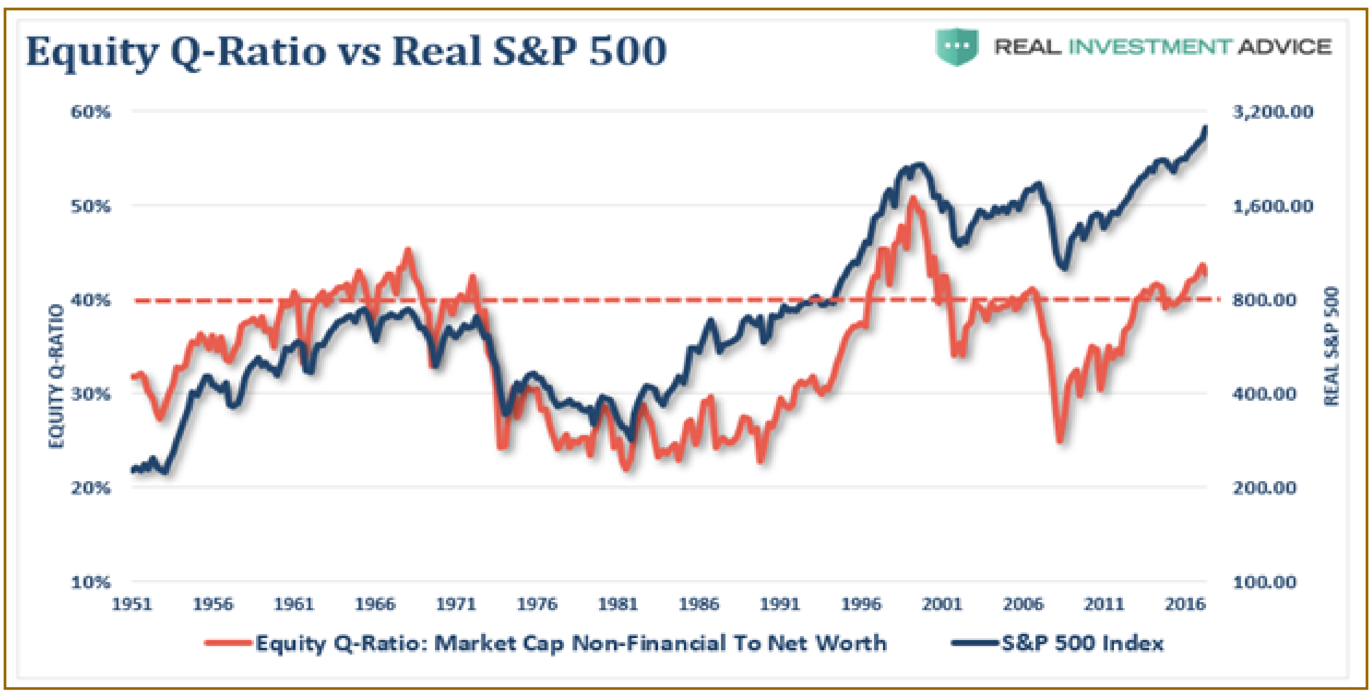
JP Morgan just published what could be the most well-documented financial crisis forecast ever written. The bank's quant team put out a 143-page report chronicling how the next crisis will unfold which features the opinions of almost 50 of Wall Street's top analysts and strategists. The consensus is that there will be a major "liquidity crisis" with huge selloffs in major asset classes, and no one to step in to buy. The losses will be exacerbated by the shift to passive management and the rise of algorithmic trading. JP Morgan says that the Fed and other central banks may even need to directly buy stocks, and there could even be negative income taxes. The bank thinks the crisis will hit sometime after the first half of 2019, most likely in 2020.

John Carney noted "The U.S. is the Only Improving Economy in the World Right Now."

Former BIS **chief economist William White** explains how a stronger US dollar could present serious problems for global borrowers whose debt is in USD but earn their revenue in some other currency. The entire system is vulnerable and anything could trigger a crisis. White notes a sustained "risk-off" shift could simultaneously strengthen the dollar and reduce US short-term interest rates. That combination is inconsistent with some popular highly leveraged trading strategies. The results might not be pleasant for anyone.

Corporate insiders are dumping stock in their companies at a rate not seen in 10 years. Yet, announced US **corporate stock buybacks** look set to approach one trillion dollars this year if one annualizes the YTD pace, **the highest on record**. So companies are using shareholder equity to buy stock while corporate insiders are selling stock.

There is no pessimism reflected in the data this chart represents.



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REFERRALS

A successful business grows through personal recommendations from satisfied clients. If you have a friend or associate who may benefit from our services, please ask them to give us a call. Thank you to those of you who have already referred clients.

"Not my dog" Scott

Scott's Thoughts.....

There is an old truism that retail investors are the last to buy in a bull market and the last to sell in a bear market. Basically, retail investors are great at being wrong. This can be demonstrated by the returns generated over the 20 year period ending December 2017. Stocks returned 7.20%, bonds returned 4.98%, inflation was 2.16%, and average investor earned 2.11%. Such a dramatic under-performance is achieved by buying high and selling low. Said another way, by owning too much when it was expensive and too little when it was valued.

The economy is growing at a brisk rate of 4.2%, unemployment is at/near record lows, employment is at record highs, and we have more job openings than job seekers. The economy is doing just fine, but I am aware of the abundance of lower quality debt (record levels), the lack of liquidity in the bond market (due to legislation passed in response to the Great Recession), the complacency regarding the record valuations placed on earnings and growth, rising interest rates and the higher cost to re-finance corporate debt, the effects of both trend following and high frequency trading, and our divisive politics. However, the good economy is trumping (pun intended) all concerns. For now.

It was a good summer. Perhaps too much rain, but my lawn is the best it has ever been. I never got the boat in the water this year, but I was fortunate enough to be invited (again) to a week of fishing Prince William Sound with some good friends (thank you again). Lets' hope for a mild winter and some glorious winter colors. And take care.