



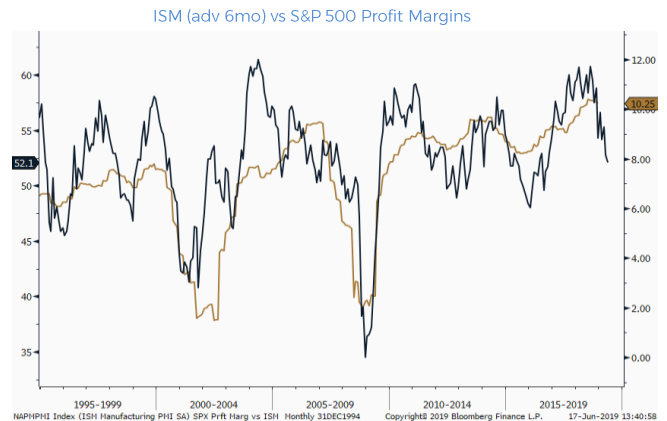
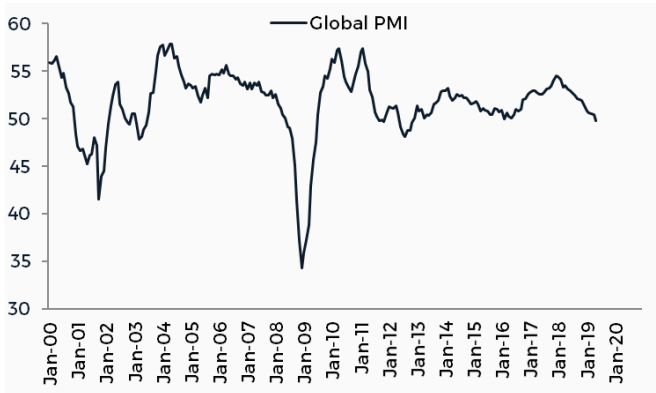
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# “By The Way”

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“Not because I’m trying to make money, I just don’t want to play in this environment.”

Geopolitical risk, most importantly the US/China trade war, has been the driving force for financial markets, both equity and fixed income for the past few months. While impactful in the short term, it is my opinion that over the next six to twelve months the direction and level of economic and earnings growth will be the more important factors in where equity markets will find themselves. If that is the case, what are our growth expectations for the next year. Statistics such as GDP, industrial production and unemployment are at best, reflections of where the economy is currently, and at worst, misleading, due to frequent revisions. Over the years we have instead sought to find and use leading indicators that, while not definitive, help us identify the direction the economy is likely to take. High on that list is the Purchasing Managers Index (PMI) from the Institute for Supply Management (ISM). As you can see from the chart, the most recent survey for Global PMI fell below the 50 level which suggests global growth will be in contraction in the near future. However, as you can also see, while the survey was very accurate in 2001 and 2008 it also gave a false warning in 2012. Delving deeper into the ISM reports for further confirmation of trend, we see more signs of weakness particularly the decline in new orders. There is a strong historic correlation that implies corporate sales and margins will be weaker, when the ISM is weak, and consequently earnings will also be weak. The well-respected Economic Cycle Research Institute is also predicting slowing growth, and the Wall Street Journal Economic Forecast Survey has consensus GDP Growth at 2.3% for this year and 1.8% for 2020. One more thing; Morgan Stanley just released its U.S. Business Conditions Index which dropped to 13, far below the 33 consistent with growth, and the lowest level since 2008. All in all, I am of the belief that while a recession is not necessarily at hand, the rate of growth in GDP and company earnings will not be sufficient to move equity markets significantly higher. Having said that, the Fed and its monetary policies have so far proven to have the ability to provide support for markets.



The credibility of the Fed has to be coming into question. While no one can accurately predict the future, it would be nice to feel that, given the power to affect all our lives, the board has a better sense of the future of the economy than swinging from a tightening policy to easing within the space of six months. At the end of 2018 the futures market indicated there would be 2-3 hikes in regulated rates in 2019. As of today, futures are saying there is a 50% chance of 3 cuts before year end. The Fed must be absolved of some of the blame as its task is not made any easier by the threats of tariffs and wars emanating from the oval office. Still, with the parsing of every speech and press release having a major impact on markets, a more consistent policy approach would be appreciated. Nevertheless, rate cuts this year now seem inevitable and that should be positive for markets. Other central banks are also easing: China to offset the effect of U.S. tariffs; Europe to fight off a slowing economy; and some countries like Australia have already cut rates. Increased liquidity has been a wind fall for markets over the past decade, and in the short term, that should again be the case. However, I am not convinced it will be enough if, as, and when there is a meaningful decline in global economies, which is a risk I foresee over the next year.

The equity market itself is not giving us a strong indication of where the future lies. Geopolitical concerns like tariff wars, Brexit and Iran have taken the wind out of our sails recently, but not to the extent of invalidating the longer term up trend. Thus, I will not fight the Fed and at least for the short term, I remain invested, but very nervous. As one analyst recently wrote, staying in the market at this late date could be like "picking up nickels in front of a steamroller".

One of my great concerns if we were to see a decline in the growth of the worlds economies is the risk of severe losses in credit markets. As we have mentioned many times, low regulated rates have pushed investors into more risky assets in the pursuit of higher yields. Many funds are required to only invest in "investment grade" bonds, and the best return is currently in the lowest rung of the "investment grade" market, which is BBB rated debt. As a consequence, the "Triple B" market has grown from \$686 billion to \$2.5 trillion in the last 10 years, and now constitutes 50% of the entire investment-grade market. Many of the corporations that have taken the opportunity to borrow in this market at relatively low rates are euphemistically described as leveraged. More accurately, one might say the companies have too much debt, such that there is great risk they will not be able to cover interest costs in the event of an economic downturn. At that point they would be downgraded to junk status, which would force funds to divest and create a vicious cycle. The size of this market is every bit as big as the subprime mortgage market was in 2007 and has the potential to be just as devastating.

Stanley Druckenmiller is a hedge fund manager who is considered by many to be the best and smartest in the business today. In a recent interview he said that in early May he sold all his equities and bought Treasury Bonds. To quote him, "Not because I'm trying to make money, I just don't want to play in this environment." I understand where he is coming from.

## Forward Looking Information and Disclaimer

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