Resuscitating the Canary

FC Advisors' Quarterly Investment Update – Q2 2016

The term "canary in a coalmine" comes from a crude method of determining air quality in coalmines. Before the science to detect various gases existed, miners discovered that small animals such as mice and canaries were more sensitive than humans to toxic gasses. So it became common practice to bring a canary in a cage down into coalmines. Any sign of distress from the canary was an early warning that there may be deadly gas in the air and that the miners should evacuate immediately. Applying this analogy to our financial markets, we see several possible canaries that are signaling distress, such as violent moves in currency markets, negative interest rates and rising political tension. One thing we doubt the miners ever tried was resuscitating the canary in order to continue working. However, central banks seem intent on trying to resuscitate these financial canaries, and investors seem happy to squeeze out a little more profit in the meantime. We believe the market's complacency and government stimulus are giving us a good chance to reduce risk and move out of harm's way.

The Quarter in Review

The second quarter of 2016 was punctuated by some violent market swings around the Brexit vote. Before the vote markets rallied strongly in anticipation of a victory by the Remain campaign. Markets were caught completely off-guard by the victory for the Leave campaign which led to a selloff in virtually all equity markets and rallies in government bonds and gold. Since the initial reaction, most equity markets have recovered their losses, while safe havens such as treasuries and gold have maintained their gains. It appears that markets are eagerly awaiting more stimulus from governments and central banks.

Relevant Index Performance

	Total Returns as of 6/30/16	
	Qtr to Date	Year to Date
S&P 500	2.46%	3.84%
MSCI World ex-US	-0.79%	-2.59%
MSCI Emerging Mkts	0.80%	6.60%
S&P Municipal Index	2.67%	4.35%
10 Year Treasury	3.08%	8.25%

Executive Summary

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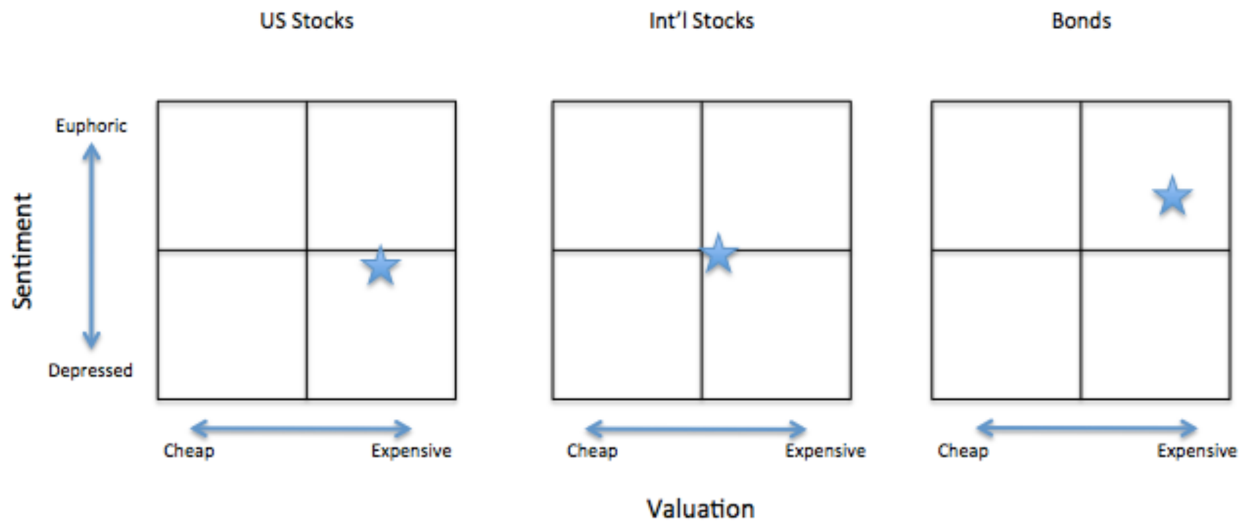
Sentiment & Value



The charts above show our opinion on where various markets are as of June 30th 2016. Many of the best purchase decisions are made when prices are cheap and sentiment is depressed (bottom left quadrant). Conversely, many of the best sell decisions are made when prices are expensive and sentiment is euphoric (top right quadrant).

Sentiment: In every major bull market investors eventually put too much faith in certain drivers of economic growth. Typically, belief in things like infinitely increasing revenues for technology companies and ever-rising real estate prices eventually shows up as euphoric sentiment for equities. Since 2009 sustained optimism in stocks has been non-existent. However, faith in the ability of central bankers to support asset prices has never been higher. Yet, the tools central bankers use have never been more ill-suited for confronting the problems in the global economy. While we continue to accept the possibility that new all-time high stock prices could be achieved in the near future. We believe extreme belief in the power of monetary policy may be a proxy for euphoric sentiment in stock markets. In the bond markets, investors all over the world are buying government bonds with no fear of inflation rising, suggesting that enthusiasm for bonds has also reached extreme levels. We are approaching both stock and bond markets with caution and looking to selectively raise cash levels on strength in either equity or bond markets while emphasizing assets that can perform well in divergent circumstances.

Value: The US stock market is expensive. Prices continue to be near all-time highs, despite the decline in corporate profits. Outside the US prices are more attractive; however, the risks of violent currency moves and liquidity problems are rising. As a result we now see worse risk/return tradeoffs in international stocks. In the bond market, the 10-year treasury now yields significantly less than the most recent Core Consumer Price Index (1.44% vs. 2.2%) suggesting that bonds are also very expensive. When forced to choose between stocks and bonds today, we favor stocks slightly. Given high prices all around and a lack of fear in the markets, we will be selectively raising cash. All things being equal, if the S&P 500 were to trade below 1900, we would be more

comfortable buying US stocks. On the fixed income side, if the 10-year treasury yielded more than 1.75% we would be more comfortable buying bonds.

The Impact of Brexit

Issue: On June 23rd, British voters stunned financial markets and political elites by narrowly (52% to 48%) voting to leave the European Union. The EU negotiates trade deals for the all its member countries as one giant $18 trillion block, making it larger than the US. This creates a great deal of bargaining power that all members get to enjoy. However, EU membership also has its drawbacks. All EU member countries are required to abide by one-size-fits-all rules regarding immigration, budgets, banking, etc. The British have decided that the costs of membership outweigh the benefits. Questions are now swirling around what this means economically and politically for the UK, the EU and the rest of the world.

Impact: For the UK there are three major impacts. First, they are almost certainly going to endure a recession in the short-term as the UK economy adapts to this shock. Second, they will need to negotiate new trade deals with all their trading partners now that the EU no longer negotiates on their behalf. And third, they will need to address factions in Scotland and Northern Ireland that are likely to pursue options for seceding from the UK in favor of rejoining the EU. Meanwhile, the EU has two problems to address. First, the EU needs to find ways to better meet the needs of their diverse members who are also pushing back against some of the EU's regulations. Second, the EU needs to re-establish the value proposition of EU membership. Unless the benefits clearly outweigh the costs of membership, the EU now faces increased risks of a disastrous break-up.

FC Advisors' Position: Europe is a mess and we are keeping our distance. The short-term consequences will be worse for the British, but in the long-term the EU faces the bigger problems. The UK economy even without Scotland and Northern Ireland is still the 7th largest in the world, which is plenty big enough to have bargaining power. Additionally, the British have their own nuclear arsenal and are key members of NATO. Lastly the UK, like the US, imports more than it exports which means that on balance the Brits are customers of their trading partners. All these factors make the UK a country that is an attractive trade partner and strategic ally. Meanwhile, the British move to leave the EU is a critical turning point in the process of European integration. Ultimately we see economic and political pressure building on the EU while its members still cannot agree on how to work together. We believe the EU's existential crisis is just beginning.

Italian Banks on the Rocks

Issue: As if Brexit was not enough of a problem for the EU, a new banking crisis is popping up in Italy. Unlike the US, EU banks did not get bailed out during the financial crisis and they have not cleaned the bad loans out of their banks. Now bad loans at Italian banks are at levels that are more than twice as high as US banks faced during the financial crisis. To make matters worse, in January the EU passed a new banking rule that forbids bank bailouts unless stock & bondholders of the bank realize losses first.

Impact: Another of the EU's regulations designed to help bring its members together is now threatening to tear them apart. As the situation stands now, the new regulation requires that stockholders will have to be completely wiped out and bondholders will need to suffer losses too. Following the new rules will be hugely destabilizing, as billions of euros worth of assets will be destroyed. Also, because many regular Italian citizens own Italian bank bonds, it will likely have a broad impact on the economy adding to the growing resentment of EU regulations. However, breaking the new banking rule would be a massive affront to the EU and would certainly lead to outrage among other EU members who are afraid of having to pay for irresponsible banking in Italy. Unless the EU members can rally around a solution that provides more than enough money to stabilize Italian banks and sets a precedent that EU members are willing to adhere to in the future, the dissolution of the European Union and the Euro is likely to accelerate. If a member of the Euro currency were to leave the European Union it would likely require the imposition of capital controls. In other words, the government of the exiting country would be forced to put harsh restrictions on the ability to move money in and out of the country.

FC Advisors' Position: Once again, Europe is a mess and we are staying away. The passing of the new EU bank regulations was the primary diver behind our decision to eliminate our dedicated European equity exposure in January. We hope that the gravity of this situation leads to a "grand bargain" within the EU that solidifies its core. In the meantime, this crisis raises the possibility of serious fault lines emerging within the Euro currency zone. Much of the world's financial system is predicated on the seamless movement of money around the world and between currencies. While still a low-probability outcome, we do not think that the possibility of capital controls being instated in a European country is adequately reflected in global stock prices. In response we are de-emphasizing international equities in favor of more predictable opportunities in the US.

Central Bankers to the Rescue!

Issue: Social and economic crises are coming to a boil all around the world and the only institutions that seem to be willing to confront these crises are central banks.

Impact: Central banks were originally created for one purpose – to manage the value of their respective currencies. Some of them, such as the Federal Reserve in the US, have also expanded their roles to include managing other parts of the economy such as unemployment. Today's crises are all at their core social/political conflicts. The US cannot seem to determine how to properly balance the interests of large corporations with the interests of individual citizens. The EU cannot seem to agree on a way to share the social and economic burdens of Europe. Central bankers have no means of answering these questions. The only thing they can do is print more money in hopes of resuscitating investors' appetite for risk and buying time for politicians.

FC Advisors' Position: We see risks rising until these social conflicts are resolved. The notion of central bankers trying to address social problems with monetary policy is absurd and troubling. Additionally, we see the enthusiasm in financial markets for more money printing and more government stimulus as a sign of complacency. At some point, suppressing financial crises and supporting asset prices begins to enable the dysfunctional behavior of governments and we believe we have crossed that threshold. If these political conflicts are left unaddressed, we fear that governments and central banks may resort to extreme measures to maintain order. In short, the risks of dramatic spikes in volatility and the possibility of liquidity drying up are continuing to rise.

Keep in mind that for disciplined, long-term, investors neither volatility risk (prices moving wildly) nor liquidity risk (not being able to sell assets at fair prices *today*) has to be detrimental. The only risk that can truly destroy wealth is financial risk, which is the risk that the cash flows produced by the investment deteriorate or disappear. We tend to focus our attention on financial risk, but we know that volatility and liquidity risks often convince investors to commit the cardinal sin of investing: *selling at desperation prices.* The goal is to prepare adequately and understand that volatility risk and liquidity risk are temporary. While we do not yet see dire scenarios as being likely, we are moving portfolios into more defensive and US focused positions. Ideally this will keep our clients less exposed to these risks and better able to take advantage of desperation pricing if it arises.

If you have questions about these topics or any other financial needs, please contact FC Advisors at:

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