Problem Parents & Problem Children

FC Advisors Quarterly Investment Update – Q3 2016

It is often said that success in life boils down to accepting short-term pain in order to achieve long-term gain. This is easier said than done, but most of us recognize that with discipline and planning that we can adhere to this principle in our personal lives. However, when the situation becomes more complex and we have to depend on others to make decisions that impact us, focusing on long-term benefits can be much more challenging. The classic example is the parent who routinely lets their child get candy at the supermarket in order to prevent or stop tantrums – a short-term fix for a short-term problem. However, most will agree that this short-term "solution" creates the long-term problem of teaching the child that tantrums = candy. After reinforcing this lesson for years, the parent will face a massive challenge in order to teach the child that they can no longer have candy, regardless of how epic and socially embarrassing their tantrums may be. Problem parenting can create a problem child. For better or worse, once an understanding between the two parties has been established, it is hard to change and both parties will be unhappy until a new understanding emerges.

For the past seven years the Fed has been delivering candy on a regular basis in order to quell market tantrums. Now the Fed is talking tough about raising interest rates and discontinuing the candy policy. The interesting question is – who is really in control? Has the Fed trained the market to calm down in return for free money or has the market trained the Fed to handout free money in order to end tantrums? Either way, we are bracing for more tantrums and encouraging our clients to plan for the long-term and maintain discipline.

The Quarter in Review

The third quarter of 2016 was characterized mainly by a recovery from the Brexit induced panic at the end of the second quarter. Assurances from central banks looking to restore calm to the markets helped equities, particularly international equities, recover powerfully despite a continued decline in earnings. Conversely, after rallying in the second quarter, bonds gave back some ground in the third quarter. Once again, markets are laser focused on any and all communication from central bankers around the world.

Relevant Index Performance

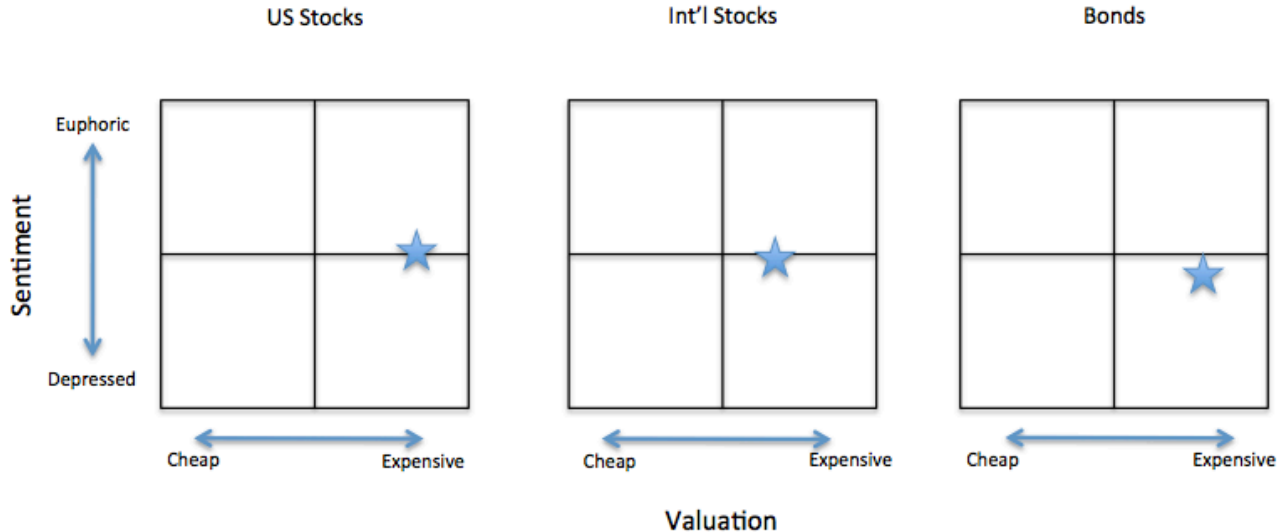
Total Returns as of 9/30/16

	Qtr to Date	Year to Date
S&P 500	3.85%	7.84%
MSCI World ex-US	5.66%	0.59%
MSCI Emerging Mkts	8.32%	13.77%
S&P Municipal Index	-0.14%	4.21%
10 Year Treasury	-0.59%	5.50%

Executive Summary

- Sentiment & Value Update
- All You Need to Know About:
    - The Italian Referendum
    - Japan
    - "Gold" ETFs, Physical Gold and Gold Miners

Sentiment & Value



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

Sentiment: Investor sentiment for equity became more bullish throughout the quarter. Despite a continued (now approaching 6 consecutive quarters!) decline in earnings. Increasingly, investors are becoming convinced that equities are the only game in town. With regard to international stocks, *fears* of violent currency moves and financial market instability have receded. Meanwhile, the Fed's stated intentions to raise interest rates have created a more bearish tone in the bond markets. Virtually every financial news source has been warning about the dangers of rising rates for bond investors.

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 slightly more attractive; however, the *risks* of violent currency moves and liquidity problems continue to be elevated. As a result we now see less attractive risk/return tradeoffs in international stocks. In the bond market, the 10-year treasury still yields less than the most recent Core Consumer Price Index (1.62% vs 2.3%) suggesting that bonds are also expensive.

As we alluded to in the introduction, both investors and policy makers seem to be primarily focused on short-term risks and opportunities. Given high prices all around and a lack of fear in the markets, we are maintaining high cash positions. When forced to choose between stocks and bonds today, we favor stocks slightly. All things being equal, if the S&P 500 were to trade below 1900, we would be more comfortable buying US stocks and if the 10-year treasury yielded more than 1.75% we would become more comfortable buying bonds.

The Italian Constitutional Referendum

Issue: On December 4th Italians will vote on a set of major reforms to their constitution (similar to a constitutional amendment in the US). Additionally, Italian Prime Minister Matteo Renzi has said that he will resign if the referendum fails. Currently the race is too close to call.

Impact: Italy's economy has been stagnant since the introduction of the Euro 16 years ago. The constitutional reforms are considered essential for Italian economy to adapt to the constraints of the Euro. If the referendum fails, it will create political chaos in Italy, opening the door for anti-Euro parties to gain even more support. Italy is the 3rd largest economy in the Euro, if it were to threaten to leave the Euro currency financial markets would react severely.

FC Advisors Position: This is not the Italian version of Brexit. The media may present this as such, but the actual vote is about whether or not Italy is willing to make changes to its constitution in order to break-up political gridlock that has prevented necessary economic reforms. This vote is ultimately more about the future of the European Union (EU) and the Euro currency than it is about Italy. Italy joined the EU and the Euro and enjoyed the short-term benefits of membership, but they failed to make any of the difficult changes necessary to insure long-term success. If these reforms pass, it will be the first example of political and economic elites sacrificing their power for the long-term benefit of their country and, more importantly, the EU. **If it fails, the viability of the Euro and the EU will continue to erode.** We are continuing to stay away from Europe where we believe the risks outweigh the benefits.

Japan

Issue: The Japanese government and the Japanese central bank have been struggling to generate growth and prevent deflation. The rumor is that they are considering an extreme approach known as "helicopter money" to jolt the economy out of its 30+ year rut.

Impact: We touched on "helicopter money" in our deep dive on Negative Rates. Printing a massive amount of money and literally giving it away to tax payers or to the government is considered the "Nuclear Option" when it comes to fighting deflation. Utilizing helicopter money would dramatically devalue the Japanese Yen and could even spark a hyper-inflation (10%+ inflation rate) in Japan.

FC Advisors Position: Owning Japanese equities, while hedging the risk of a major yen devaluation, is an attractive opportunity. Japan has been one of the pioneers in the trend of increasingly aggressive monetary policy. They have done quantitative easing, bought massive amounts of bonds and stocks and have even tried negative interest rates. If any country is likely to

try helicopter money, Japan is probably at the top of the list. In this scenario, globally competitive Japanese companies, such as automakers, will benefit doubly as their products suddenly become much cheaper than their competitors and their earnings in yen skyrocket due to increased foreign revenue and a weaker yen. To the extent that this scenario triggers instability elsewhere, or occurs in response to global financial stress, **owning Japanese stocks without the risk of the Yen is an excellent counterweight to the risk of another financial crisis.**

"Gold" ETFs, Physical Gold and Gold Miners

Issue: Recently we have been getting lots of questions about gold. Is it an inflation hedge, an investment, or just a piece of metal with only imaginary value? Could it be all three?

Impact: More than almost any other commodity or stock, gold's enigmatic nature tends to push investors into emotional decision making. More often than not, emotional investment decisions end up being decisions to buy at the top and sell at the bottom.

FC Advisors Position: Gold and gold related investments tend to do well when people lose confidence in the global financial system or are concerned about the competence of central bankers. Typically, as these fears grow, the price of an ounce of gold rises. Conversely, as investors become more confident in the global financial system and central banks, gold typically falls in value. Thus, gold tends to be an inflation hedge only when inflation is accelerating. **Currently, we see risks of accelerating inflation and declining confidence in both the financial system and central bankers.** We view gold ETFs, physical gold that you can readily access, and gold mining companies, as three different and distinct ways to invest in gold. See below:

	"Gold" ETFs	Physical Gold	Gold Miners
Benefits	* Easy to buy & sell	* Helps some people sleep at night	* Easy to buy & sell * Productive asset * Profits grow as gold price rises
Drawbacks	* Storage cost * Unproductive asset * Hard to actually get the gold	* Storage cost/risk * Unproductive asset * Difficult to buy & sell	* More volatile than gold * Can be expensive relative to gold price
FC's Take	Merely an investment in the *idea* of physical gold	Feel free to own up to 1% of your net worth in readily accessible gold if you want	***Our favorite option today.*** They are cheap compared to the price of gold.

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

415-528-2826

hello@fcadvisors.us

www.fcadvisors.us

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