Preparing for The Big One

FC Advisors Quarterly Investment Update – Q2 2017

To live or work in San Francisco means living with the risk of a major earthquake. The operative word in this statement is "living." If we knew with certainty that a major earthquake would hit the Bay Area next week, then the majority of the city would probably evacuate the area, putting everyone's life on hold. If we knew a major earthquake would strike the city in the next 4 seconds, we would probably end up hiding under our desks! But of course we don't know with any useful degree of confidence when and where the next major earthquake will occur. The best we can do is make sure that we have prepared for the risk by setting aside provisions and creating back up plans for communicating & reuniting with loved ones. Once we have prepared vigilantly, we have to get on with our lives. If we can't move past the anxiety caused by ever-present earthquake risk, then our lifestyles that we care so much about will gradually deteriorate anyway.

Recessions are a lot like earthquakes. Both destroy wealth, upend lifestyles and neither can be predicted with relevant precision. The resulting damage, though painful and emotionally taxing, is usually not permanent. With effort and time both our portfolios and our communities can bounce back stronger and more resilient than ever. In fact, disasters like earthquakes and recessions often create unique opportunities for new and better ideas to be implemented. For investors anxiously waiting for the next recession, we'd suggest developing a plan, embracing the best possible options, and then getting back to finding ways to make money. For our clients, we are making sure that cash balances and reserve accounts are topped up, and incorporating assets that are likely to provide us the flexibility to capitalize on the opportunities that the next recession will likely create. But don't let our bearish views on the markets paralyze you. There are always opportunities to make money and sometimes the best ones occur when you least expect them.

Executive Summary

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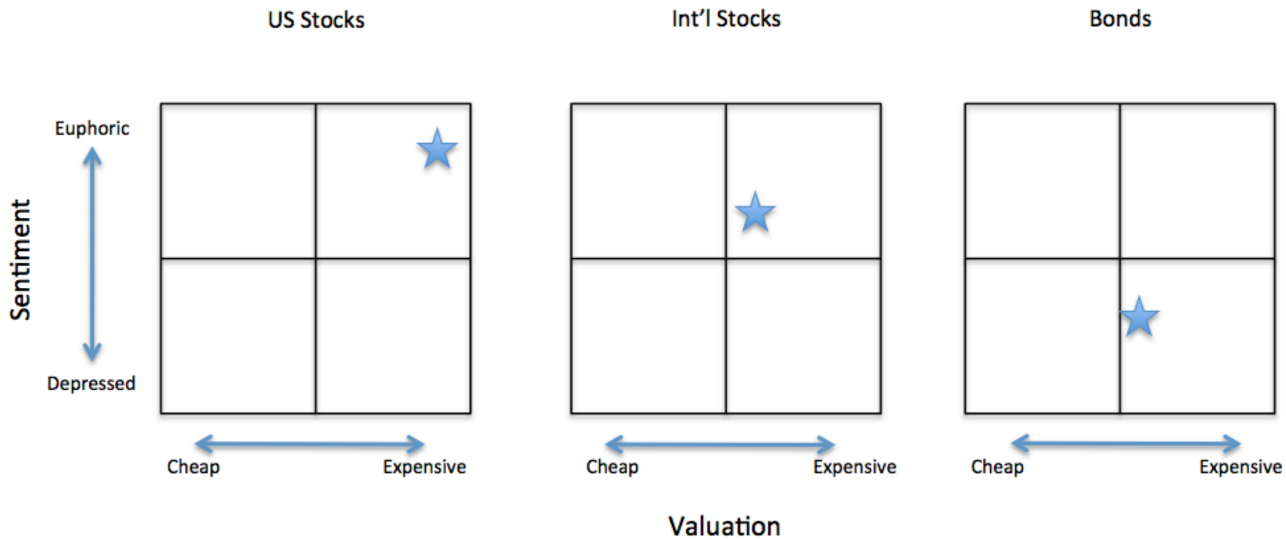
The Quarter in Review

US stocks continued to rally even though expectations for the US economy began to cool. European stocks rallied on the back of Emmanuel Macron's sweeping victory in the French elections. And a rally in the US bond markets was stopped in its tracks when the European Central Bank (ECB) began to contemplate winding down its quantitative easing (QE) plan.

Relevant Index Performance

	Total Returns as of 6/30/17	
	Qtr to Date	Year to Date
S&P 500	2.93%	9.17%
MSCI World ex-US	4.59%	10.92%
MSCI Emerging Mkts	5.47%	17.22%
S&P Municipal Index	1.81%	3.25%
10 Year Treasury	1.26%	2.06%

Sentiment & Value



The chart above shows our opinion on where various markets are as of June 30th 2017. 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).

	US Stocks	International Stocks	Bonds
Market Sentiment change in last 3 mos	More bullish. Automation, AI and massively scalable businesses are considered the wave of the future. Current profitability is almost irrelevant.	More bullish. The political crisis in Europe has morphed into an opportunity for France & Germany to cooperate. Emerging markets have become a popular long-term investment	Less bullish. With the Fed raising rates and the ECB contemplating a reduction in QE, investors are wondering who will buy bonds.
Market Value change in last 3 mos	More expensive - prices rose with little improvement in earnings or economic growth. Valuation ratios of all sorts are very high.	More expensive - prices rose, but so did earnings and GDP growth. Weakening US dollar has also helped boost performance.	Slightly less expensive - prices rose slightly (and interest rates declined), but inflation has been falling faster.
Signal	Sell	Neutral	Neutral
FC's Take	We are still enjoying the rally, but are in the process of gradually reducing US stock positions.	The best place to look for equity investments, we just wish it was cheaper and less popular.	Another window for buying bonds may be opening.

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The most unique characteristic of this now 8-year-old rally in the US stock market has been the incessant money printing by central bankers. At least one, and usually two, of the three major central banks (The Fed, the ECB and the Bank of Japan) have been buying billions of dollars of assets every month for the past 8 years. Non-stop money printing has been widely considered a tailwind for asset prices, especially stocks. However, now many pundits claim that central banks raising rates (the opposite of printing money) is unlikely to be a headwind for stocks. We doubt that equity investors will get to have it both ways and therefore conclude that stock markets around the world are broadly too optimistic about economic growth. Luckily, while opportunities in equity markets appear to be shrinking, the opportunities in the bond market have improved slightly. Bond investors once again have opportunities to receive a small premium above inflation for buying longer-term bonds. Lastly, there has been one undeniably positive development for all investors – the Fed has now raised rates enough that we can get more than 1% yields on 3 month T-bills. This makes it significantly less expensive for us to wait for better buying opportunities.

We will continue to gradually lean more toward bonds, and away from the most expensive equity markets. *All things being equal, if the S&P 500 were to trade below 2000, we would be more comfortable buying US stocks and if the 10-year treasury yielded more than 2.75% we would be enthusiastically buying bonds.*

Themes We Are Still Watching

We've mentioned lots of issues and themes in these letters. Just because we aren't writing about them every quarter, does not mean we have forgotten about them. We continue to track these issues as they evolve and adjust our portfolios accordingly.

Risk/Opportunity	Major Theme(s)	Potential Surprise	FC's Position
Public Sector Pensions	*Debt & Demographic challenges	*Underfunded pensions suddenly matter	*Expect slower economic growth *Deflation risk, good for government bonds
Brexit, European Elections, Protectionism	*Waning globalization	*Europeans cannot agree on how to mutualize their budgets & debts	*Probably missed a short-term opportunity recently, but the long-term problems still exist. We are avoiding Europe.
Oil Market Drama	*Waning globalization	*Geo-political conflict threatens energy supply chains	*We are looking for opportunities to take advantage of bearish views on oil.
Gold & Gold Miners	*Overactive central banks *Waning globalization	*Global financial system is more fragile than people think	*Cheaper than when we first wrote about them, more upside now! *Good hedge against global economic instability

India

Issue: Despite having a young, increasingly well-educated population that is unencumbered by debt, India has been unable to ignite a major wealth creation process. This may be about to change.

Impact: If India can unlock a wealth creation process similar to China's it will lift 150 million people out of poverty and grow a middle class of more than 200 million people. Wealth creation on this scale creates huge opportunities for investment in a growing Indian domestic economy.

FC Advisors Position: *We like the opportunities in India.* While the Indian stock market is up significantly, we do not believe that current stock prices account for important changes to the Indian economy. Up until now, despite all its promising attributes, India has been stuck in an economic no-win situation due to three self-reinforcing issues. **1)** The country lacks critical infrastructure such as electricity and running water in many rural areas. **2)** Much of the economic activity (some estimates are as high as 50%) in India is black market activity. The black market fosters corruption and is impossible for the government to tax. **3)** The government has lacked the revenue necessary to invest in the critical infrastructure necessary to ignite widespread economic growth and wealth creation.

Recently two important changes have taken hold. First, the government has built a biometric database (known as Aadhaar) that now links individual identification numbers and other official government information to the retina scans and finger prints of over 1 billion Indian citizens (99% of the population over the age of 18). Second, in December of 2016, the government instituted an aggressive demonetization program in which two of the largest denomination bills (500 and 1000 rupee) were taken out of circulation in order to curtail the black market economy in India.

As a result, today any Indian citizen in the Aadhaar system can walk into any bank in India and open a bank account with only a finger print or retina scan. Additionally, India's banking system has been modernized such that any Indian citizen with a bank account can instantly send money directly to a business or another individual. These transactions are easily tracked, allowing the government to apply the appropriate goods & services tax to business transactions. Now the black market is being pushed into the official economy, the government has more revenue, and India is focusing on making ambitious investments in infrastructure.

The Robots Are Coming!

Issue: Artificial intelligence (AI) and automation seem poised to revolutionize the US economy through labor saving efficiency gains. Some prognosticators are even suggesting that robots will put millions of Americans out of work.

Impact: Many businesses may be able to increase their productivity and reduce costs by investing in artificial intelligence and automation. On the flip side, the majority of investments in AI and automation seem to be focused on reducing labor costs & cutting jobs.

FC Advisors Position: *It's time to tap the brakes.* You know that a theme in the economy is getting overblown when websites like www.willrobotstakemyjob.com start to pop up. A few minutes spent perusing one of these websites or any of the dozens of scholarly reports about the impact of automation and artificial intelligence will give you the impression that the next 10 years will see millions of good paying jobs in the US eliminated. Self-driving vehicle technology alone threatens the jobs of 1.7 million Americans who make a median income of over $40,000 per year driving a truck. For better or worse, changes of this magnitude simply cannot happen in a 10-year time frame. The US economy is built on a system in which people work to earn money and then spend that money to support their lifestyle and invest in their family's future. The United States' economy has many obstacles to overcome, but too many "$40,000+ per year jobs" is not one of them. If the United States experiences a net reduction in jobs over a period of more than just a few months, it will almost certainly cause a recession and short circuit the current wave of investment in AI and automation. In other words, robots are probably not about to take your job anytime soon.

We have no doubt that these technologies will eventually unlock incredible growth opportunities for our economy, but it appears unlikely to occur in the next few years. Labor saving technology is great, but at some point, in a consumption-based economy like the US, it becomes self-defeating. The opportunity to invest in technology that will increase profits by reducing headcount may be great for an individual business. But when thousands of businesses all make these decisions together without creating enough new jobs in the process, the economy ends up shrinking. We believe the way these technologies are being utilized today is likely to create a net loss of jobs and is also preventing wages (and inflation) from rising at normal rate. Until businesses identify ways to grow the economic pie with AI and automation, the adoption of these technologies is likely to be bumpier and slower than the market seems to think today. Ironically, one of the best investment opportunities that the current wave of automation is creating may be in long-term US treasury bonds, which tend to benefit when the economy is weak and inflation is falling.

Are Indexes Wagging the Dog?

Issue: Hundreds of billions of dollars per year have been flowing into index ETFs and other "passive" investment strategies. Indexed based investment products now control trillions of dollars.

Impact: With so much money in index funds, the arbitrary decisions made by the architects of these indexes are impacting markets more everyday. Moreover, now that investor optimism or pessimism is being expressed through index funds, broad swaths of the market are moving up or down regardless of the unique characteristics of individual businesses.

FC Advisors Position: The original concept was that an investment in an index fund would be able to get a "free ride" as informed investors bought & sold stocks in order to get the best return in exchange for risking their money. Because the amount of money controlled by passive investors was relatively small, it used to be that the market price of any given stock was almost entirely determined by the behavior of informed investors. Whether or not a stock was in one or more popular indexes had little bearing on the price. Today, we believe the sheer volume of money that blindly follows indexes has reached a point where it can easily overwhelm the daily investment decisions made by informed investors.

This is a new fault line that has emerged in capital markets. Because so much money is flowing into indexes and equity markets in general, the prices of most stocks (especially popular stocks with little or no earnings) are incredibly high. Our response has been to reduce some of our exposure to US equity index ETFs in favor of buying individual stocks that have significant earnings, and are trading less expensively. We don't expect this to have a huge impact on performance while the markets are rising. However, we expect that the next recession will trigger massive amounts of selling in the equity markets, particularly in index funds. When this panic selling of indexes occurs, we expect that it will drive down the value of all the important stocks in the indexes significantly, even the very best companies in the indexes. We are preparing vigilantly so that we will be ready to meet high quality investment opportunities at rock bottom prices in the event that The Big One eventually happens. Until then, remember that life is for living and money that you are unlikely to spend in the next ten years is for investing – recessions and all.

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

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