Who's Knocking on Your Door?

FC Advisors Quarterly Investment Update – Q2 2018

In Benjamin Graham's classic book, The Intelligent Investor, he utilizes a character named "Mr. Market," to help his readers better understand the concept of value investing. As Graham emphasizes, you can count on Mr. Market to give you a price for your investments everyday, but he offers no promises regarding the validity of the prices he quotes. Mr. Market can be a misleading, volatile person whose views are subject to change at a moment's notice. Some might even say he has multiple personalities. Merely understanding that Mr. Market is not always right and more importantly, that he changes his mind on a regular basis can make you a more confident and rational investor. Knowing who (or which of Mr. Market's personalities) is knocking on your door can help you make better decisions.

Most of the time Mr. Market's personality is rational, opinionated and prone to extrapolating recent trends… think CNBC's Jim Cramer. On his show "Mad Money," Jim is always up on the latest investment fads and all the most exciting themes and he is never in doubt. He doesn't know everything, but he will always give you an answer. You can count on him to give you an accurate read on what is "hot" right now, but rarely is he focused on time frames longer than the next two years.

Occasionally, Mr. Market can get carried away quoting prices that are hopelessly depressed or wildly optimistic. For those who have confidence in their own reasoning behind the intrinsic value of an investment, these occasions can offer extraordinary opportunities to buy or sell certain assets. The key point that Benjamin Graham sought to teach us is that we don't always have to believe Mr. Market. More importantly, we don't have to trade at his prices if we don't find them attractive today. After all, he will be knocking on our door again tomorrow with new prices.

Until recently, with cash offering little or no return, we could only compare Mr. Market's prices on a given risky asset such as US stocks, with other risky assets such as long-term bonds or foreign stocks. Without cash as an alternative, virtually all asset classes have been bid up to fair or overvalued levels. Now that the rate on short-term T-bills is roughly even with inflation, the "no alternative" era is officially coming to a close. In most cases we think Mr. Market needs to sweeten the deal if he wants us to buy risky assets from him.

Executive Summary

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The Quarter in Review

It was a bumpy quarter for both US stocks and bonds as growing trade war fears periodically took attention away from solid economic growth and strong corporate earnings data. International investments of all sorts, especially emerging markets stocks struggled as the US dollar rallied strongly. The one true bright spot was oil, which rallied on strong demand and emerging supply constraints.

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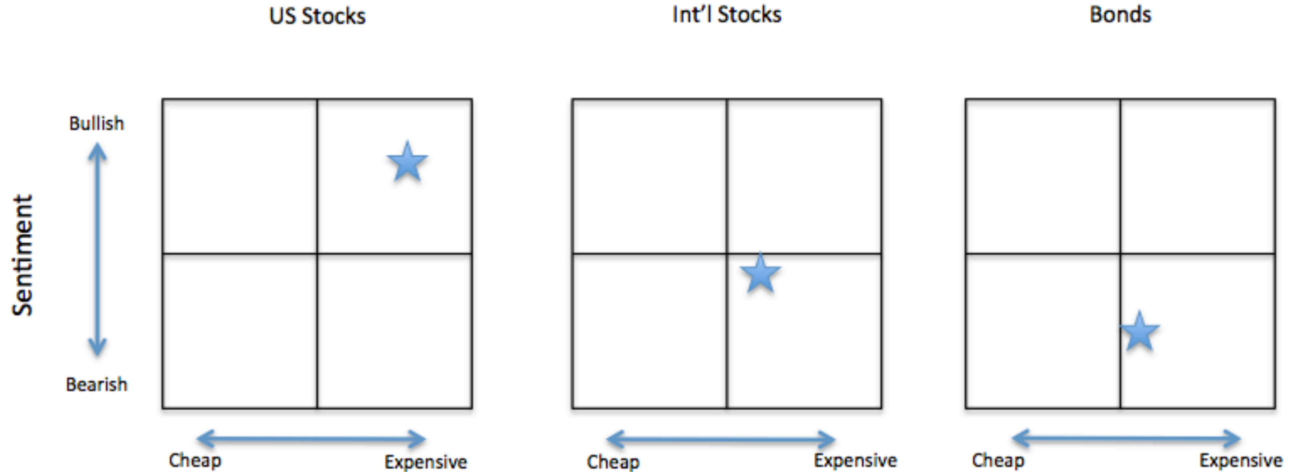
Relevant Index Performance

	Total Returns as of 6/29/18	
	Qtr to Date	Year to Date
S&P 500	3.43%	2.65%
MSCI World ex-US	-0.75%	-2.77%
MSCI Emerging Mkts	-7.86%	-6.51%
S&P Municipal Index	0.91%	-0.02%
10-Year Treasury	-0.04%	-1.55%

Sentiment & Value



The chart above shows our opinion on where various markets are as of June 29th 2018. 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	Less bullish. The excitement around earnings growth has fallen off and trade war fears are percolating.	Less bullish. Trade fears are most prevalent in international stocks where optimism around growth has morphed into skepticism.	Unchanged. The steady rise in interest rates has stopped and inflation concerns are cooling.
Market Value change in last 3 mos	Cheaper. Earnings beat already optimistic targets in the 1st quarter with little price appreciation.	Cheaper. Earnings have continued to move higher in many international markets while prices have fallen.	Cheaper. Short-term bonds appear very cheap on a relative basis. Longer-term bonds are a little cheaper, but still expensive.
Signal	Sell	Neutral	Neutral
FC's Take	We have not yet moved into cheap & bearish environment; however, we continue to see pockets of opportunity emerging.	International markets have been hit hard recently and still offer the best value.	We would look to buy more long-term bonds if yields move sharply higher. For now, short-term bond yields look more attractive.

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US stocks have shaken off concerns about the implementation of tariffs. Whether Mr. Market believes that trade concerns are already priced in, or that trade tensions will ultimately be resolved – we believe that more caution is warranted. While we are not predicting a sharp acceleration in inflation, rising inflation is definitely a risk as globalization goes into reverse. Investments that can benefit from inflation such as energy stocks and various commodities look attractively priced. *All things being equal, if the S&P 500 were to trade below 2,400, we would be interested in buying US stocks and if the 10-year treasury yielded more than 3.25% we would be adding to long-term bond positions.*

Tariffs… part II
Issue: In our last update we wrote, "until any tariffs are actually implemented, there is no trade war." Well, now there are several new tariffs that have been implemented and each side is preparing more.

Impact: Global trade has become very interconnected. A trade war would be very disruptive and it could easily cause a recession and/or inflation.

FC Advisors' Take: *Tariffs are just one small part of the global trade picture. The powers that be need to consider all the variables.* The current rhetoric on trade seems to treat the trade balance (the total imports from a trading partner less the total exports to that trading partner) and the threat of implementing tariffs on those trade flows, as the whole story. If the Trump Administration sees the issue this way, then this is a dangerous miscalculation. While the US may be in the best position to survive, there are no winners in these conflicts. Here are a couple of things to watch:

After tariffs, there could be sanctions – Economic sanctions go a step beyond tariffs and generally involve banning certain types (or all) transactions with a company or potentially all companies based in a certain country. China already has a history of implementing unofficial sanctions in order to exert leverage on its trading partners. Recently, the US effectively imposed sanctions on China's ZTE telecommunications company for failing to comply with US sanctions on North Korea. And there are more sanctions risks on the way. The US has stated that all of its trading partners must stop importing Iranian crude oil by November 4th. Iran's largest buyers of crude oil are, in order of largest to smallest: China, India, South Korea, Turkey, Italy, Japan, U.A.E, Spain and France – all of which import more than 100 thousand barrels per day according to Bloomberg. What's the penalty for non-compliance? You guessed it, sanctions.

Supply chains are the biggest risk for corporations – As free trade spread from the end of WWII to the present; the global economy became much more interconnected. In particular, the supply chains that are used to make complex equipment such as cars and airplanes have become global as well. Hundreds of parts from different countries come together to make these products as efficiently as possible. The more tariffs are enacted, the more risk there is that these businesses will have to cope with severe price increases and shortages of certain inputs. As businesses struggle to adapt they may be willing to pay more for labor too, which could stoke inflation. Tariffs, sanctions and wage inflation are all bad for corporate profits, even in the "winning" country.

Social Security

Issue: On June 5th 2018 the board of trustees for the Federal Old-Age and Survivors Insurance Trust Fund (aka Social Security) issued their annual report. For the first time since 1982, and for the foreseeable future they expect to have net negative cash flow.

Impact: If no changes are made, trustees expect that Social Security will run out of money by 2034. From that point forward, draconian benefit cuts of 25% or more will be required. With so many current and future retirees making financial planning decisions based in part on Social Security, sixteen years is not a lot of time to solve this problem.

FC Advisors' Take: Social Security is an example of the problems that face tax payers and anyone expecting to retire with the assistance of a government sponsored entitlement program in the next 20 years. In one form or another all entitlement programs face the following three challenges.

Returns – The ultra-low interest rate environment we have been living in since the financial crisis has diminished the returns that conservative investors such as pensions plans or Social Security can earn on their assets. Moreover, the "No Alternative" environment has pushed up the prices on risky assets meaning that the returns for taking more risk are likely to be lower from here.

Demographics – As the US population ages, the ratio of retirees to workers increases. Advances in healthcare that increase the average life expectancy will continue to exacerbate this trend. When Social Security was first initiated in 1935, the average life expectancy was 61 years. Even adjusting for higher infant mortality rates in the 1930s, less than 60% of the population who reached adulthood would live to be 65. Currently, 82% of the US population lives to be at least 65. In order to solve the US's pension problems, we need to re-evaluate what "retirement age" means.

Expectations – Entitlement plans like Social Security and pensions create expectations. Once an expectation is baked into someone's plans, changing it can be painful. Any new plans or changes to current plans need to be accompanied by safe and durable expectations. This will be hard to do, primarily because politicians are incentivized to sugarcoat any plans they endorse and they are more motivated by short-term (read: during their political careers) rather than long-term outcomes. In our opinion, the best approaches incorporate dynamic and flexible guidelines. For example, the "retirement age" for a plan could be set to rise by 1 month per year beginning in 5 years and continue rising until the "retirement age" is 15 years less than the average participant's life expectancy. A scheme like this would minimize the pain experienced by those closest (and typically most dependent on the plan) to retiring, while ensuring that younger participants will be able to count on the plan being there when they finally do retire.

Woulda, Coulda, Shoulda

Issue: When Mr. Market changes his mind investors often feel regret because they "woulda, coulda or shoulda" done something differently.

Impact: If investors feel regret too much and too often it can erode confidence and lead to even more poor investment decisions.

FC Advisors' Take: When it comes to investing, perspective is everything. The nature of financial markets is such that no matter how good the outcome may be, there is always a way that could have been just a little better. "I could have bought a little sooner, or a little more!" "I could have held that winner longer! "I should have sold that loser earlier!"

Behavioral research clearly shows that human beings are programed to feel losses more than they feel gains. By extension, this suggests that we tend to play these counter-factual games with ourselves primarily to the extent that we can envision decisions that would have improved our current situation. The best investors know that it is crucial to keep a positive attitude and maintain confidence and conviction in their investments.

While there is always a way to imagine a better outcome, the opposite is also true. People rarely give themselves credit for all the thousands of losing investment ideas that they did not buy. Similarly, people tend not to spend much time celebrating the relatively good decisions they made. Lastly, people often fail to pay enough attention to longer-term gradual winners because the most recent or more volatile investments tend to be more exciting. Next time you find yourself having a negative feeling about investing, try to remind yourself that it could have been worse! There is no changing the past, but you will probably be happier and have a healthier perspective on risk if you have a more balanced perspective.

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

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