Cavelti

Cavelti & Associates Ltd.
188 Eglinton Avenue East, Suite 706
Toronto, Ontario, Canada M4P 2X7
Phone 416 - 486 1900
Website: www.cavelti.com

October 3, 2017

To: Our Clients
From: Peter Cavelti

The Elusive Correction

Dear Client:

It's difficult to ignore the world around us. I fervently believe that the geopolitical environment is turning more explosive, and that the social, economic and monetary policies followed in most of the industrialized world are not only unsustainable, but close to hitting a wall. Most people in leadership positions recognize that, as do increasingly many citizens. Yet, financial markets keep advancing, partly because central banks have lost their way, and partly because investors tend to stick with what's been working for them.

As Oaktree Capital's Howard Marks, one of the most respected money managers, recently said, "Risk is high and prospective return is low, and the low prospective returns on safe investments are pushing people into taking risk—which they're willing to do—at a time when the reward for doing so is low."

How risky are the broad stock indices? It depends how you look at it, but there is plenty to worry about. To begin with, valuations are high by any yardstick; in the U.S. for example, the S&P500 cyclically adjusted price-to-earnings ratio has only been higher once—in the late 1990s. Then there is the fact that during the past decade S&P500 corporations have spent more on dividends and share-buybacks than they've earned. That, in turn, has boosted corporate indebtedness to close to $9 trillion, which is a third higher than it was at its previous peak in 2008. U.S. corporate debt is now at 46% of the country's GDP, a historical high. In short, America's companies are more highly valued, less profitable and more indebted than they've been in years.

Unfortunately, none of this gives us a clue as to when exactly the inevitable correction will unfold. All it provides us with is a historical marker. If we want to take it seriously, we can react by making a portfolio more defensive, or we can exit markets entirely. A number of prominent hedge fund managers have done just that in recent months, by liquidating their positions and returning cash to the clients. As you know, our approach has been different: we believe that the key central banks have no alternative but to keep interest rates at extreme lows, and that politicians fully support that stance. Of course, the continuous use of stimuli to counteract economic challenges is extremely imprudent—eventually, a much bigger crisis will force creative destruction and bring this folly to an end. But when that happens is completely unknowable.

Uncertainty Everywhere

What's happening in the social policy arena and in geopolitics is as eery. There is little doubt that America's, Europe's and Japan's entitlement and pension systems are headed for a brutal crash, but timing it is impossible. On the political front, too, danger signs abound, as the U.S. turns more isolationist, while also escalating tensions with China and Russia and confronting several Middle Eastern regimes and North Korea. Yet, while the odds are strong that something will sooner or later ignite, when that happens remains elusive.

Our view remains that, given the many permutations that can arise from the number of uncertainties and their scale, we need to prepare for a variety of possible outcomes. Pursuing 'investment styles' introduces inflexibility and therefore unnecessary risk; betting on one specific outcome is even more imprudent. I shake my head when I listen to the talking heads on television prognosticate what the central bankers will do next, or how a military showdown with North Korea will affect financial markets. Such projections are idiotic and those acting on them skate on thin ice.

As I said three months ago, we believe pragmatism is the best approach. In our media-centered world, the narrative of the moment *is* critically important, and embracing it on a tactical level has so far been profitable. However, we try not to lose sight of our strategic goal, to allow for inclusion of investments that do well in scenarios that *may* see reality. We hope this approach, along with paying attention to downside risk and occasional retreats into cash, will continue to help us outperform.

During the third quarter of 2017 we did significantly better than the key indices. For the year to date, your account has appreciated by roughly 15%. We are more than satisfied with this result, especially when considering last year's considerable outperformance, but we remain concerned that a setback may be imminent.

Please let us know if you have any questions or concerns.

Kind regards,