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To: Our Clients
From: Peter Cavelti

Of Events, Trends and Catalysts

Dear Client:

Describing the past year is not easy. To many, 2017 brought tension and strife; to some, it brought a great deal of suffering. Blissfully, to those of us fortunate enough to live in North America, Europe, Japan or down under, it was a year not unlike others—a lot of headline noise about the world's many trouble spots, but at home mostly wellbeing. Most economies experienced faster-than-anticipated growth, and if you were invested in the stock market it got even better. Your portfolio appreciated quite a bit more than what the financial industry expected.

When projecting what may lie ahead, it's always tempting to pay excessive attention to recent events and extrapolate. Yet, with few exceptions, we believe trends that have been visible for several years are a far better compass to the future. Here are three of the most important dynamics:

- In the economic arena, the effects of extreme central bank manipulation have now been with us for nearly a decade. The consequences are material changes in consumer and corporate behavior, and a gross distortion in asset prices.
- On the social policy front, demographic pressures have been building for years. Highly transparent, but completely ignored by policy makers, most governments and many large corporations in the industrialized world face massive unfunded liabilities. At best, these will result in broad cutbacks in retiree payouts; at worst they will cause the bankruptcy of numerous public and private pension regimes. This will prove extremely painful, as the disparity in wealth continues to widen and low interest rates make it impossible for members of the middle class to generate income on their diminishing savings.

- Politically, much of the industrialized West has in one way or another allowed itself to become hopelessly overextended. Government debt levels are absurdly high and unwillingness to correct the problem will push them progressively higher. Here are two excellent examples of fiscal overreach. One is Europe's social welfare addiction: the EU makes up roughly 25% of global GDP and accounts for nearly 70% of global social spending. The other is America's use of military power to preserve the uni-polar world that emerged from the collapse of the Soviet Union: the U.S. operates over 700 bases in nearly 80 countries and spends US\$640 billion annually on defense—about the same as the next nine largest-spending countries combined. Overreach always leads to systemic collapse or brutal retraction.

There are many other examples of trends that have been allowed to race in the wrong direction for far too long. Imprudently conducted agricultural, energy or environmental policies, mismanaged health care, the erosion in educational standards—we're on a destructive course in far too many policy applications. When systems fail, government can allow "creative destruction" or intervene by propping up even highly visible systemic weaknesses. The reaction to the 2008 global economic crisis was a prime example of the latter. Massive liquidity injections and bail-outs allowed the least worthy to survive and take their inefficiencies to new heights. The problem with kicking the resolution of problems ever further down the road is that it pushes society toward ever greater instability, as stresses exponentially grow. Eventually, one or more outside events will decisively end the status quo.

No one knows what the catalysts will be, but there is a growing list of candidates, some of which emerged only during the past few months. I would place the following in the critical category:

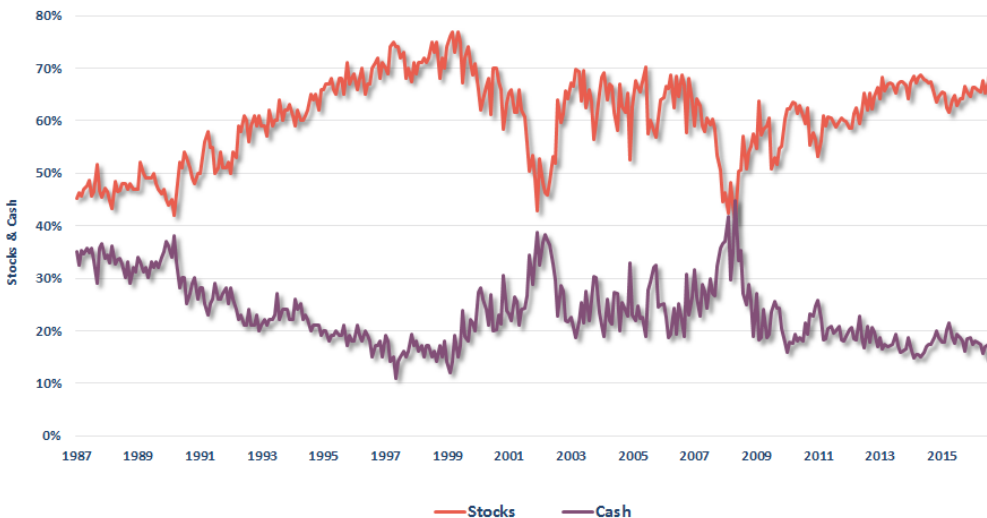
- The row over North Korea's nuclear program could easily escalate into war;
- The overthrow of the Saudi Kingdom's power structure and the increasingly transparent effort by U.S., Israeli and Saudi interests to emasculate Iran could turn into a broad regional conflict;
- America's "Russia-gate" hysteria, coupled with other neo-conservative initiatives in Washington, London and some European capitals, could lead to a NATO-Moscow clash;
- America's efforts to counteract China's rise as an economic and military power are deepening the rift in bi-lateral relations. This could have a major impact on trade patterns and threaten the global financial fabric.
- Progressively broader and more frequent cyber-attacks on commercial and state infrastructure indicate that warfare, crime and terrorism are all pushing new boundaries. Any serious confrontation between the major power will almost certainly target electrical grids, digital connectivity and the ability to conduct financial transactions.

As I said, I have no idea which of these issues may spin out of control and lead to an unravelling of the current order—what's of concern is that there are a significant number of dynamics in place that could quickly unleash broad chaos. Investing under such circumstances is a difficult proposition. Even so, we've done well, achieving an appreciation of just over 20% during 2017, bringing the cumulative performance for the past two years to roughly 45%. We are pleased with this result, especially because we achieved it while pursuing a fairly defensive strategy.

How long can the stock market's winning streak continue? Valuations and other analytical tools suggest that we are overdue for a correction, but the prevailing narrative, articulated by central bankers, establishment economists and the financial industry remains firmly positive. The investment community's belief system of the moment is that, a) central banks won't allow a meaningful correction in equities, b) there are few attractive places for money outside the stock market, and c) the market's overvaluation is therefore justified.

Investors All In....Again

REAL INVESTMENT ADVICE



If someone had asked me a year ago where the market was headed, I would have argued that a meaningful correction was in the cards. Yet, despite that, we decided to remain invested, albeit with a decidedly cautious stance.

Behind our decision to stay in was the creative tension that exists between Melissa's and my own philosophies. You see, my instinctive reaction is that the market's next moves will surely be determined by its relative over or under-valuation. After all, I'm first and foremost an analyst. Melissa's tendency is to pay a lot of attention to the reigning narrative, probably a smart thing to do in today's media-centric world. So, what you get is a blend: we consider valuations, especially when looking at specific sectors or stocks, but we also take into account the dominant story. It's worked well so far, and we hope it will prove to be the right formula as we enter another challenging year.

We hope you spent a relaxing holiday and, as we enter the New Year, wish you good health, success and satisfaction!

Thank you for your continued trust.