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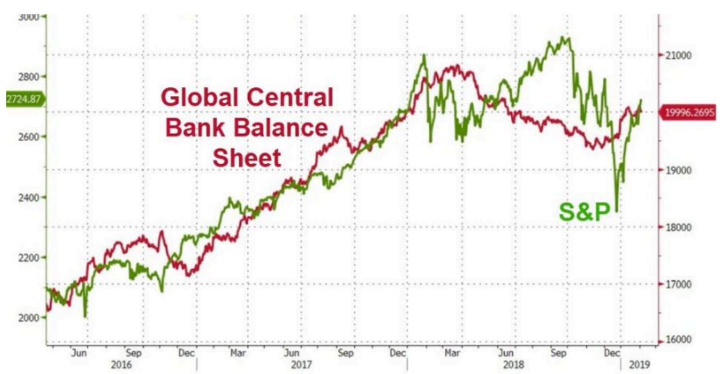
To: Our Clients
From: Peter Cavelti

Command and Control

Once again, predictably and on time, the U.S. Federal Reserve and the European Central Banks, have shifted gears. After talking tough for most of the past year, the world's key monetary agencies have softened their stance. The Fed suddenly sees no further need to ratchet up short-term interest rates, while the ECB has put in place measures to make life easier for the continent's ailing banks. The reason for all this, in plain and simple language: the economy is so weak that without ongoing stimulus from the world's central banks, a global recession is virtual certainty.

The legacy of a couple of decades worth of central bank intervention in free markets is a profoundly sad one. We've now arrived at the stage where the most advantageous corporate investment is to buy back its stock and where stock markets won't be allowed to decline, because that would undermine society's perceived well-being. Or put differently, those borrowing and deploying their capital to the stock market look like geniuses, while investors paying attention to stretched valuations and falling corporate profits look ridiculous. The idea that equity and bond markets should price in risk is dead, at least for the moment.



That is largely because central banks have, in effect, become a central planning mechanism. They command and control, and by doing so destroy the principles of ethics and prudence. So far, the regime of near-zero interest rates has disenfranchised millions of savers, while luring millions of others into catastrophic indebtedness. Meanwhile, hundreds of corporate and public pension funds are woefully underfunded, caught between ridiculously low yields and demands for higher-than-ever payouts. And, perhaps worst of all, the disparity in wealth continues to rise exponentially. In the United States, the gap between rich and poor is now larger than in any other major developed nation, as the middle class bears the brunt of misguided central bank policies.

Chances are that it will get worse. As I've noted on many previous occasions, the climate on every front is deteriorating. Any number of economic problems, monetary imbalances, social discontent or geo-political flashpoints could quickly bring the stock market party to an end. Yet, having said that, timing major market moves remains as elusive as ever. In the end, whether to cash in some or all of the chips on the table is a matter of temperament. When I talk to the strategists at the larger financial institutions I'm frequently told that they wish they could do what we do—take a chunk of money and retreat to the sidelines. The reason they can't, they explain, is "because it's too risky".

When the Music Stops

To me, such thinking is at best counter-intuitive, even though I can intellectually grasp it. I was brought up in a generation where market exposure constituted risk and cash was considered risk-less. In contrast, many of my younger peers see the market as a game where exiting means that they might temporarily underperform and therefore lose some of their notoriously fickle clients. Chuck Prince, Citigroup's CEO, famously captured that spirit in 2008, when he said this to the Financial Times: "When the music stops, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Shortly after, the market collapsed and his bank was one of several that had to be bailed out.

A friend recently asked me why I feel so confident that my approach is better? To begin with, I don't see things in terms of better or worse. Rather, I believe that it's a question of mandate, and the client mandate I perceive is to exercise prudence. When it comes to the stock market, that means paying attention to macro-economic and stock-specific fundamentals. At a time when organizations like the IMF and the BIS warn that a further slowdown would prove devastating to Europe and the emerging markets, and when key U.S. recession indicators flash orange, I prefer to err on the side of caution—or to return to Chuck Prince's jargon, dance close to the exit.

Importantly, foresight is not a guarantee for underperformance. Despite above industry-standard cash positions, we handsomely outperformed the relevant indices in each of the past three years. So far in 2019, due to our robust cash position, our performance lags the benchmarks. Still, we're up 6.32%, more than three times last year's loss. I'm reluctant to make projections for the remainder of the year, but I wouldn't be surprised if recent market strength soon gave way to another painful round of profit taking.

Please let me know if you have questions or concerns.