Cavelti

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

April 4, 2016

To: Our Clients
From: Peter Cavelti

The Central Banks, Again

Dear Client:

On January 19, after a gut-wrenching multi-day sell-off, I wrote to you and other clients what we financial professionals call a "hand-holding" letter. I urged you to consider whether investing in an asset class that was prone to such fluctuations was really right for you, and pointed out that extreme in negative psychology were often synonymous with market bottoms. As it happened, the timing of my letter could not have been better. The following day, key stock indices started a robust recovery, and as I write this letter, we can look back on a positive return for the year to date.

Much of the volatility that is the hallmark of today's financial markets has been baked into them by the world's major central banks. The U.S. Federal Reserve pioneered its foray into the deeply experimental in order to hold together its financial system during the 2008 crisis; Japan, Europe and China followed. In October of 2015, I wrote, **"Let's be clear about one thing: central banks appear to have lost control over their intended path toward 'normalization', but their experiment continues and their power remains undiminished. That is why financial asset markets will continue to take their cues from statements made by a few central bankers. And given the large number of unresolved issues on the economic and geo-political fronts there will be lots of such statements, each of which will yank precariously jumpy financial markets in one direction or another."**

Chart courtesy Mauldin Economics

To wit, the deep January correction in stock markets was fully attributable to the Fed's hints that higher U.S. rates were imminent, just as the more recent market euphoria can be attributed to Europe's latest round of monetary relief and reassurances by the Fed that rates would not be raised, after all. The bottom line: the world economy is doing poorly, and while that lasts, central banks are likely to dive ever deeper into the untried.

The positive effect of central bank shenanigans is that equity values, for now, are being propped up, which boosts the wealth effect and in turn makes consumers a bit more confident. The negative is that our monetary authorities have managed to distort every conceivable link between the pricing of financial assets and their underlying fundamentals. In doing so they have also undermined the ethics complex that governed the successful operation of society during the past many centuries. Working hard and saving for a rainy day no longer seems like a smart idea; consumption in excess of production is what is being systemically promoted instead.

Providing for Different Outcomes

All of which begs the question of what a prudent investment approach might look like. We have for some time tried to anticipate a variety of outcomes to the current quagmire. What if the Great Central Bank Experiment resulted in unstoppable deflation? What if a new inflationary age were the outcome? What if, like in the 1930s, central banks and governments resorted to ever more policy directives to control the movement of capital and trade? In the absence of knowing in which direction our domestic economies or the global economy will move, it seems to us that a strategy recognizing various outcomes and diversifying accordingly, may make the most sense. We have used recent market strength to further move in that direction.

We also believe that, no matter how unimportant investment fundamentals have become to most market participants, companies with a strong capital structure offer vastly superior downside protection. As the global economy continues to undergo serious tests, players with strong balance sheets will not only manage to survive, but will be able to take market share from their financially stressed competitors. Intriguingly, many of the financially best-managed firms also pay a handsome dividend.

No matter which twists and turns the path forward takes, we are convinced that volatility in the pricing of financial assets will increase sharply. Global trade is showing signs of acute stress, much-needed structural policy change remains lacking in all key economies, geopolitical disequilibria prevail, and the potential for social unrest keeps rising, both in the developed and emerging economies.

There are also numerous stock specific factors that may boost volatility. To begin with, earnings are under pressure and valuations rich—in the U.S., the average price-earnings is nearly 50% above its long term average. When looking at projected earnings growth, it gets worse: the S&P500 is currently trading at a PEG ratio (price-earnings-to-growth) of 1.7 times, an all-time record. We are also concerned that the bull market is now more than seven years old. Historically, only one rally lasted longer: the one from late 1987 to early 2000—and the subsequent correction cut stock values in half.

We do not know how long the world's central banks can perpetuate the stock market miracle in the face of a sputtering world economy, but it appears they are determined to try anything. That reality introduces a significant risk to simply withdrawing from the market, especially at a time when other asset classes offer little investment incentive. Still, we believe that the record low volatility (see chart on previous page) we are currently experiencing is unlikely to last beyond the next few weeks and that a period of considerably gyration lies ahead.

Finally, a word regarding performance. Your assets appreciated substantially and ahead of relevant benchmarks during the first quarter, reversing the decline experienced during the fourth quarter of 2015. We have made a number of adjustments to your portfolio, designed to further boost downside protection. If you have any concerns or questions, please let Melissa or me know.

Kind regards,