Cavelti

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

April 7, 2015

To: Our Clients
From: Peter Cavelti

On A Wing And A Prayer

Dear Client:

The first quarter of 2015 brought the art (or folly) of central bank watching to new heights. While the European Central Bank and the Bank of Japan are still vowing to "do whatever it takes", the U.S. Federal Reserve keeps tinkering with its rhetoric. The result: seemingly intelligent economists and money managers are engaging in spirited arguments over whether a small rise in U.S. interest will be seen as early as June or as late as December. One prominent money manager, in a recent client letter, actually argued that an expected three-month delay in a rate-hike fully justified his commitment to stay 100% invested in U.S. equities.

The central bankers themselves, meanwhile, are doing everything possible to obfuscate their intentions. A key question that arises is whether heads of the Federal Reserve, the European Central Bank of the Bank of Japan actually have a defined plan or whether they are flying, as middle-America would call it, "on a wing and a prayer"? Given the failure of multi-year massive quantitative easing to inject energy into a sadly imbalanced economy, and considering the sluggish behavior of consumers and the increasingly cynical attitude of investors, I'd have to guess it's the latter. In other words, I believe that the world's pre-eminent central bankers are at the point where they have lost the ability to proactively manage and where reacting to whatever happens next is the only way out. Worse, with many of the central banks' conventional tools long gone, the ability to react is considerably diminished. With interest rates near zero (and in several countries in negative territory), the only monetary stimulus possible is through supplying more money. And that is where rhetoric comes in: in the absence of being able to *do* anything of substance, central bankers give us sound-bytes, which are magnified a thousand-fold by the media.

So, will the big central banks, led by the Federal Reserve, start raising interest rates in summer, fall, or not at all? I believe the global economy is so strung out that any rate hikes will be minuscule and, at best, symbolic. To be sure, there are positive developments that may embolden the Fed to talk about the need to exit the biggest experiment in U.S. monetary history. Lower gasoline prices help most consumers and, for some, a buoyant stock market and firmer housing prices create the illusion of wealth.

On the other hand, turning off the monetary tap at this time ushers in significant risk. To begin with, there is the super-strong dollar, which erodes profits for many globally active U.S. corporations. Then there is the crashing shale economy, which is just now starting to impact the economy. Last year, the energy industry led capital spending and “fracking” made up a huge segment of employment growth; this year, it’s the opposite on both counts. So, with America’s exports less competitive, with capital expenditures sluggish and with government spending under pressure, who will carry the U.S. economy? Central bankers and government figures bank on the consumer, but so far their bets aren’t paying off. Despite lower gasoline costs, Americans are increasingly cautious about spending—consumer confidence is uninspiring, retail sales are poor, the savings rate is up. Surveys say that consumers don’t *feel* in a recovery, that they are deeply distrustful of government, not believing central bank rhetoric, and inclined to build an ark before the rain.

What about the money manager I quoted earlier? If central banks will remain cautious and won’t raise interest rates until some time later, is the stock market a safe place to be? Interestingly, we asked ourselves the same question a year ago. Melissa and I concluded that, yes, equities were likely to keep rising, but that multiples were becoming stretched and that we should therefore pursue a defensive strategy. The result was that for 2014 we underperformed the popular indices quite considerably.

A More Dangerous Place

Looking ahead now, there are distinct differences:

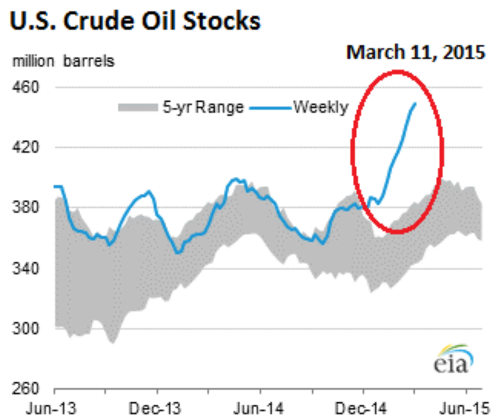
-As a result of last year’s massive rally in U.S. stock markets, valuations are considerably richer, raising the probability of a correction.

-Multinationals make up a significant component of key stock indices. The dollar’s value rose roughly 10% between bottoming in spring last year and year-end. It has risen a further 13% since, which will negatively impact earnings for many American companies.

-The domestic political scene in two of the three big developed economies has sharply deteriorated since last year. Policy paralysis is far more likely now in America, with a Republican controlled congress and a lame-duck Democrat president. In the Eurozone, meanwhile, the electorate is speaking up against the existing order—the governments of the five largest EU countries are all under pressure to cut back on Euro-centric thinking. Meanwhile, a desperate Greece is forcing a review of several deeply enshrined European concepts.

-Monetary policy, when viewed globally, is even more accommodative than last year. While Fed rhetoric is centered on exiting the quantitative easing experiment “when conditions permit”, the EU and Japanese experiments with QE have only just started in earnest. Continued worldwide monetary ease will have a temporarily stabilizing effect on the economy, but poses huge challenges further out.

-In the emerging economies, the climate has deteriorated sharply. China, whose future is debated most vigorously, continues to do relatively well, but economies from Brazil to Indonesia to Nigeria are contracting at an alarming rate. Some emerging countries are suffering because a material portion of government and corporate debt is in rapidly rising dollars, others because they are producers of commodities whose prices have been falling.



-The oil price collapse has unleashed additional stresses, which will become more noticeable as we go forward. In the U.S., inventories of crude oil are rising at a terrifying rate; capacity at key storage facilities like Cushing is nearing its limit. That will delay an oil price recovery and could even push oil lower.

-Finally, the geopolitical landscape is far more volatile than it was a year ago. Washington's foreign policy adventures and the prevailing view that the U.S. is entitled to and needs to impose its will on the rest of the world, is running into difficulty—not only potential foes, but equally with allies. We are at the beginning of a transition from a world led by the U.S. as its hegemon to a multi-polar organism. Most of the world has deep sympathy for U.S. values as articulated by its leaders, but can see that these values are sadly lacking when U.S. policies are implemented. Interestingly, this is understood everywhere except in America, which is a virtual guarantee that tensions will only mount.

All in all, the world is a more dangerous place than it was last year at this time. Moreover, the odds suggest that things will deteriorate further during the period ahead. Monetary, economic and social policy platforms in most countries that matter are utterly unsustainable; at some point they will collapse and be replaced. What we don't know is when that will be and which catalysts will unleash the change. Considering all these factors, we believe it is prudent to pursue the course we have been on, emphasizing diversification and remaining committed to minimize downside risk. Having said that, we must realize that such a strategy may hamper performance, if the equity bubble keeps on swelling.

One of the worst manifestations of regulatory compliance is the gathering of meaningless information. One financial institution we deal with asks us whether any of our clients is related to the president or a cabinet minister of a foreign government; in the same questionnaire, we are asked whether our clientele includes "agents of a potentially hostile foreign army". But occasionally (and only occasionally), the regulators come up with a good idea. One of these is that money managers should know their clients. Another, and one I want to introduce you to today, is that it may be smart for money managers to remind their clients that they should know themselves. Let me explain what I mean by that.

As individual investors, we all know how we react to rising markets. Not only do we feel good as long as our portfolios do well, but things we didn't plan all become possible. Feeling and being richer, we can consider remodeling our home, indulge in a fancy vacation, or upgrade our car. Things become more problematic when markets drop. We are poorer than we thought, we may have to scale back our expenditures and, worst, our emotional wellbeing may be threatened. Statistics are replete with evidence that most investors liquidate their portfolio near the bottom of market corrections, mainly because that is when they conclude that the stress a rapidly declining stock portfolio unleashes "just isn't worth it." Most of us personally know people who, during the 2008 calamity, lost a large part of their wealth.

The Importance Of Knowing Yourself

When I think about my more than four decades as an investment executive, one thing stands out above all others: how little my clients know themselves. Now that we may be approaching another market top, I am once again asked why our portfolio strategy isn't more aggressive. "Aren't you ignoring opportunities," my clients say, or, "Shouldn't we stay more fully invested a bit longer?" Intriguingly, these are the same clients who congratulated us after the 2008 market meltdown for protecting their assets so well. The problem, the way I see it, is that people find it difficult to assess their "risk tolerance". In the context of a buoyant market, it's easy to conclude that we accept a 30% downside risk—but once the market drops 15% and every headline pronounces that much worse is to come, it's tough to hang in.

So, let me get to my point: what I wanted to share with you is a table that details different expectations for an average portfolio return during the length of a typical cycle. It's based on actual investment returns achieved in a basket of equity mutual funds which include international holdings, over several business cycles.

Average Annual Return During Cycle	Maximum Gain In Any One Year	Maximum Loss In Any One Year
6%	12%	7%
7%	15%	11%
8%	20%	16%
10%	26%	20%
12%	45%	32%

Percentages are rounded. Portfolio model used is 65% North America, 35% international.

Ask yourself what you feel you should expect in terms of a return on your stock portfolio. If it's 8%, the table suggests, you are likely to experience a peak annual return (in the best part of the cycle) of 20%. Conversely, you should also be prepared to lose 16% a year during the correction that will inevitably follow. Expect a 12% average annual return and you need to adjust these parameters considerably, accepting the possibility of a 32% annual loss when the correction hits.

The most important question when mulling over this table is how much you feel you can afford to lose and how much stress you can stand. Answering that now is not easy, because you are making a judgment when things are stable and there is no emotional tension. But even so, contemplating the potential risk and reward of investing is a valuable exercise, because it helps you understand that shifting your expectations has consequences.

With kind regards,