▶ 2017 - The Year Of Opportunity ............... 1-9

▶ It's Like déjà vu All Over Again ................ 9-11

ISSUE 7 | VOLUME 5 | JANUARY 2017

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

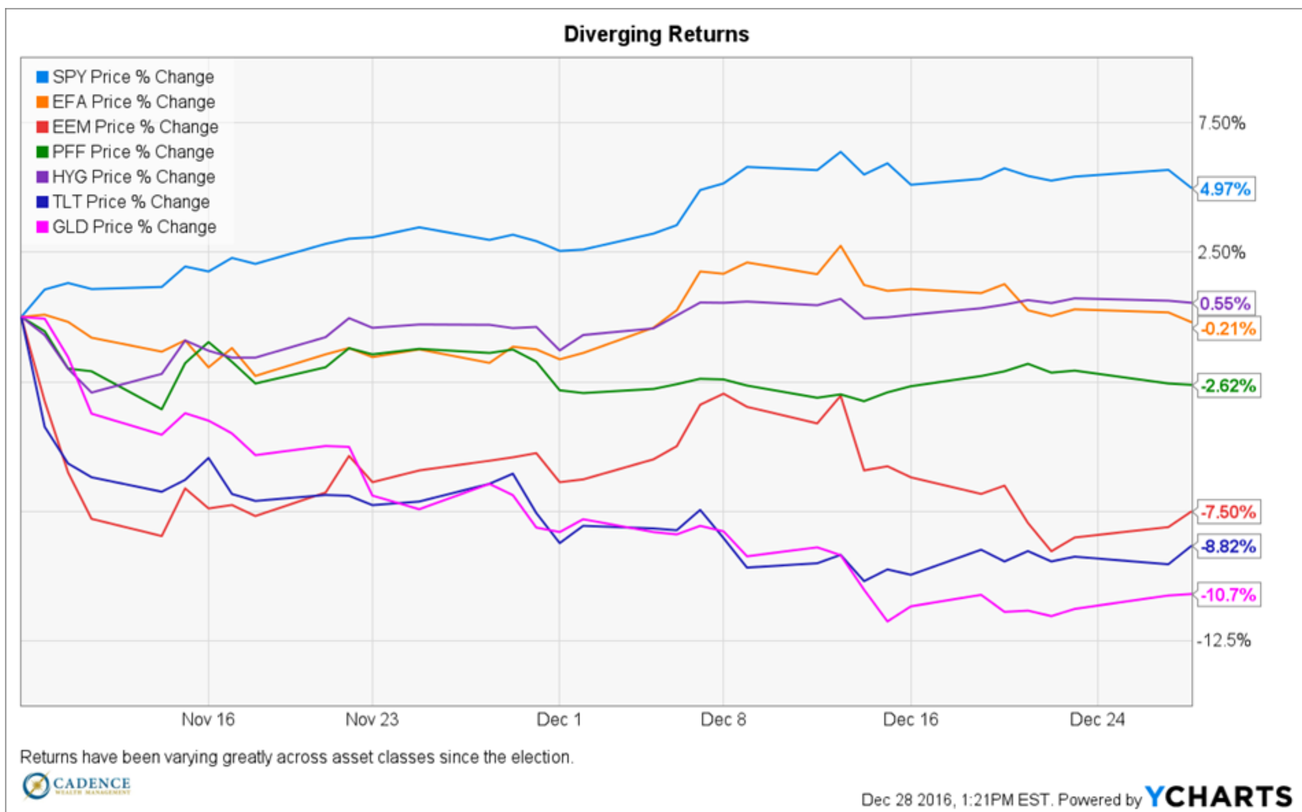
# 2017 - The Year of Opportunity

There's no question that a lot of what's happened in 2016 will continue to affect us in 2017 – historic currency moves, European banking drama, cowardly terror attacks, and of course a new president unlike any we've had to date. Regardless of how these and other events play out, our optimism moving into the New Year is based on data, facts, and math. Most markets are outrageously expensive by historical standards, but the good news is that we know this condition always leads to opportunity for those who are prepared. The question always is timing and to this we don't have an exact answer – nobody does. As we'll lay out on the following pages, timing isn't always as important as you'd think. What's crucial is that in protecting our capital we're early rather than too late. U.S. stocks are in an historic bubble and there's no shortage of pins floating around the world at this very moment. So prepare, protect and embrace opportunities as they unfold. It should be an interesting year.

Before making our case on the current state of the investment universe as we see it, let's address briefly how investors fared in 2016. Warning: If you don't want all the technical jargon or find yourself drifting off as you read on, please just jump to the Key Points at the end of the write-up.

2016 – The Year of Diverging Performance

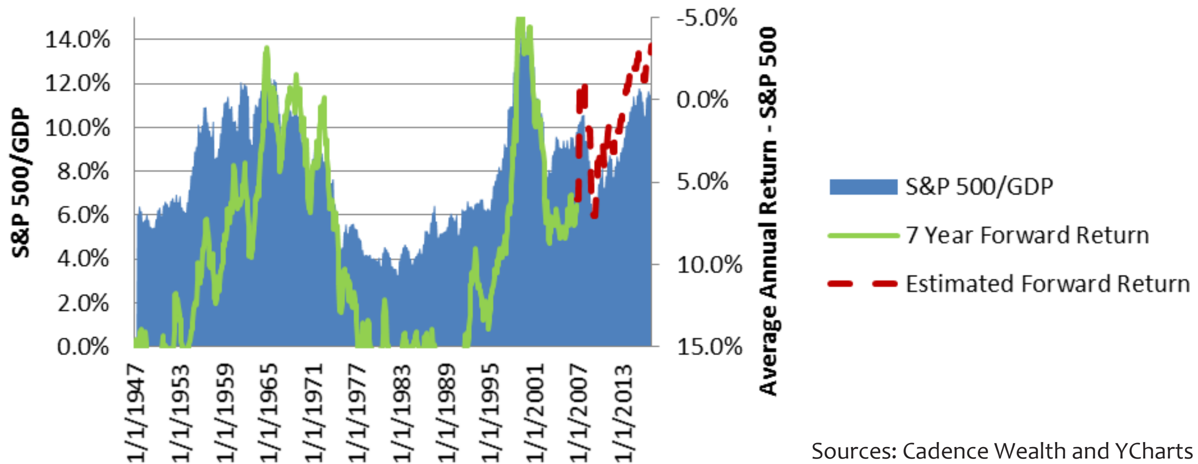
Without going into too much detail on how different asset classes performed in 2016 (please read "It's Like Déjà Vu All Over Again" for that), it's fair to say that your performance was only above average if you were invested primarily in U.S. stocks. If you had a globally diversified portfolio, your returns were probably in the low single digits, regardless of whether you were aggressive or conservative. The reason – with the exception of U.S. stocks, most things struggled in 2016 making it much less constructive a year than it might appear. Since the election on November 8th, the S&P 500 is up about 5%, while a host of other asset classes are actually down. Emerging Market Stocks, Gold, and U.S. Treasury Bonds were among the worst performers. This performance gap really jumps out in the chart below.




In our opinion, this is not representative of a broad-based acceptance of good things to come. A more universal reaction across risk-based asset classes would be a stronger vote of confidence. Needless to say, a properly diversified portfolio hasn't participated in the post-election rally in a meaningful way. We don't necessarily view it as bad, it just is. To get caught up in what could have been is a pointless exercise since it's not realistic. To be primarily invested in U.S. Stocks would be far too risky and an unacceptable risk to your longer-term financial goals. Here's why we feel that way…

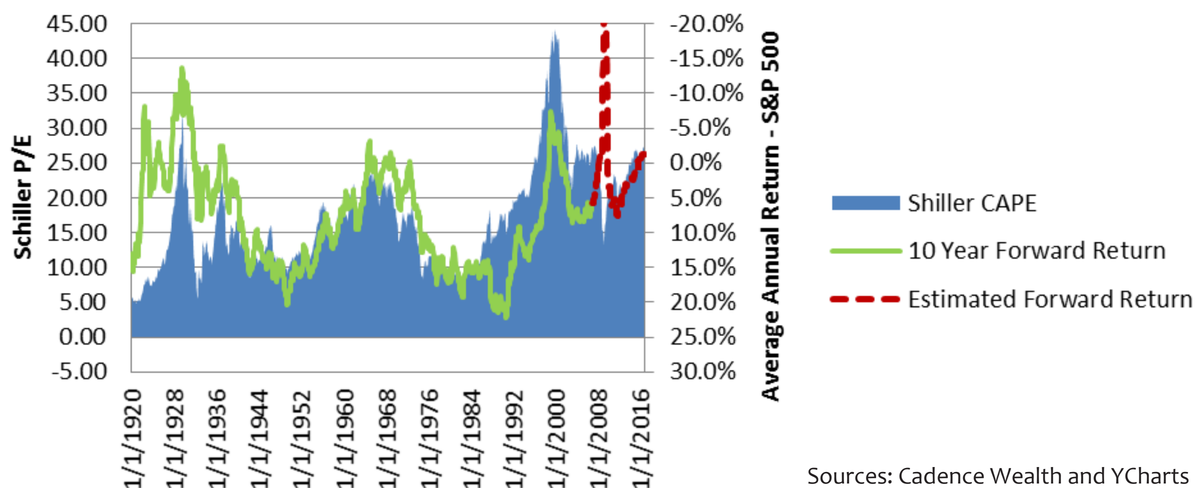
A Bubble Looking for a Pin

To invest heavily in U.S. stocks, you'd have to accept that you are paying absolute top dollar from a historical perspective. And because you are paying top dollar, you must also accept that your returns over a long period of time will be pretty horrible, horrible defined as around 0% over a 10 year period. Some will hear this as negative, dooms day-type talk, but we'd rather look at it as historically informed math. If something is priced too expensively and that something's price moves in up and down cycles over time, we only have to accept sub-par returns over the long term if we actually own it. We have a choice. If we choose to wait until the price comes down to a lower more reasonable level, then the math changes and returns over time get much better. It's from this perspective that we're very optimistic in our assessment of things. We simply have to impart some discipline in our decision-making and wait for a better risk-reward scenario before owning certain investments for the long-term - stocks being at the top of that list. The chart below shows how the price of the stock market (as measured by S&P 500/GDP) has a very high negative correlation to long-term performance.




Basically, when the market gets too expensive for the size of the economy (GDP), then it comes back down eventually. When it's too cheap, it will ultimately come up, so on and so forth. The blue part of the chart above represents the stock market relative to GDP while the green line plots returns you would have realized over the following 10 years had you invested (this scale is inverted so up is bad, and down is good). What's very apparent is that if you invested when the blue line was high, your returns generally would have been below average over the next 10 years. The red line estimates the returns over the next ten years based on the historical relationship between the two since we haven't yet hit the end of those ten year periods. Notice that as of now, the return estimate for the next 10 years is less than 0%.

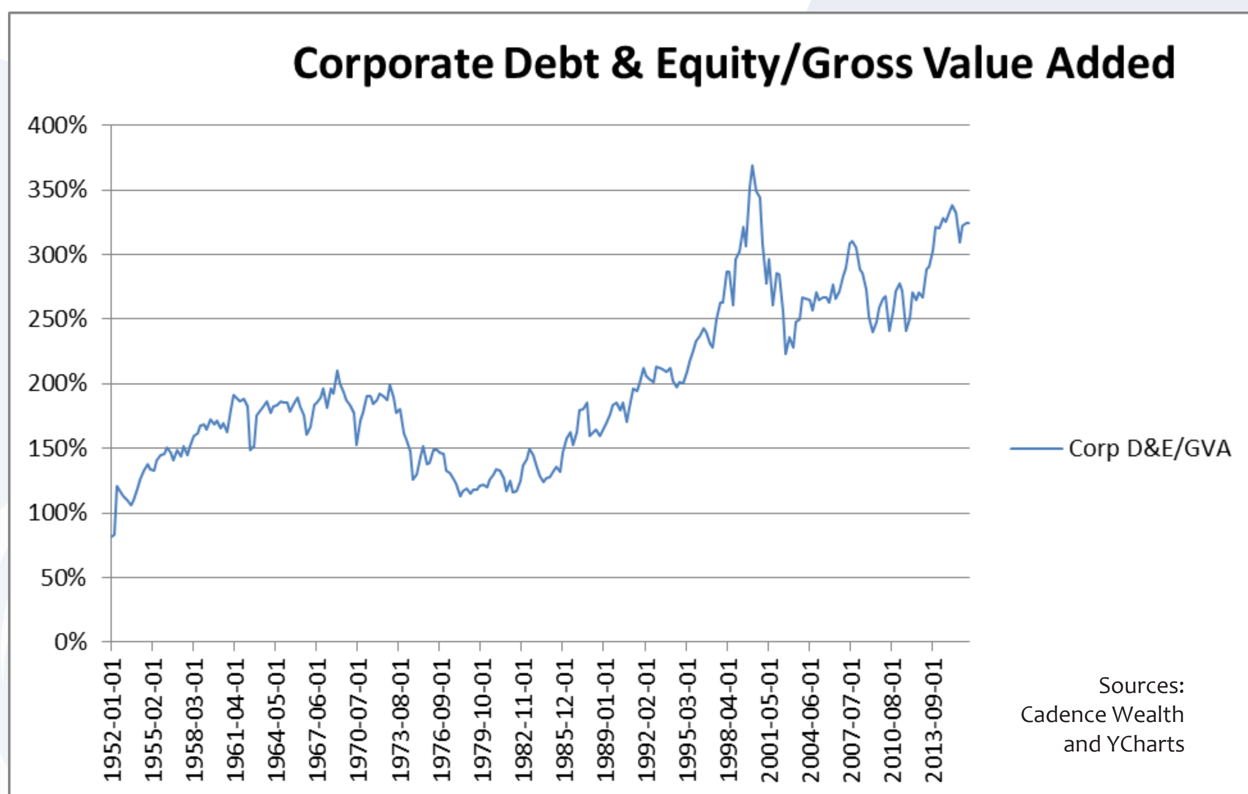
We see a similar relationship when we look at the Shiller Cyclically Adjusted Price to Earnings ratio. This ratio looks at average inflation adjusted earnings on the S&P 500 over the last ten years relative to the price of the S&P 500. The higher the figure is, the worse returns are over the following ten years. (See chart below. Note that returns are on an inverted scale.)



John Hussman of Hussman Funds looks at market capitalization of non-financial stocks relative to non-financial gross value-added, a price to sales ratio of sorts for corporate America, and finds that it has one of the deepest negative correlations to forward 10-year returns. Similar to the Shiller CAPE and S&P 500 to GDP, Hussman's model is implying sub-zero returns for stocks over 10 years. Hussman has a track record of paying attention to extreme market valuation levels on both sides of the market cycle (expensive and cheap) by using hard data in a historically informed way. As a result, his clients avoided in large part the deep declines that followed the market peaks in 2000 and 2007. In John's December 19 Weekly Market Comment, he very poignantly writes:

*"While our short-term outlook may shift with changes in the quality of market action, the long-term and full-cycle market outlook, in our view, is unavoidably disastrous. We've long argued, and continue to assert, that the most historically reliable measures of market valuation are far beyond double their historical norms. At current market levels, our estimate for 12-year S&P 500 average nominal total returns has collapsed to just 0.8% annually. Among the valuation measures most tightly correlated across history with actual subsequent S&P 500 total returns, the ratio of market capitalization to corporate gross value added would now have to retreat by nearly 60% simply to reach its pre-bubble average."*

Here's a look at a model that tracks U.S. corporate debt and equity relative to corporate gross value added, a valuation metric very similar to Hussman's. Technical gobbledygook aside, it paints a picture of how expensive or cheap U.S. stocks are relative to other times throughout history. It's beyond 2007 levels, the peak preceding the financial crisis, and rivaling 2000 tech bubble levels. Anyone making the case that stocks are fairly priced is either uninformed or has some sort of conflict of interest. As you can see, the facts say otherwise.




Regardless of which metric one uses, U.S. stocks are priced in the nosebleed section of history. What's followed in every prior instance we've been at these levels has been dramatic moves lower in price completing the natural and entirely ordinary market cycle. It's not something that should be feared or denied. With this downward phase, waste-

ful and non-productive investment is cleared from the system, careless lending and risk-taking is purged, and general excess is wiped out returning balance to markets and opening up opportunities for those who exercised patience and prudence along the way.

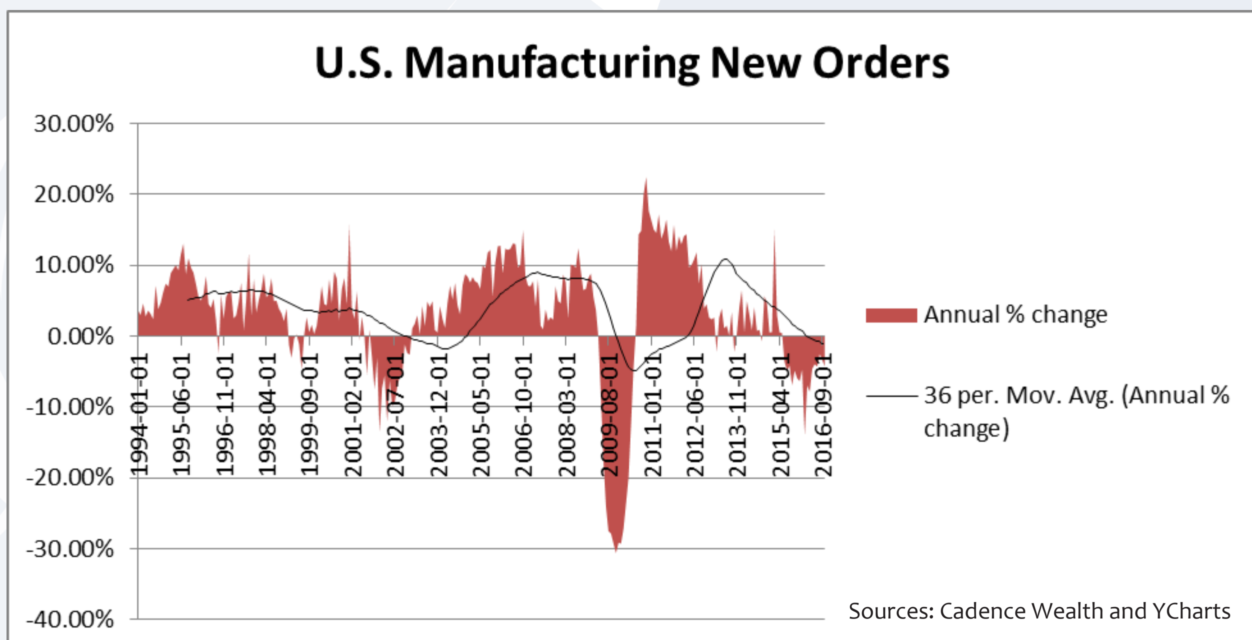
Letting Returns Go

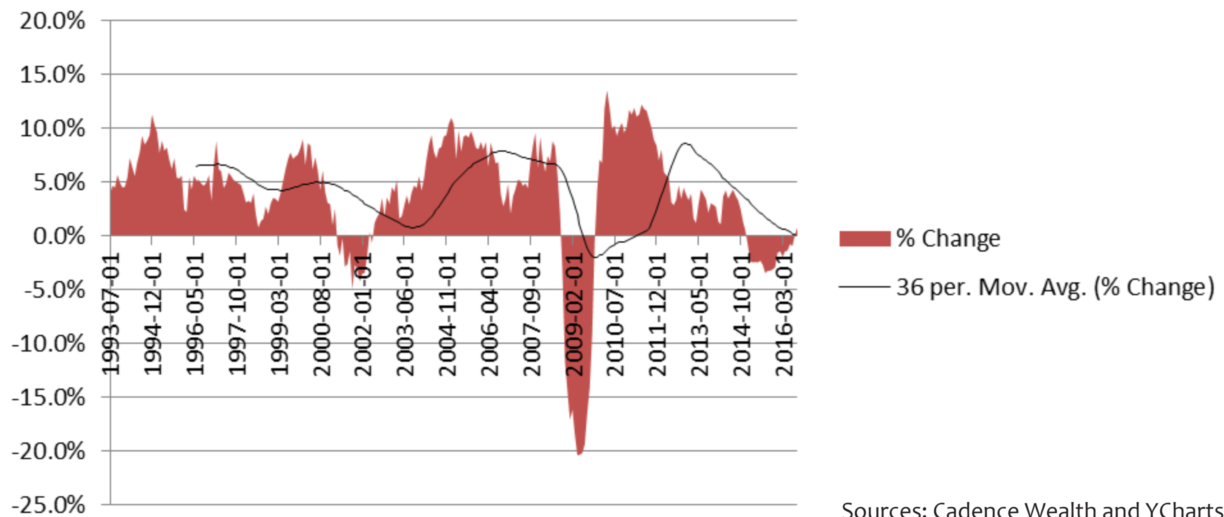
If you buy into the fact that risks in the market outweigh potential rewards over an investment time horizon, then what happens in the short-term is irrelevant. If we know the market has the potential to fall by 50% or more, just as it did at similar points in history, and we've decided taking on those types of losses would be unacceptable, then we must be willing to detach ourselves physically and emotionally from additional market returns. Nobody can call market tops. Therefore, if we move to a more conservative positioning, we'll almost certainly witness other more aggressive investors earning higher returns for a period of time. Whether that period is one month or three years doesn't really matter, since the downward phase of market cycles tends to wipe out the majority of gains made toward the tail end of the upward phase. And since getting out of the market is extremely difficult once it begins falling, exiting early is one of the most effective ways of minimizing the risk of large losses and achieving respectable returns over long periods of time.

Let's look at an example. If we're fully invested in stocks and experience a 10% loss, we have to decide whether to sell or hold. If we sell and the market bounces back, then we've locked in losses. If we don't then we risk losing another 10%. The decision continues to get more and more consequential until most investors find that they can't afford to lose another penny and sell out toward the bottom of the decline. In the end, it typically would have been far better to get out early and avoid the whole dilemma in the first place. The downside of course is that we have to be willing to let additional market returns go in the interim.

Economic Weakness

While U.S. stocks have marched higher this year, most other asset classes (that have struggled) seem to be better reflecting the true state of the global economy. Some of the most important data to look at is that at the top of the economic funnel such as manufacturing new orders and corporate sales. Both of these metrics have been suggesting economic weakness for many months, as displayed in the charts below.






What we've witnessed more recently is a decline in corporate earnings, which generally is more aligned with the direction of stocks. When earnings drop, stocks generally drop. Earnings are much more easily manipulated to look a certain way than sales due to write-offs, expense cutting and other accounting trickery, so the fact that earnings have declined ~18% from their 2014 highs is concerning. If corporate executives could make them look better, they would. This earnings decline is consistent with the weak front-end economic data that we've been observing for some time. What's more concerning is that stock prices haven't come down to reflect that large decline in earnings.

This supports the notion that rational minds haven't been driving stocks higher, but rather the hope that central banks will keep bad things at bay and that somehow this time will be different. This is classic bubble behavior. Despite the wishful thinking, as you can see from the charts above, the underlying fundamentals are not strong.

So here's a short list of some of the facts we're faced with as we head into 2017:

- U.S. Stocks are tremendously expensive relative to history
- The current near eight year bull market is much longer than average
- Forward returns from current stock price levels historically have been very bad over a 10-year stretch and have included significant and sharp losses throughout that timeframe
- Interest rates are near historic lows despite their rise over the last few months
- Safe-haven assets such as gold and U.S. Treasury Bonds have suffered historically significant losses over the last few weeks and months
- The U.S. dollar is at multi-year highs against foreign currencies
- A host of foreign currencies have fallen significantly and are at their lowest levels in decades
- A number of leading economic indicators are at or near recessionary levels
- U.S. and Global debt is significantly higher than it was in 2007, our last market turning point
- Central banks have tried just about everything in their tool bags to keep markets higher and economies out of recession. There isn't much left to try the next time action is needed.

Thoughts Heading Into 2017

We'll tackle the easy one first – stocks. Simply put, they're dangerous and we feel strongly that it's ill-advised to have too much exposure to them. History tells us it's wise to let any final bull market gains go since investors typically get burned very badly when the turn finally takes place. Many years of gains get wiped out from the downward part of the cycle, so fine-tuned timing isn't the goal. Most investors would have been plenty happy reducing exposure to stocks in 1927, 1997, or 2006 - all periods in history that threw up flags similar to the ones we've been talking about over the last couple of years. We continue to be content with minimal exposure to stocks heading into 2017.

That said, when prices come down across the board, we'll likely look first at emerging markets and developed international stocks as their valuations are much more attractive than U.S. stocks at this point. Our suspicion is that all

categories will move lower together through the early part of the next bear market however, so valuations are likely to get much better than they are right now. This is something to keep an eye on and be optimistic about.

Our thoughts on bonds are mixed. Long term, they should offer slightly better returns than stocks simply based on yield being higher than our estimated return from U.S. equities over ten years. That said, with interest rates so low, the potential for moves upward toward more “normal” levels would affect bond prices negatively. If inflation picks up, then this would be the most likely scenario. On the other hand, if the bubble in risk assets such as stocks and real estate finds its needle, then we could actually see rates heading lower in response to safe-haven buying and a more deflationary economic environment. In short, the fate of bonds in 2017 will be determined by the battle between inflation and deflation. The best way to position for this unknown is to have a good balance between short and long duration bonds in the portfolio.

Another trend heading into the New Year that seems to be picking up steam is the battle to maintain economic activity through currency manipulation. Quite simply, whenever central banks intervene, it’s to manipulate their currency and just about every central bank on the planet has intervened recently. This has contributed to some very large currency moves in recent weeks and could very well affect other markets more seriously in the coming months. This ongoing global currency war not only has us more cautious on markets in general, but it has us considering gold more so than we have in the past. If confidence in paper currencies wanes, then gold could be looked at not only as an inflation hedge, but also an alternative currency. The recent surge in Bitcoin only reinforces the idea that confidence in central banks and their respective paper currencies can be lost and may be actually be happening now.

Our general sense given the facts we laid out is that global markets are much more likely to be an overly complex house of cards than a sluggish system waiting for a good reason to grow. Despite all the positive rhetoric about how tax cuts and fiscal spending will give the global economy the boost it needs to keep going, we’re skeptical. We liken the current state of affairs to a modified game of musical chairs where there aren’t nearly enough chairs for everyone in the game. Lots of players will be left chairless when the music stops and it very well could happen in 2017. We wouldn’t be at all surprised.

Our recommendation continues to be to accept lower returns for the time being by investing more conservatively. Any reach for “more” is much less likely to be rewarded than it has been in the past. Even worse, the longer markets continue to stretch, the more damage that reaching and chasing is going to do. Be prudent and be optimistic. There may be tremendous opportunity in 2017 for those who are prepared and have fresh capital to take action with.

Key Points:

- Although U.S. stocks fared well in 2016, most well-diversified portfolios struggled.

- Stocks are in an historic bubble and are very expensive by historical standards. All prior instances that mirror this one experienced sharp and significant market declines. Stocks remain tremendously risky moving into 2017.

- Low quality bonds remain risky while higher quality corporate and government bonds could go either way. If inflation materializes, then most bonds with the exception of the shortest duration issues and TIPS will suffer. On the other hand, if we see deflation due to risk assets declining, a financial crisis, or an otherwise weakening global

economy, selective high quality bonds could do well as corresponding interest rates fall further. In our opinion, this could go either way and portfolios should position for both outcomes.

- Countries are getting more aggressive in manipulating their currencies which could lead to volatility in other asset classes/markets. Gold becomes more attractive as a potential hedge against inflation and/or loss in confidence in paper currencies.

- Additional trends are in place globally toward protectionism and nationalism that further increase investment risk. There are plenty of potential pins that could pop our stock market bubble (along with others) as we head into 2017. Being positioned for this outcome can lead to tremendous opportunity. We're optimistic.

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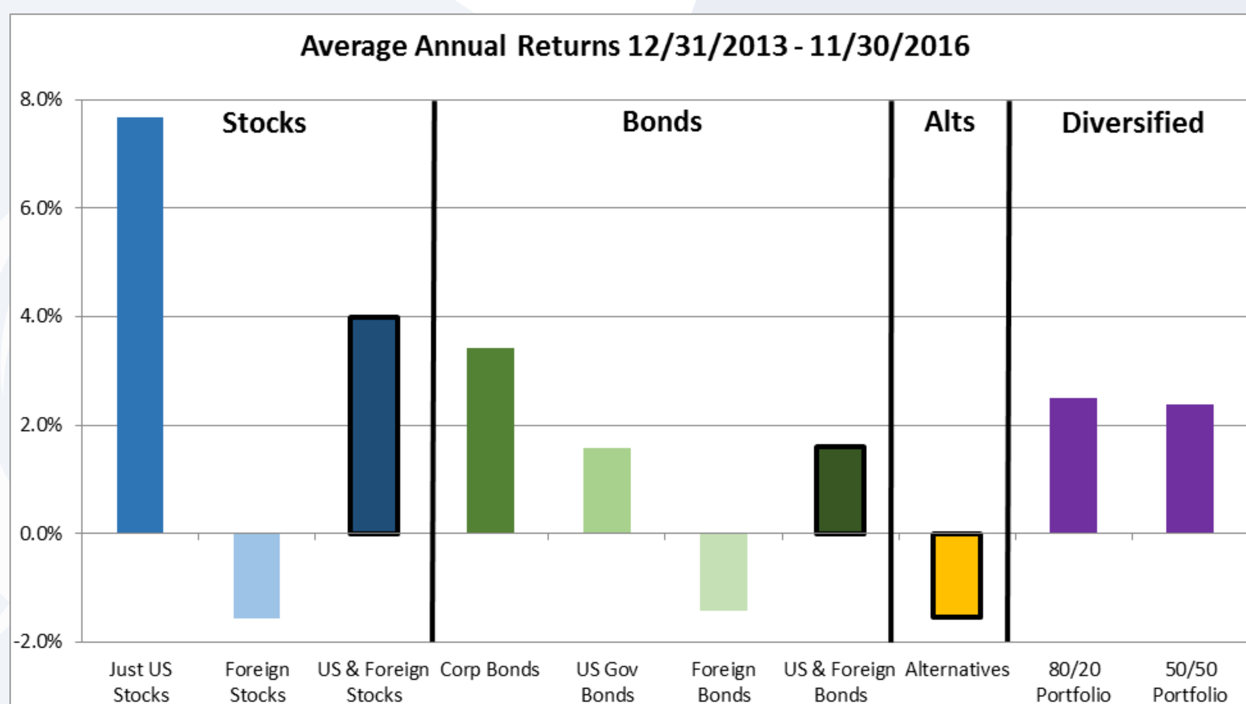
# It's Like Déjà Vu All Over Again

During what is approaching an eight year bull market for the S&P 500 where it has increased around 333% off its March 9, 2009 low, and where its largest month-end to month-end loss over that time was ~-8.4%, it is continuing to be easy to feel like a diversified portfolio is not making enough. It is also getting easier and easier to forget the risks that come with investing in stocks, and what we are left with is the feeling that we should be more aggressive, even though aggressive investing can lead to very large losses. Day after day with the media covering the S&P 500 and NASDAQ reaching all-time highs without giving equal time to what other asset classes are doing helps reinforce for some investors this notion that their returns should be higher.

The chart below shows a very imbalanced picture: a mix of stocks of large, medium, and small-sized US companies have averaged around 7.7% per year, which is below their longer term averages:



A portfolio of just stock investments diversified to include foreign stocks, which have averaged a negative return the past three years, would itself have averaged around 4% since the end of 2013. So even if investors had gone "full aggressive" and owned just stocks, diversifying across the globe, their returns the past three years would have left them feeling like they were somehow missing out. Keep in mind a portfolio like this would have lost around -60% during the financial crisis.

Bonds haven't had a good three year run either, with US corporate bonds leading the way with a 3.4% average annual return, US government bonds returning less, and foreign bonds averaging a loss. A portfolio of just bonds diversified across the globe similar to the just stock portfolio would have returned around 1.6% per year since the end of 2013. As a result, a moderate 50/50 portfolio rebalanced annually, combining the 4% from US & Foreign Stocks, the 1.6% from US & Foreign Bonds, and a sprinkling of negatively performing alternative investments has returned around 2.4% since the end of 2013. Even a more aggressive diversified portfolio with 80% of its investments in US & foreign stocks, also rebalanced annually, has only returned around 2.5%

As a result, it is easy to feel like we are missing out, especially with those stock market headlines.

But we've been here before, more than once. When all we're doing is evaluating the performance of our diversified portfolio during a long period of stock market gains, we're ignoring the other important part of the full investment cycle: the bear market. A bear market is described as a time period over which stocks lose at least 20% of their value. Hopefully not too many people have forgotten that they can lose an awful lot more than that.

To help illustrate the need to evaluate investment performance over a full cycle, we looked at the performance of large US stocks, as measured by the S&P 500 index, versus the performance of a balanced investment during the latter stages of the tech rally as more and more investors were being tempted to get more aggressive for fear of losing out. From January 1998 through August 2000 when the S&P 500 peaked, you can see how investors in that balanced investment could have felt that they were underperforming, considering the S&P 500 had returned around 50% more over that time period:

However, by March of 2003 when they hadn't lost nearly as much as investors in just large US stocks, they could see their strategy of managing their potential for loss over a full market cycle had paid off. They were still net positive since the end of 1997 while stock market investors were negative. By the way, this is not showing the performance of Tech stocks over that same time period. Many people could not help themselves in 1998 and 1999 and loaded up on them only to see the value of those investments plummet to a historic degree.

Over the past three years, diversified portfolios have trailed US Stocks, which get the vast majority of the coverage of the financial media. And even though US stocks themselves have trailed their long-term averages, the low returns of the other asset classes covered with the extreme media coverage of the only sectors that have returned anything close to their long-term averages has left many investors feeling like they've lost out. While we always want higher returns if we can get them without taking undue risks, don't forget there will be bad stock market returns ahead. Don't be lulled into the thinking that preceded the tech bubble bursting, or the catastrophe of the 2007-2009 financial crisis, that it is somehow safer to take big risks AFTER the risky investment have grown year after year, instead of being willing to play it safe and wait for the inevitable big correction to buy aggressive investments on sale.

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Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.