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FOCUSED ON WHAT MATTERS MOST.

Changing the Rules

If one thing's abundantly clear from studying history, it's that the rules of the game always change. Whether we're talking about unit investment trusts' role in adding vast amounts of leverage to the financial system in the roaring 1920's, the departure from the gold standard in 1971, or today's unprecedented suppression of interest rates by central banks, humans have always had a knack for tinkering with the current "system" out of self-interest. Usually the motivation for this is profit, self-preservation, and/or power.

What's also clear from history is that these wholesale changes to the system that made each period different, although beneficial at first, often created strife for the economy and financial markets. Unit investment trusts helped create the debt and leverage-fueled equity bubble in the 1920's that eventually led to the Great Depression. One could very much argue that the longer-term negative effects of all that leverage unwinding outweighed the benefits of that very leverage on the way up. Going off the gold standard in 1971 led to a decade of economic stagnation that coincided with crippling inflation. As for the most recent "this time is different" moment, the one we're currently experiencing, it's reasonable to expect that there will be a cost to bear just as in prior periods.

So what's the rule change we're faced with today? Central banks that are hell bent on preventing the completion of a full economic cycle. We'll stay high level here as to keep the discussion apolitical, but the fact is that central banks panic when markets decline and have attempted to do whatever it takes to keep them and the global economy from contracting. The short-term consequence of this is and has been positive. Rates are lowered and more money is injected into the financial system with which to lend and speculate. This drives up asset prices. However, there are clear long-term effects of this unnatural stimulus. It helps to create debt and leverage across the financial system which in large amounts serves to actually slow the very economy central bankers are attempting to speed up. Excessive amounts of debt become an albatross and steal consumption from the future by bringing it forward into the

present. Of course, there's more to this equation, but at its core, this is what overzealous monetary intervention achieves. It very quickly becomes an endeavor that cannot be stopped without deleterious effects. With financial markets and the global economy propped up by mountains of debt and leverage, any decline can result in a cascading effect that threatens to undo everything central planners have accomplished. This is the trap and it's very clearly something that global markets have never encountered on this scale.

And so, the challenge today for investors is to determine whether or not this current rule change will succeed, leading to perpetually higher stock markets, or whether it will eventually succumb to normal market forces and cycles. After 10 years of virtually nothing but up for U.S. stocks, it certainly seems like the answer is the former and the layman investor couldn't be blamed for thinking so. It really takes a good understanding of market history and a belief in the power of cycles, free markets, human behavior, gravity, math, and a number of other things to believe that the good times will in fact end – and most likely with a significant bang.

Often times when markets behave in an extreme fashion, good or bad, for an extended period of time, human beings start to believe that behavior is now normal. It's easy to assume those factors that are responsible for the market's behavior have successfully changed the rules of the game and so long as those factors don't stop or abate, then the markets will continue acting in this new way indefinitely. Recency bias plays a big part in this. The bottom line however, is that both markets and human behavior work in cycles. This has always been true and will always be true. Eventually those factors that acted on markets create such an outrageous extreme that those very humans responsible for the extreme in the first place begin to change their minds. This turning point in sentiment, or Minsky moment so named after economist Hyman Minsky, marks that point in time where humans begin thinking more about protecting against losses than seeking further gains. As this sentiment shift becomes more widespread, the downward part of the cycle ensues, usually in the form of a crash if large amounts of leverage played a role on the way up. Almost everything in life ebbs and flows.

When this Minsky moment takes place can be difficult to pinpoint. Cycles can get stretched out, muted, and manipulated for much longer than one would think possible. Throughout this process, normal market mechanisms and functioning can break down. What normally would drive markets lower simply doesn't and it's important that we as investors are able to adapt to this circumstance in a way that doesn't expose us to outsized risk of loss. This has been the challenge in recent years and will likely continue to be as markets get yanked back and forth in seemingly random fashion. We've experienced 2-3 normal cyclical contractions in corporate profits, economic growth, and inflation over the last 10 years, yet U.S. stocks never meaningfully departed from historically high valuations. This central bank intervention however isn't working everywhere. International stocks have struggled greatly and still remain almost -20% below their peak according to the MSCI World ex-US Index. Investors taking risk overseas have not been rewarded for that risk. This seems to better reflect the economic fundamentals we've observed over the last few years. Savers have also found it difficult to earn any meaningful return on their deposits. With interest rates at or near record lows and even negative in some places, there has been little incentive to save and if people aren't saving for the future, it's pretty easy to envision how that could be problematic.

It's essentially U.S. stock and bondholders who have been rewarded most over the last 10 years, but it's important to note that they've chosen to pay exceedingly high valuations in order to reap those gains. As we've written about extensively, eventually your returns depend almost entirely on the price you pay for something. For U.S. investors that "eventually" just hasn't arrived yet. Today, U.S. stocks sit beyond the most expensive levels in history, which means for investors to realize and keep those gains they've already accumulated, they must be able to avoid the likely sudden downward part of the cycle – a near impossible task for most. The fourth quarter of last year saw the S&P 500 drop by nearly -20% and we'll bet most investors didn't see it coming nor react to it. Risk is often underappreciated until it plays out. Losses happen fast.

For investors who've identified and chosen to sidestep the risk inherent in U.S. stocks (and most bonds due to artificially low rates), it's been a tough stretch. Our challenge as money managers has been to try and grow our clients' assets without exposing them to the risks of sudden large losses that we believe litter financial markets today. Whenever normal business cycles are muted or delayed, the bad stuff doesn't just go away, it gets pushed into the future where it piles up. Eventually bad loans, too much debt, over-speculation, all things that correspond with the expansionary part of cycles, have to be dealt with. Risk doesn't go away, it just gets deferred and it gets bigger. This is what we're dealing with today. Our inclination has been to steer clear (to a large extent) of the most expensive markets and focus on buying what we feel will perform the best when that Minsky moment arrives. It just so happens that some asset categories we find attractive also offer tremendous long-term growth potential due to the fact that they've been ignored and overlooked by those chasing U.S. stock market performance. These shifts in positioning in our opinion are the best way to play the long game with respect to portfolio preservation and performance. In the end, so long as one expects to be alive and spending money 5 to 10 years down the road, it's the long game that matters.

The last few years have been a completely different and unique experience for the markets. The rules of the game have undoubtedly changed. Over $12 trillion dollars of bonds are currently trading at negative interest rates globally. Let that sink in for a moment. In addition to lending money for free, you would have to pay a fee to that person/entity you lent it to. Pure insanity. Most interest rates are still at record lows here in the U.S. as we sit 10 years into an economic expansion and near record highs in markets – this is generally a period where interest rates should be much higher. Our government is running a $1 trillion dollar-plus spending deficit as far as the eye can see AFTER a 10-year economic expansion. These deficits normally only take place in recessionary times. As a result of artificially low rates, debt levels are at all-time highs across the spectrum of individual, corporate, and government sectors. All of this is just goofy and abnormal.

Although this specific set of circumstances is in fact different this time, the outcome in our opinion is relatively predictable. One doesn't need a PhD or an over-articulated white paper to get a sense as to whether or not something smells fishy. Too much debt? Bad. Paying somebody to take your money (negative interest rates)? Ridiculous. Only upward moving markets forever without risk? Probably not. The over-arching theme here is that there's no free lunch – it's just not how life works. Stay focused on the big picture, longer term, and what's most important. It's when the rules of the game have changed that risks often grow the largest. And for those who are keen to the risks and have largely chosen to step aside, preparation always comes at a short-term cost before it yields longer-term gain. Sometimes investors must be willing to make concessions in order to stay on track over the long run. This in essence is the definition of investing.

Precious Metals Have Something to Say

As we've discussed with clients for a couple years now, the outlook for precious metals has been steadily improving. From a price or relative value standpoint, they've seldom been cheaper relative to financial assets and as we've stressed, long-term investment performance is all about the price we pay for something. From a fundamental standpoint, the potential for precious metals to provide investors, governments, and the global populace in general with peace of mind and a reasonably stable store of value has probably never been better. Here's why, as we touched on above:

Central banks are ten years into an economic expansion (granted one of the weakest on record) fueled by low rates and liquidity injections via quantitative easing (QE), yet we still have more debt and greater deficits than at any other time in history. As a result, governments and central banks have put themselves in a position where they can't raise rates in a meaningful way without the system breaking. Europe hasn't been able to raise rates at all, and although we've raised them here in the U.S., the economy is already showing signs of distress with rates still at historically low levels. With the effective federal funds rate at 2.4%, and stock markets near all-time highs, the Federal Reserve is prepared to not only lower rates at the first signs of trouble, but to do "whatever it takes" to keep the expansion going. To us, this is a clear sign that there is no exit from aggressive central bank intervention. It has proven to be the Hotel California as sung about by the Eagles - "You can check out any time you'd like, but you can never leave". Although they might talk about normalizing rates at some point in the future, follow-through has proven difficult if not impossible.

The circular thinking goes like this… We'll raise rates and reduce our balance sheets (take that newly printed money back out of the system) once the economy improves and inflation picks up meaningfully. Only, that doesn't happen as quickly as planned since all the easy money has created massive amounts of debt and inefficiency from malinvestment which tends to be deflationary – it inhibits strong organic growth. Perversely, this creates the appearance that more intervention is needed and so the withdrawal of monetary accommodation is delayed or limited.

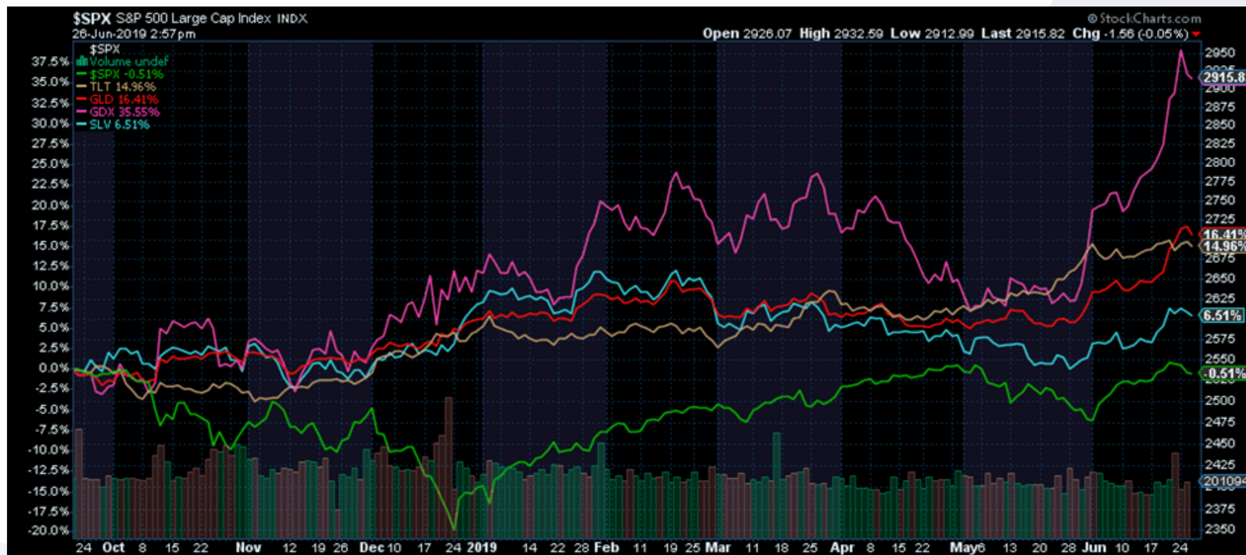
In the event a withdrawal of stimulus is attempted, rapid weakening in the economy and markets makes the effort short-lived. Whatever economic activity existed before the withdrawal of stimulus was based on that stimulus. It only makes sense that without it, things will begin to break; no different than how the human body would feel without a drug it has grown dependent on. In addition, and this is the real crux of the issue, the rise in interest rates makes it harder for those with greater levels of debt to meet their interest payments. However, the longer borrowing rates are kept low, the more debt accumulates making it eventually impossible to raise rates in any meaningful way without really nasty consequences for indebted individuals, corporations, and governments.

Interest rates in the U.S. right now are below half of what they have averaged historically. Now think about the payments you have toward car loans, mortgages, and other debt and imagine how those payments would change if your interest rates doubled. It would be equally painful for corporations and governments. This is the trap central banks have gotten themselves into. There is no clean exit.

On a more optimistic note, this is probably one of the most favorable environments for precious metals over the longer term. Whether a deflationary or inflationary situation ensues first, precious metals could provide refuge as assets and fiat currencies experience tremendous volatility. Pair this with favorable valuations relative to financial assets and we have some very compelling long-term investment potential.

What's more, since the market peak last September, precious metals along with Treasury bonds have outperformed the stocks by a healthy margin. This represents a very nice momentum shift that has rewarded investors who have

been patient and disciplined enough to position themselves early. As you can see in the chart below, regardless of all the focus on new highs in the stock market, precious metals have staged a very stealthy run over the last nine months. As the current cycle plays out along with all its unique challenges, the momentum shift across these asset categories could well represent just the beginning of a longer-term multi-year trend. Of course, as with anything, investing in precious metals can be risky and volatile and should be part of a broader, well-defined investment strategy. Everything has the potential to go down in price over different periods of time. The goal is to invest in those things that have more up than down still ahead of them. After all, it's not what's in the rearview mirror that matters, but rather what we see on the road ahead.



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