3rd Quarter Client Update Letter

Santa Claus Is Not Coming To Wall Street

When I wrote you my brief interim market update on August 24th I specified that I was expecting the stock market to make a peak in the late summer / early fall time period that could last for 3 to 9 months. It is now my view that this is what has transpired as evidenced by the Standard & Poors 500 Index having recently put in a lower higher and not a higher new high, as shown here on the following weekly logarithmic chart:

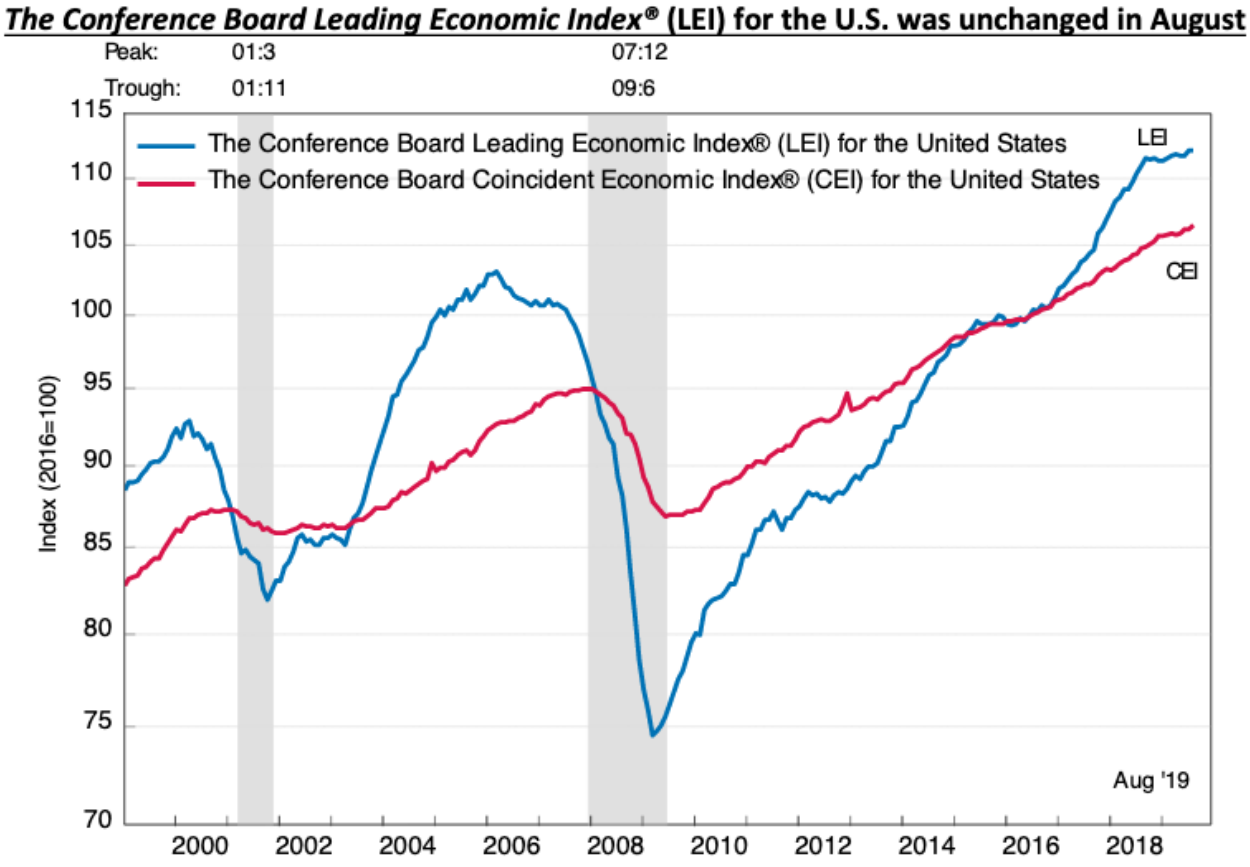
courtesy of barchart.com; ***click to enlarge***

My expectation is that the S&P 500 is going to fall into a clear downward trend over the next month or two. The question in my mind though is will we have a 10% or so decline to the lower trend line on the above chart, which would be about to the

2,650 level or will we see a deeper decline over a many more month time period, perhaps even coinciding with a U.S. recession, that breaks below this lower trend line? The only thing that I am firmly convinced about right now is that the stock market has put in a top that will last for awhile and the strong 2019 upward bull trend is over.

I see fundamental economic results as being the determining factor that ultimately answers this question. All sorts of short-term events could drop the market by 10% to 20%—which is what happened one year ago—but it will take a real, end-of-cycle economic contraction that hits the consumer and the service sector of the U.S. economy for the stock market to fall more than this and remain in a bearish trend for a longer period of time.

The Conference Board's Leading Economic Index is an excellent way to measure the overall strength of the U.S. economy. You can see here that its growth has slowed this year but it has not yet rolled over:



source: The Conference Board; ***click to enlarge***

The following related chart of the 6-month trend change is even more instructive when it comes to assessing economic turning points:

source: The Conference Board; ***click to enlarge***

You can see here that the trend has been all downhill this year but we are now at an inflection point where we could still see a reversal higher in the coming months. This would take time to develop though.

There is no doubt that global economic data has been deteriorating this year, especially in countries like Germany that are more dependent on global trade. Copper demand is a favorite indicator of many for the global economy. I have a detailed supply & demand model for copper that I built for Industrial Minefinder™. It gets deep into the weeds of the copper market and it is showing perhaps 1% demand growth this year versus the typical 3% or so.

I think the key takeaway from weakening global economic data as it relates to global stock markets is that *a weaker economic environment creates conditions where bad outcomes are more likely*.

Portfolio Positioning For The Bond Bubble

I have your portfolios prepared for a stock market decline. I have reduced the amount of stocks held significantly and those that I do still hold for you are almost fully hedged. In other words, if these stocks decline in value, then the hedges will make money to offset the losses. I continue to monitor the effectiveness of these hedges. During the big market decline the one day last week, my Moderate portfolio strategy barely budged to the downside which is what I am shooting for.

My view is that the bond market is *the* bubble of our lifetimes. When this thing turns it will not be pretty because these are the *safe* assets that financial advisors are taught to put people's money into. The older and/or more conservative you are, the more you are supposed to hold.

I expect to see inflation as the event that gets the bond bear market out of a long, long, long hibernation, but it could just eventually come down to the fact that the U.S. government continues to spend way, way, way beyond its income. The budget deficit is around $1.5 trillion and this is when tax receipts are relatively robust. What happens if we do have a recession? What happens if we have a recession and some Socialist-Communist gets elected by convincing the carnal nature of enough Americans that education, healthcare, and retirement funds just grow on trees? The government budget deficit getting worse during a recession seems logical but this may not drag down the bond bull market because enough investors have been trained to buy *even more* bonds (even when they are yielding less than inflation) during a recession. This is why it is a real, classic financial bubble of epic proportions. Many professional investors will be blindsided by this. This is why I think inflation is the trigger. Inflation has the power to break the intellectual dogma perpetuating the bubble.

I recently added a significant amount of floating rate preferred stock from two higher quality U.S. banks. (By the way, since last quarter's letter when I mentioned that Warren Buffett had recently bought a lot of U.S. bank stocks, one day I

happened to have a list of large U.S. banks with the strongest debt ratings sitting on my desk. Right there they were. Essentially everything he bought.) These preferred shares are trading for around $21 per share and yielding about 4.7%. The interest they pay floats so if rates rise enough their yields will rise accordingly. But here is the kicker: if rising rates get out of hand and the banks go to redeem these preferred shares in order to avoid higher capital costs, then they have to pay $25 per share and these bonds appreciate 20% or so, not counting interest, potentially in a short amount of time. Earlier this year I was able to buy one of these for around $19 per share. The fact that this opportunity is out there—an opportunity that would benefit from a rising rate spike (fall in bond prices)—further reinforces my view that bonds are in a bubble that few are prepared for.

In conclusion, I would like to recommend some additional reading. Every once in a while I come across an article or interview with another investment professional that synchronizes with my own views. I say "synchronize" because the fund flows of global markets are like puzzle pieces that can only fit together in certain ways. I found this interview with Louis-Vincent Gave to be one such article. Notably, Gave pointed out the following concerning inflation:

> *We are being told today that there is no inflation, but if you take a basket of the 72 most bought items at Walmart, the price of that basket is up 4.8% year on year. So, if you are among the poorest people in America and you buy your Walmart items, your cost has gone up 4.8%, while your wages go nowhere. Should we be surprised that people are angry? One of the factors that has helped to keep inflation down was the drop in oil prices in the past decade. And here we can legitimately put a question mark behind the idea that oil prices will continue to fall, given the uncertainties in the Middle East and the collapse of capital spending in the energy sector in America.*

The price of the 72 most bought items at Walmart is up 5% and the Federal Reserve is *cutting* interest rates. (Note: raising interest rates generally reduces inflation.) That is definitely food for thought.

Thank you for your business.

Joshua S. Hall, ChFC

Disclosure:

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