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Newsletter Q3 2018

Bonds & Gold

"All that glitters are bonds"

For thousands of years humans have been attracted to gold based on its beauty, endurance and rarity. I would posit that many of those attributes can also be applied in the present to the purchase of certain bonds.

Why the comparison between a metal and a debt instrument? And how is this relevant to today's market?

Bonds are acting like they are supposed to in a rising rate environment and we see opportunities arising. We have positioned client portfolios for a rising rate situation including the start of individual bond purchases. Allocation to individual bonds is also based on account asset size in dollars and individual client needs. We anticipate rising interest rates, so we proactively sold some income-based ETF's with exposure to longer underlying maturities and increased exposure to ETF's with shorter maturities (2019 and 2020 for ETF symbols BSJJ or BSJK). We have also chosen an ETF that is based on floating rate bonds whose underlying debt gets repriced higher to the borrower as rates rise (ETF symbol BKLN). For years, the world has been living with historic low rates. All the while, we have had a desire to start allocating purer fixed income to our accounts in the form of individual bonds. Currently, the increasing rate trend is allowing us to feel opportunistic in buying certain bonds.

Individual vs Diversified – We have moved away from the purchase of individual stocks into ETF's for added diversity, higher liquidity, and lower volatility. So why then own individual bonds?

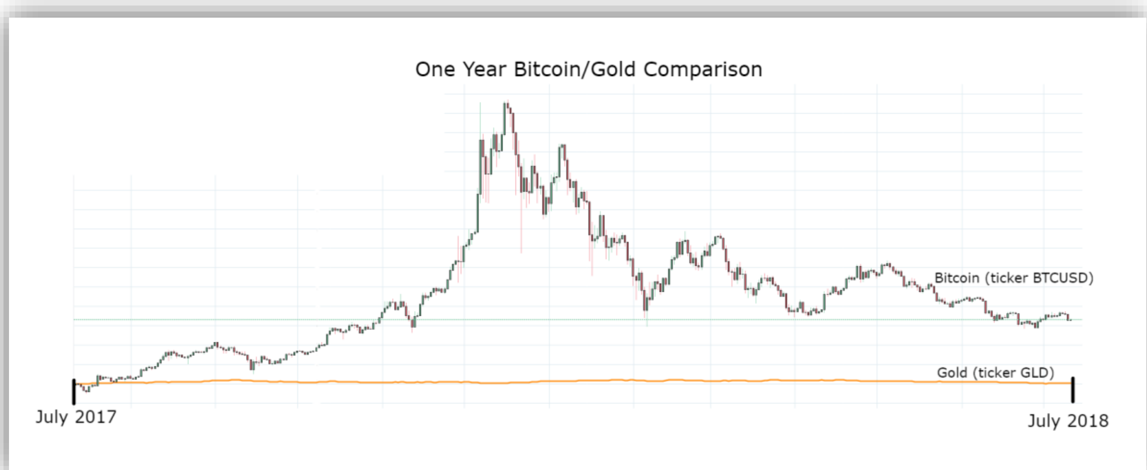
Owners of a bond know when they will get paid interest and when they will be paid back the principle investment upon maturity. Investing in a collective like a mutual fund or ETF does not allow for protection of principle upon maturity. There are pros and cons to owning ETF's and individual bonds and we feel that our clients are best served with a combination of both, when it is suitable for the clients needs and account profile. It is far easier for us to limit our purchases to ETF's. Individual bonds require extra research not only on the fundamentals of the underlying company, but also the debt structure of the bond. This analytical work is not performed alone as we rely on the research of multiple different companies (e.g. Morningstar, Moody's, Standard and Poor's, Dorsey Wright, financial blogs and more). With over twenty years' experience buying bonds, we are quite adept at the purchase and dissemination of information for fixed income bond buying.

Bond Trends -The high-quality issuers rated A-AAA are currently priced with very little return vs the risk of time. Tax-free bonds of quality are still priced in an unattractive manner for our consideration in total return investing. For high-quality and safety, we have been using CD's (certificate of deposits) with rolling 3-4 month maturities. Our recent bond purchases have been of 5-7 year maturities with companies rated **under** investment grade quality. With the current Fed Yield chart flattening as evidenced by; 1yr US Treasury is currently yielding 2.36% and a 30yr is 2.97%, 29 years of waiting gets you slightly more than a half of percent. We can always explain to any client why we are purchasing specific investments. Feel free to ask, we are passionate about our research and happy to share our methodology. We typically look for beaten up turn-around stories or those companies with potential positive catalysts ahead. Examples of some bonds we have recently purchased include:

- TEVA – oversubscribed recent debt offering, Berkshire Hathaway taking a position, lowering expenses, fundamental business with generic medicine.
- Sprint – T-Mobile merger hopefully will go through Fed Regulator approval as we waited to purchase this Sprint bond partially based on the positive outcome of the Time Warner Spectrum merger. The largest shareholder of Sprint is Softbank and they understand tech and want this merge to happen.
- AMC – Movies traditionally do well in good or bad economies, so we like their basic business. The majority shareholder of AMC is the China based company Wanda Group and they have been expanding their global entertainment holdings.

<u>Gold</u> has not been acting like it is supposed to, based on performing consistently with decades of historical performance analysis. When the world panics investors historically go to gold as an alternate source of investing. This hasn't occurred in recent months even with the threat of nuclear war, so we don't know what catalyst would cause a different result. Our hypothesis for this Gold/Fear disconnect is shared by many other investors and analysts. In short this hypothesis posits that:

1. Gold is no longer the fear trade it once was and now trades in tandem with the US dollar denominated.
2. Crypto, short for Cryptocurrency (Bitcoin, Ethereum, etc.), has replaced gold as the alternate source of investing in times of market duress. Adam Meyers created this chart which demonstrates the relatively high volatility of Bitcoin (ticker BTCUSD) vs. gold (ticker GLD).



In addition, we have read many reports and articles regarding the valuation of gold written by people far smarter than this author. The consensus among these authors lies in the potential for higher gold pricing next year, but this is based on a weakening US Dollar - attributed to our budget deficit and possible trade wars. These analysts may be correct in their pricing, but we didn't buy gold as a currency hedge or political investment, we bought gold as a contributor to lower portfolio volatility in times of market duress. As of this writing, today Wednesday, July 11th, I have just exited our clients' entire position in gold ETF's. The market was down this morning on increased tension for tariffs between USA/China and gold was equally down, but it should be up if it was a fear trade as was BTCUSD this morning.

Bond Counterweight **–** Should we own gold on the hope its price will increase based on the predictions of currency analysts? Hope has never been a solid investment strategy, which is why we exited the gold position. With bonds now an attractive counterbalance in select accounts, we appreciate the productive and stabilizing effect of predicable income.

Unemployment is now our biggest focus on economic news as we are starting to feel the effects of higher wage inflation and the stagnation of growth based on the inability to fill jobs. Washington farmers lack the labor to harvest apples, and the shortage of truck drivers translates into longer delays and higher costs for delivery. The flattening yield curve is also something we closely watch as our concern becomes elevated if the curve inverts (yield higher for short maturities vs longer).

The Fed is signaling another rate hike or two in the coming four months. GDP growth is good and getting better. If the USA can collect more money in revenue from tax law changes or the economy is stimulated through corporate tax changes, then this will lead to positive trickle-down economics. The numbers for this to bear truth have yet to be established contrary to what the talking heads in Washington claim. Any person who has ever balanced a checkbook knows you don't have more money in the account because you still have blank checks.

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