Blackthorn
ASSET MANAGEMENT

Witches' Brew

It is a witch's brew that the policymakers in Washington DC are conjuring up and it is not making things easy for investors or even other policymakers. While the 8 years since the financial crisis were filled with monetary policy band aids Federal Reserve Governors never had to manage the delicate balancing act of the merger of their monetary policy with fiscal stimulus from the Legislative or Executive branches. Much as they begged for fiscal policy it never arrived. Now with Congress and the Executive branch controlled by the Republican Party, tax reform, deregulation and infrastructure are the current beltway buzzwords.

If you haven't been keeping up with our Quarterly Letter it is our current market view that the odds are high and rising that we are going to have some sort of error in monetary and/or fiscal policy. The combination of experimental central bank monetary policy and the Trump administration's stated goals, if not enacted in concert, raise the risks that something is going to break. Those stated policy goals, while giving the Federal Reserve cover to raise rates, also make the Federal Reserve's exit from their easy money polices of the last 8 years particularly tricky. To be frank their exit was never going to be easy.

This high wire act by the Federal Reserve entails anticipating the moves of not only the Trump Administration but also the response from Congress to the administration and as we have seen in the last few weeks, predicting Congress' reaction may be the most difficult part. On March 15th the Federal Reserve chose to raise interest rates as the Trump Train was seemingly rolling down the tracks towards, first, healthcare reform and then quickly on to tax reform. But, only days later, markets were disappointed in the lack of policy movement on the ACA or "Obama Care" as it failed to even make it out of committee. This failure seemingly put the rest of the Trump agenda at risk. Federal Reserve policymakers are very carefully considering the policy that is coming out of the White House and Congress and plan to adjust monetary policy accordingly but they are having a difficult time predicting what will or won't become law. They are now taking into account fiscal policy in their discussions for the first time in 8 years and predicting what the policymakers in Washington are going to do which is anything but easy money.

Any policy error could resolve itself in one of two ways. If central banks drag their feet and raise rates too slowly then that policy error could continue to incite animal spirits and drive equity valuations even higher, possibly to bubble like valuations. The Fed is also wary of the fact that there is a possibility that if they were to move too quickly they could throw cold water on the recovery especially if Trump's fiscal and tax objectives get bogged down in the swamp - which we think they already have. Equity prices could then fall sharply.

So far, it appears that the policymakers at the Federal Reserve are moving too slowly as the animal spirits of the market are winning. In fact, as the Federal Reserve was raising rates on March 15th they reinforced the narrative that they would move slowly with their statement in the press conference afterward. The Fed has been consistent in stating that 2% inflation was a target of theirs. In her latest press conference, Yellen made it clear that the 2% target is a target but not a ***"ceiling".*** Additionally, her comment that the return to 2% inflation should be ***"sustained"*** made it clear to the market that the Fed is okay with letting the economy run "a little hot". The market took that as an all clear signal to take valuations higher as the Fed made it apparent that they are in no hurry to raise rates and slow this rally down.

Their statements made it seem as though the Federal Reserve feared a negative market reaction so much that they needed to couch the rate hike with statements to cushion the blow. That reinforced markets feeling that easy money is here to stay and markets turned higher in anticipation of a continuation of the easy money policy that we have seen over the last 8 years.

The market valuations are quite elevated at present time and rising. The possibility of a policy error by the Federal Reserve and/or the Trump Administration only looks to be increasing while increased valuations increase the repercussions of any policy mistake. We have been of the belief that a policy error could set the stage for a substantial rally and then fall ala 1987.

As the market has combined the clamor and excitement over deregulation and tax reform with a slow moving Fed you have room for the Animal Spirits to run as investor euphoria takes hold. A 30% run from the lows before Election Day, much like 1987, (we are up 12.5% from Election Day as we write) would put us squarely in bubble territory as the S&P 500 would approach the 2750 area. A subsequent 30% retreat would bring us back to the 2000 area. Currently at 2360 on the S&P 500 one can see the potential for misstep by exiting one's holdings completely and trying to time reentry. One solution is that we dial back risk as we see markets rising and adding risk when the risk premium is more in our favor. We will always make sure that we have the ability to buy when discounts come.

The Fed must attempt to act in concert with the President and his fiscal policy to avoid overheating or stalling the economy but good luck to them anticipating his next move and /or Congress' reaction to his moves. Raising rates is not an exact science in the best of times but Washington DC seems hell-bent on confounding even the best informed or best intentioned.

Until Something Breaks

In his latest webcast last month, Jeff Gundlach, the current bond maven on Wall Street, made it clear that he expects the Federal Reserve **to begin a campaign of sequential interest rate hikes until "something breaks".** In *Cashin's Comments* last month, Arthur Cashin notes that David Rosenberg's (Gluskin Sheff) research shows that since World War II, the Fed has embarked on 13 tightening cycles. Ten of those cycles led to recessions. While we do not see a recession on the horizon we do believe the Fed is behind the curve and may need to hike more aggressively than they would like. That will create imbalances throughout the system much like the sequential rates hikes in 1982, 1987, 1990, 1997 and 2007. The crises that raged in the aftermath of those rate hike cycles ranged from the Latin American debt crisis in 1982 to the S&L crisis in 1990 to the subprime debt crisis of 2007.

The rate hike on March 15th is the third rate rise of this cycle with the stated goal of two more rate hikes in 2017. The old Wall Street adage is 3 hikes and a stumble. Wall Street lore suggests that the third rate hike is when markets start to falter. The Fed is damned if they do and damned if they don't. It's a guessing game with imperfect information. This is the kind of decision a trader makes and not the kind that academics make well.

The reality is that the Fed may be so far behind the curve that this rate hike, the third of this cycle or even the fourth rate hike doesn't affect the market but sooner or later the Fed will hike and something will break. They are academics and they do not anticipate change. It's like driving using the rear view mirror (h/t BR). The data that they rely on is from the past and doesn't show when the trend has changed. They will hike until something breaks.

Bumps in the Road

What other bumps in the road do we see? We are watching very closely not only the developments in Washington but also in Riyadh. The oil market may be our best hint as to what is going to happen next. The oil market and the high yield bond market are very closely related as much of the loans in the high yield sector have gone to oil related

operations. Any falter in the price of oil could have further consequences and ripple effects across the economy. Oil has hit it own speed bump as West Texas Crude slipped below the psychologically important $50 a barrel level. As so goes oil so goes the economy and the stock market. If oil slips, so may stocks. High yield bonds may be our canary in the coalmine here.

Our biggest worry over the next several months is the impending Debt Ceiling negotiations in Washington. The Freedom Caucus is a group of Republicans that skewered the Obama Care replace and repeal. They have become a very powerful group in Washington all of a sudden. They are no fans of raising the debt ceiling. This could turn into a showdown with massive repercussions. In June of 2011, February of 2013 and October of 2015 we saw circumstances where we have been faced with debt ceiling negotiations. Two out of those three events saw markets move lower in response. It is about time that Congress took away the uncertainty surrounding this biannual discussion. Let's see how far they push things this time. Warren Buffett once said that he did not like to invest when there was possible government intervention and over regulation in a business. We are all invested in what comes out of Washington DC now.

In the investing game it is worthwhile to follow retail investor money flows. It is the retail investor that is usually late to the game and the marginal buyer at tops in the market and a seller at the lows. Retail investors are currently pouring money into equity ETF's as shown by the fact that the S&P 500 ETF (SPY) had its largest inflow since 2014 last month and its second largest daily inflow since 2011. We also watch closely the movements of corporate insiders. While we place a premium on insider buying, insider selling should be taken with a grain of salt. (There are many reasons to sell. There is only one reason to buy.)As per a report from CNBC company insiders are dumping stock into the marketplace at accelerated rates.

By way of Arthur Cashin, we see that according to Jason Goepfert at SentimenTrader hedge funds are also pulling back.

"After reaching one of their most-exposed levels in 15 years, hedge funds have started to lessen their positions in stocks. There have been three other times that they were as exposed as they were in the past month, and when they started to pull back and volatility rose, stocks fell hard, fast." 3/24/17

Valuations are quite extended and perhaps rate hikes will bring things gently back to earth. Much is being made of the idea that there seems to be a global upturn in economies. The global upturn and Trump's policies could provide more cover for the Fed to raise rates to try and cool valuations off. You have to remember that they are not

the only central bank adding fuel to the fire. Japan, China and Europe are all doing the same.

Heisenberg Uncertainty Principle

There is always something to worry about but currently there are too many investors on the same side of the boat. One of the best ways to generate alpha or excess returns in the last 8 years has been to BTD. Buy the dip. It is actually BTFD but we are too polite to write that. Traders have been *conditioned* over the last 8 years to buy every pullback in pricing.

The Heisenberg Uncertainty Principle, from German physicist Werner Heisenberg, shows us that simply the act of observation affects the particle being observed. (The original version of the uncertainty principle appeared in a 1927 paper by Werner Heisenberg, a German physicist, titled *"On the Perceptual Content of Quantum Theoretical Kinematics and Mechanics".)* In investing, we see the Uncertainly Principle at work when the market observes an outperforming strategy, subsequently, that strategy will then begin to lose its outperformance. That is why you see investors all on the same side of the boat. When investors observe an outperforming strategy they pile on. All those flocking to the same side of the boat decrease the odds of outperforming and raise the risks of underperforming. When you find the key to the market they change the locks.

Our job is not to predict the future but to manage risk for our clients. History tells us that future returns are, in good part, reliant on starting at low valuations and that when beginning at high valuations we see lower than average returns. It is prudent, at this juncture, given that valuations are currently in the highest 10% in history, that we take some risk off of the table for our more risk averse clients. We will continue to press our bets for our more aggressive clients but we have one hand on the brake.

A lot depends on the perception of the Trump Administration post vote. Is tax reform coming or has the swamp won? We believe that the last 30 minutes of trading each day will give us clues as to what managed strategies are influencing the market and whether the big intuitions are leaving the market. We still think that this could be the last 10% of a move that started in the post 2008 crisis period as valuations are rich. It is awfully hard to predict time *and* direction but we believe that given historically high valuations it is prudent to trim down risk (and accept possibly lower returns) until the risk premiums are more in our favor. We believe that a move lower at this juncture will be met with buyers down 5-8% from the highs while history tells us that the old highs will be approached once again. That is when the real decisions will need to be made.

Moreover, the years ahead will occasionally deliver major market declines – even panics – that will affect virtually all stocks…During such scary periods, you should never forget two things: First, widespread fear is your friend as an investor, because it serves up bargain purchases. Second, personal fear is your enemy. It will also be unwarranted. Investors who avoid high and unnecessary costs and simply sit for an extended period with a collection of large, conservatively-financed American businesses will almost certainly do well. - Warren Buffett

I think we aspire less to foresee the future and more to be a great contingency planner… you can respond very fast to what's happening because you thought through all the possibilities, – Lloyd Blankfein CEO of Goldman Sachs

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5845 Ettington Drive
Suwanee, Georgia 30024
678-696-1087
Terry@BlackthornAsset.com

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