

IT'S NEVER DIFFERENT THIS TIME

“I learned early that there is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again. I've never forgotten that.” – Jesse Livermore

Jesse Livermore was a legendary Wall Street trader and his biography “Reminiscences of a Stock Market Operator” is a must read for anyone that is in the investing game. As an investor one of the most important things to remember is that it is **never** different this time. As much as we think that our time or era is unique to history we are all still human. We react psychologically to whatever stimuli are present at any given time just about the same way that our caveman predecessors did. The names change but the game stays the same.

*Up-and-down cycles are usually triggered by changes in fundamentals and pushed to their extremes by swings in emotion. **Everyone is exposed to the same fundamental information and emotional influences, and if you respond to them in a typical fashion, your behavior will be typical:** pro-cyclical and painfully wrong at the extremes. To do better – to succeed at being contrarian and anti-cyclical – you have to (a) have an understanding of cycles, which can be gained through either experience or studying history, and (b) be able to control your emotional reaction to external stimuli. - Howard Marks Founder Oaktree Capital*

The Federal Reserve and central banks around the world have added and drained liquidity over and over again repeatedly over the last century. What is slightly different this time is that the Federal Reserve and central banks around the world have added more liquidity than they have *ever* done in history and in concert. That is different but the results are always the same. When central banks add liquidity asset prices will soon follow suit and rise with the new found liquidity. When the Fed subtracts liquidity the market will also soon follow in negative course. You cannot predict when or how far the market will move but there is no point in fighting the Fed. Whatever they do the market will do in time.

I am not saying that the market will crash. I am saying that as the Fed and other central banks remove liquidity then markets at some point will begin to price that into the equation. I can't tell you how far markets will move because I cannot tell you how far the

central banks will move. It was the former NYSE President and Fed Chairman William McChesney Martin who coined the phrase that it was the central banks job to take away the punchbowl when the party was just getting started. Central banks around the world are now hinting that it is time to think about removing accommodation and draining the punchbowl. The Federal Reserve has raised rates twice in 2017 and it looks like they may do it one more time in December of 2017.

Along with these rate hikes committee members have voted to start reducing the Fed's balance sheet this month. What does that mean exactly? The Federal Reserve will be mopping up some of the liquidity that has been splashing around markets and enabling inflation in asset prices. Eventually, (QT) Quantitative Tightening will have the desired effect from the Federal Reserve. The other major central banks around the world are still adding liquidity but the Bank of England and the European Central Bank (ECB) appear ready to at least stop adding liquidity. The Bank of Japan is charting its own course and continues to add liquidity. The US Federal Reserve has begun draining liquidity as its journey has been mapped out and begins this month. The pace is slow and steady but there will be a tipping point where the reduction in liquidity will impact asset prices. When is that tipping point? That is the \$4 trillion question.

While the Federal Reserve is trying to extricate itself from its monetary experiment the first place we will look for clues to the trajectory of asset prices will be the US Dollar. As the quote below from Ambrose Evans Pritchard explains the US Dollar is our barometer and we do expect it to generate a headwind for equity and credit alike.

“The message from a string of BIS [Bank of International Settlements] reports is that the US dollar is both the barometer and agent of global risk appetite and credit leverage. Episodes of dollar weakness – such as this year – flush the world with liquidity and nourish asset booms. When the dollar strengthens, it becomes a headwind for stock markets and credit.”

– Ambrose Evans-Pritchard International Business Editor of *The Telegraph*.

In the last several weeks the US Dollar has headed higher and the yield on the 10 Year US Treasury has headed north of 2.35%. If the US dollar continues to rally as the Fed takes away the punchbowl and tightens policy then we may see a reversal of what has transpired so far in 2017. Small and mid cap stocks may outperform while gold and emerging markets underperform.

THE BEAR CASE

It is getting harder and harder to make the bear case. That alone is troubling. Markets have shrugged off a potential hot war with North Korea, US Presidential investigations, and the complete and utter failure of Republicans to pass any legislation of consequence in Washington DC. But if we were to point to any one thing that the bears can hang their hat on it is the historically high valuations in asset prices. The most astounding valuation that we have seen is that European High Yield debt now yields less than US Treasuries of the same duration! European junk debt is less risky than US government debt? Incredible. While valuations alone do not a bear market make, historically, valuations in the highest percentiles portend lower than average returns in the future. Here are some of those excessive valuations.

- The S&P 500 is selling at 25 times trailing-twelve-month earnings, compared to a long-term median of 15.
- The Shiller Cyclically Adjusted PE Ratio stands at almost 30 versus a historic median of 16. This multiple was exceeded only in 1929 and 2000.
- The “Buffett Yardstick” – total U.S. stock market capitalization as a percentage of GDP – *new all-time high last month* of around 145, as opposed to a 1995-2017 median of about 100.
- The lowest yields in history on low-rated bonds and loans.
- All time low yields on emerging market debt.
- The CNN Money Fear & Greed Index of market-based risk-appetite gauges is at 95 on its 100 scale.
- S&P 500’s Longest streak without a 5% drop of over 330 days
- Institute of Supply Management’s manufacturing Index above a reading of 60 and highest reading since 1994.

Equity markets are in the midst of a multiyear run as seen by the rise in values since the Great Financial Crisis (GFC) in 2008-09. Those valuations have risen to historical levels and are now in the 90th percentile historically. Research shows us that returns in the 90th percentile run below average. Investors are acting as if there is no risk in holding assets. The definition of investing lies in the risk return tradeoff and that is seemingly being ignored.

Another factor in the bear case is the bond market and the possibility of rising yields. In our last quarterly letter we wondered about who was going to be right – the bond market or the stock market. We have always gravitated to the bond market as the older, wiser brother of the stock market. The bond market is not done giving us clues as we believe that rates, while still mired in the range between 2.1% and 2.7%, may yet break

out one way or the other. A rate rise through 2.7% could quickly generate much higher rates and that could douse the enthusiasm of the stock market bulls.

THE BULL CASE

While the shrinking of central banks balance sheets has us cautious we need to remember that, even with the Federal Reserve telegraphing to the market that they intend to shrink their balance sheet, central bank balance sheets worldwide have still grown at 8% year over year. The bulls may keep control of the market if central banks other than the United States continue to expand their balance sheet. It is now the world's balance sheet that has our attention and not just the US Federal Reserve's.

As central banks remove the punchbowl they will be telegraphing their moves to the marketplace and moving ever so gently to the sidelines and that may appease markets for now. The conditions for a market crash do not seem to be in place. In contrast, the conditions of a spiraling melt up seem to be more likely as we have said for some months now. Investing is an exercise in mass psychology. Investors have gotten used to investing gains and see no risk on the horizon. Over inflated valuations have professional investors trimming their sails and cutting equity and bond exposure. We continue to hear the same arguments of distorted valuations and have made those same arguments ourselves but high valuations alone will not stop a raging bull market. While seemingly every investor is expecting a sell off from such high valuations they may find themselves falling behind their client's expected returns. That may force professional investors to chase returns in the last quarter of 2017. One of the hallmarks of a late-stage bull market cycle is the acceleration in price as investors capitulate by jumping in as prices accelerate.

*Jeff deGraaf, chairman and chief technical analyst at Renaissance Macro Research, is telling clients this week **the risk of a "melt-up" in stocks is "very real."***

*"Given the good economic data, loose credit conditions, benign inflation data and investor's sentiment, we think the risks of the Fed (and G7 central banks) blowing an asset bubble are above average," he says. Cyclical indicators such as the ISM purchasing-managers index above 60, with unemployment under 4.5 percent, are arguably "too good," correlating with poor 12-month returns for stocks. **"But until credit conditions deteriorate, we're holding on to this tiger's tail,"** deGraaf concludes. -CNBC*

We will continue to keep a close eye on the bond market. If equity markets were to move drastically lower we believe that the Federal Reserve will act quickly to support the market. It has widely telegraphed its intention to slowly roll down its balance sheet. If that roll off should cause trepidations in the stock market we believe that they will

quickly reverse course and, in dire circumstances, perhaps even begin buying equities. The Fed Put is alive and well.

While we have foreseen a 1987 type of market since the election it is impossible to predict the “top”. What makes us most uncomfortable about calling an end to this bull market is that seemingly everyone else is attempting the same. When everyone expects something to happen - something else will. (H/t Bob Farrell)

WHAT TO DO

It is impossible to know where the top of a market is and no one wants to feel foolish for having left the party too soon. In order to meet our investing goals we cannot afford to leave the party too soon but what we can do is recalibrate. When historical valuations are in their highest percentile we can move to investments with better risk reward profiles and if that investment is cash, then so be it. Successful investing is accomplished by doing what is unpopular or uncomfortable.

Even though no one can ascertain when we're at the exact top or bottom, a key to successful investing lies in selling – or lightening up – when we're closer to the top, and buying – or, hopefully, loading up – when we're closer to the bottom.

“Investing is not black or white, in or out, risky or safe.” The key word is “calibrate.” The amount you have invested, your allocation of capital among the various possibilities, and the riskiness of the things you own all should be calibrated along a continuum that runs from aggressive to defensive. [Howard Marks](#)

That is why we have taken steps to reduce durations at Blackthorn to very low levels. Duration is a measure of bond holdings sensitivity to a rise in interest rates. Our lowering of bond duration in client's portfolios will cushion any blow to our portfolios given higher rates from the Fed. In fact, our durations are so low that higher rates could conceivably help our performance in the longer run as we will be reinvesting at higher rates.

September is historically the weakest month of the year. 2017 has not been kind to seasonal adjustments as shown by the market's strength this summer (Sell In May and Go Away) and evidenced by its strong showing in September. But when a traditionally weak period is strong it gives more weight to the bull thesis. A strong September has been shown to be good for stocks, historically, as they portend a strong 4th quarter. According to the Leuthold Group, an equity research firm, since 1928 there has been 29 Septembers where the S&P 500 reached a 12 month high. In the 4th quarter following those 29 new highs the S&P 500 was up 80% of the time for an average return of 3.7%.

We, at Blackthorn, attempt to achieve excellent risk adjusted returns over a full market cycle and not to mimic a benchmark in the short term. We strive to give the best service possible while being as transparent as we can in order to give the client confidence in our managing of their assets. It is that confidence that is the basis of sound decision making during market extremes. We continue to be risk averse amid historical valuations that have proceeded less than stellar returns over the last 100 years whenever they presented themselves. Successful management of assets emphasizing risk adjusted returns over time requires patience and a thoughtful investor base which we have been fortunate to attract over the years.

Our risk adjusted returns show that we have chosen the right assets to rotate into while we continue to be on guard and show patience as this bull market evolves. Our experience has been that chasing returns over time does not work and paying strict attention to valuations in the marketplace and expecting some reversion to the mean is the correct approach. We manage risk. Right now investors are not getting paid an appropriate premium for taking risk, and so, we recalibrate. As Jesse Livermore once said, that it was never my trading that made me money, it was the waiting.

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

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

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