The Type 2 Investor

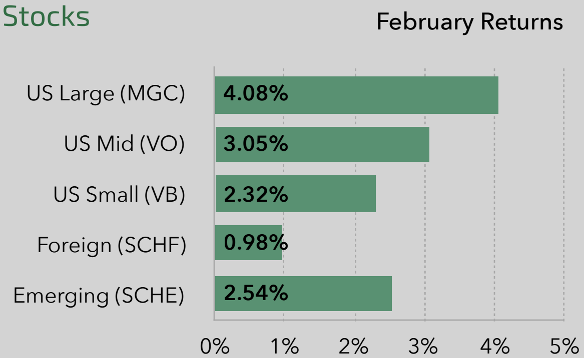
March 13, 2017

February 2017

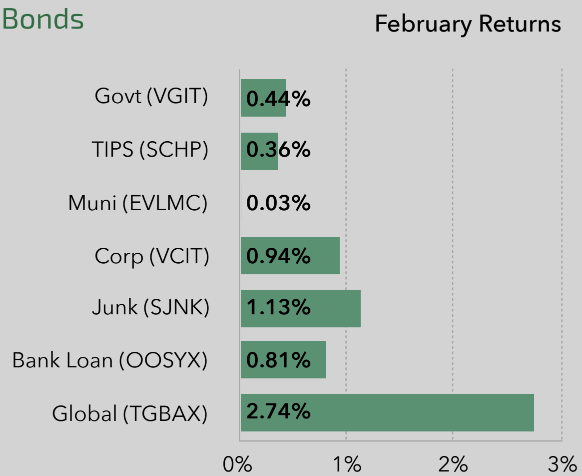
Economic Data

- 235,000 jobs were added in February and the initial jobless claims 4-week moving average hit its lowest level in 44 years
- The ISM Manufacturing index jumped 1.7 points to 57.5
- Year-over-year inflation (CPI) soared to 2.5%, ahead of expectations, and core inflation creeped up to 2.3%
- Retail sales growth came in at 0.4% in January, but autos showed weakness, falling 1.4%

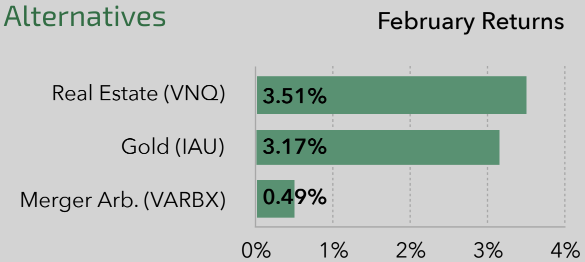
Stocks



Bonds



Alternatives



Performance data provided by Morningstar.

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system – type 2 – that we want in control of our investment portfolios.

Things Snapchat is Worth More Than

Snap, the "camera company" that doesn't make cameras, IPOed earlier this month to much fanfare. Maybe I'm a bit of a curmudgeon, but the current valuation of $25 billion for disappearing photos seems kind of ridiculous to me. Essentially, you would have to believe that the preferred medium for dick pics is more valuable than:

- The Hershey Company's chocolate empire
- Royal Caribbean Cruises Ltd. and their 49 ships
- American Airlines and their fleet of over 900 aircraft
- Hilton and their 540 hotel and resort properties
- Yum Brands and all the KFCs, Taco Bells, and Pizza Huts they own

What's even more interesting about the IPO is the shares are non-voting. You could buy all the shares and have zero influence over how the company is run. We are entering a brave new world of corporate governance with this one.

The Ides Sheep Make Their March

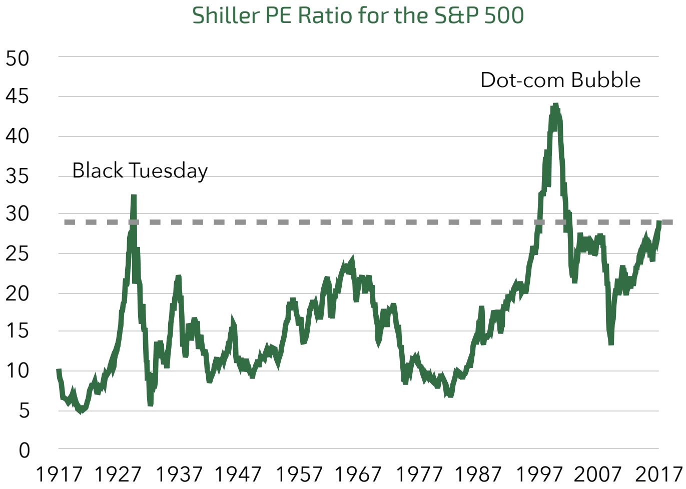
The ancient Roman calendar worked a bit differently than the modern Gregorian calendar we are all familiar with today. It was read by counting back from three special points on the lunar calendar: the Kalends (the new moon), the Nones (the quarter phases), and the Ides (the full moon). The Ides, which fell on either the 13th or 15th day of a month, were sacred to the god Jupiter. On this day every month, a priest would lead the "Ides sheep" up the Sacred Way in Rome to be sacrificed.

March 15 is also, most famously, the day Julius Caesar was assassinated. Caesar was, as dramatized by William Shakespeare, warned by a soothsayer that he would be in great danger until the Ides of March had passed. This prophecy came true by the pointy ends of 23 dagger thrusts.

This March 15, there are two very important items on the economic calendar. The first is the morning release of the CPI number for February. Inflation was well above economists' expectations last month, and the three-month jump in CPI was the largest since 2011. We expect the base effect of gas prices will add about one full percentage point to the headline number on Wednesday. I have been talking about this for eight months now, and this will be the report where inflation gets close to 3%.

The other event will be the afternoon announcement following the FOMC meeting. The Fed has been telegraphing their intentions quite clearly, and with the decent February employment report a rate hike is as close to certain as its ever going to be. The hawks are circling.

Both of these events will be hard on bonds, and have already drove yields higher. It might even rattle the equity markets a bit, which have so far shrugged off all bad news and have decoupled from reality. According to the cyclically-adjusted PE ratio, stocks have only been higher twice in the past century. And if my knowledge of history is correct, things didn't go well in the aftermaths.



We believe there is a massive disconnect between analyst expectations and earnings reality. Take a look at small-cap stocks, for example. The trailing P/E ratio for the S&P 600 is 54.21 (as of September 30, 2016 data), however analysts are projecting a P/E ratio of 20.54 going forward. That means they expect earnings to increase 164% over the next twelve months as compared to the actual reported earnings over the past 12 months.

For the S&P 500 analysts are estimating a 44% y/y increase in earnings from 3Q16 (4Q data is not yet fully available). Meanwhile, 67 S&P 500 companies have issued negative earnings guidance so far this quarter, while only 31 have issued positive guidance, according to Factset.

This type of earnings growth is possible, of course, but typically only in the immediate aftermath of a severe recession. Certainly not at the tail-end of an eight-year bull market. Tax cuts aren't going to get us to these numbers, neither is protectionism. It's pure fantasy!

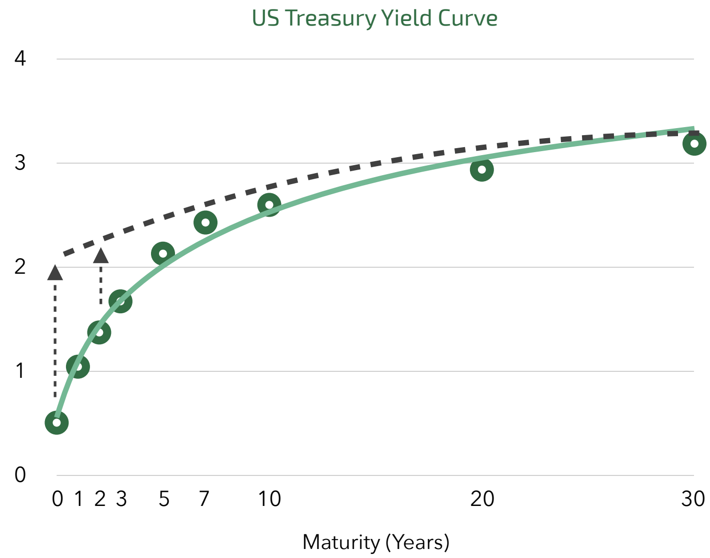
Hedge funds and institutional investors ("smart money") have been net sellers of equity on a 4-week moving average, according to Bank of America Merrill Lynch. Meanwhile, individual clients ("dumb money") have been net buyers since early January 2017. I'm not much of a soothsayer, and asset bubbles have a stubborn tendency to last a lot longer than one might expect, but I believe anyone buying into the market at these valuations is an Ides sheep being led to slaughter.

Portfolio Positioning

There have been no changes to our asset allocation strategy over the past month. We continue to be underweight equities as they remain, in our opinion, overvalued. Small caps look the most expensive right now, and we may look to cut there.

Meanwhile, emerging markets have stabilized since the turmoil following the election and are starting to look attractive again.

We are underweight bonds as well, as we see higher inflation putting continued upward pressure on yields this month. We believe inflation will cool off following this week's report, however. Despite the Fed's tightening plans, we may look to add to bonds soon.



Allow me to explain. Duration is essentially a measure of sensitivity to interest rates. The higher the duration, the more negatively impacted the bond price will be if interest rates rise, all else equal. Bonds with near-term maturities and/or higher coupon payments have shorter durations, while longer-term bonds and those with low coupon payments have relatively higher duration.

In theory, if interest rates are rising you want to keep your duration short. That is certainly true if interest rates rise equally across all maturities, which is called a parallel shift. However,

Binge Box

Peaky Blinders

This one had been in my Netflix queue for way too long, and I finally found some time this past month to watch it. I'm glad I did. The story follows the progression of the Peaky Blinders, an organized criminal element in Birmingam, England that rose to prominence following World War I. They were allegedly called the Peaky Blinders because of their practice of stitching razor blades into the peaks of their caps to use them as weapons.

Cillian Murphy, Sam Neil, and – later on in season 2 – Tom Hardy round out this all-star cast. It's like an old-timey version of Sons of Anarchy, with – dare I say – better writing and acting.

parallel shifts exist almost exclusively within the pages of finance text books. In reality, shifts are almost never so clean.

Our expectation is for the curve to flatten out, because that's what yield curves do at the end of the growth phase of the business cycle. If we're right, most of the increases in interest rates will be felt on the shorter end of the curve, and we may actually see some of the intermediate and longer-term yields drop a little. We think the 7-10 year range of maturities is the most attractive part of the treasury yield curve right now.

Happy St. Patrick's Day!

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Tactical Asset Allocation					
Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Cash				●	
Fixed Income		●			
Core Domestic		●			
TIPS					●
US High Yield	●				
Bank Loans				●	
Foreign Bonds			●		
Equities		●			
Large Cap		●			
Mid Cap		●			
Small Cap		●			
Developed Intl.		●			
Emerging		●			
Alternatives				●	
Real Estate		●			
Commodities					●
Hedging					●

About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide outsourced investment management services to community bank trust departments and independent trust companies, as well as fiduciary investment management for select individuals. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.

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