The Type 2 Investor

October 10, 2016

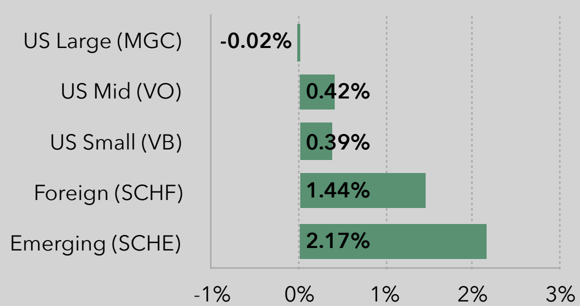
September 2016

Economic Data

- Year-over-year inflation (CPI) finally woke up in August climbing three-tenths to 1.1% while the core edged up to 2.3%
- Retail sells fell 0.3% in August; second straight month of declines ex-autos
- The housing market showed continued weakness in August as existing home sales fell 0.9% for the month
- 156,000 jobs were added in September, at the low end of expectations; unemployment rate creeped up to 5.0% as more people entered the labor pool

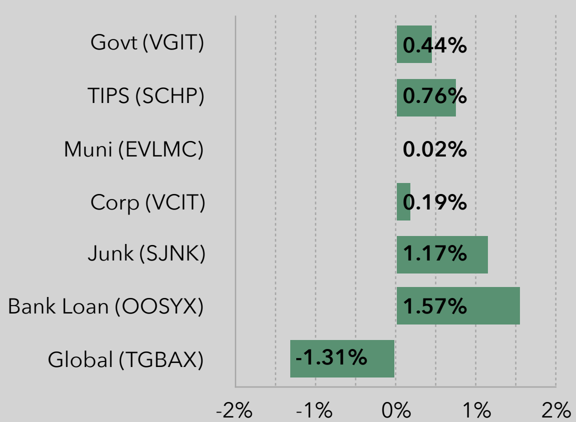
Stocks

September Returns



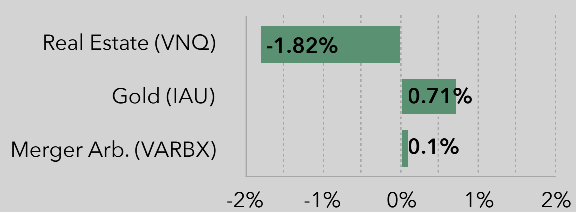
Bonds

September Returns



Alternatives

September Returns



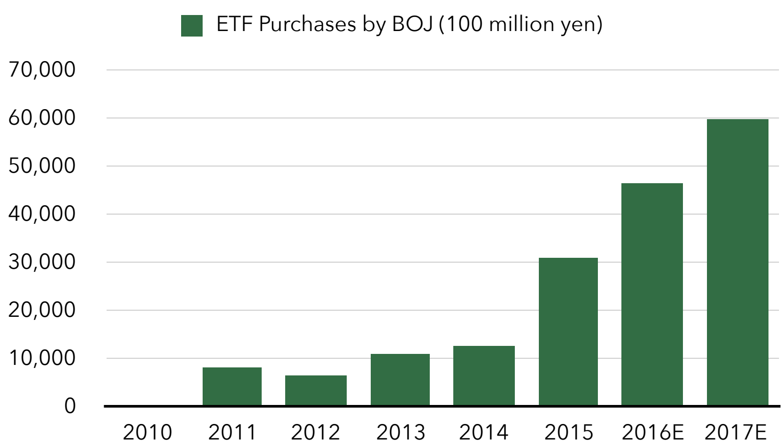
Performance data provided by Morningstar.

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.

BOJ Job

After almost three months of complacent calm in the markets following the post-Brexit recovery, indiscriminate selling of global assets began on Friday, September 9. The selloff appeared to be related to uncertainty regarding an anticipated change in monetary policy at the Bank of Japan's (BOJ) September 20-21 meeting, which did indeed happen although it was largely panned as underwhelming. Since negative interest rates, massive asset purchases, and three years of money printing haven't been working in the BOJ's quest to conjure up inflation, they shifted to a strategy they called "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control". The BOJ will now buy 10-year Japan government bonds (JGB) with the goal of keeping their yields hovering around zero percent and controlling the shape of the yield curve, supposedly in the hopes to make it steeper.

The BOJ already owns almost 40% of the total JGB market, and at last read Japan was still in a state of deflation with their CPI at -0.5% year-over-year in August. I don't really see how buying more will suddenly make the policy effective, but what do I know? They felt doing nothing was not an option and this is all they came up with.



The more controversial ETF purchase program remains in place at an increased rate of 6 trillion yen ($58 billion) per year. The program has put the BOJ on track to becoming the largest shareholder of 55 companies in Japan's Nikkei 225 by the end of next year, according to Bloomberg. Since beginning the program in 2010 the BOJ has purchased just over 10 trillion yen of ETFs ($97 billion) to date, about 2% of the total market cap. To put that in perspective, it would be the equivalent of the Federal Reserve buying a half trillion dollars of stock – basically buying Google (sorry, "Alphabet"). They are in effect gradually nationalizing their stock market. Just how is that supposed to help the economy?

Deutsche Bag

Moving from the Pacific to the European theater, we bring our attention to Germany. Deutsche Bank, Germany's largest bank, is beginning to have a sort of Lehman Brothers feel to it. The U.S. Justice Department has floated out a bank-breaking $14 billion settlement offer to Deutsche for selling supposedly defective mortgages to investors. Incidentally, $14 billion amounts to about 80% of what the company is currently valued at. Deutsche Bank's stock (DB) was down 11.25% in September, adding to a continuing destruction of capital that has seen the company lose more than three-quarters of its value from its highs in January 2014.

Chances are the settlement figure will end up being lower than that, but whether Deutsche Bank is truly insolvent or not may not matter all that much. The panic created by the question could be enough to fulfill the prophecy of the former. Several large hedge funds have already moved to pull billions of dollars from the bank to limit their counter-party exposure. Deutsche Bank has a more diversified client base than Lehman Brothers did, but it's worth noting that this is what precipitated the collapse of that firm in 2008. The company has a 13% cost of capital and has lost money in three of the past four quarters. A large run on the bank will make already elusive profitability much harder, forcing Deutsche to raise capital with their share price more depressed than ticket sales were for David Hasselhoff's cancelled European concert tour.

Deutsche's U.S. banking unit failed the Federal Reserve's annual stress test for the second year in a row with the Fed citing "broad and substantial weaknesses" in their capital planning. The interconnected nature of the bank's relations with other financial institutions also led the IMF to call it "the most important net contributor to systemic risks," in a report issued in June. With 42 trillion euros in notional derivatives exposure, there are a lot of counter-parties out there with Deutsche exposure. Angela Merkel has reportedly ruled out the prospect of government support. As politically unpopular as it might be, though, if a bailout was absolutely necessary to avoid a collapse of the German banking system and contagion across Europe we wouldn't be shocked if she changed her mind.

Third Cut to Equities For the Year

Equity valuations are rich and corporate buybacks – a key pillar of support – are slowing. As we enter the pre-3Q earnings season buyback blackout period, the largest source of U.S. equity demand will be on ice for a short while. We had been looking for a cue to cut equities again, moving from a neutral-weight to an under-weight. The September 9 global selloff of all assets served that purpose. The S&P 500 fell 2.41%, international developed stocks (SCHF) were down 2.33%, and emerging markets (SCHE) sunk 3.07%. The selloff was indiscriminate, with no asset class to buoy portfolios. Even gold (IAU) and US Treasury bonds (VGIT) – two assets that normally do well in a stock market selloff – fell 1.16% and 0.55% respectively. The global asset bubble let out just enough air to get everybody's attention.

Tactical Asset Allocation					
Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
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					●

We decided to make our move the following Thursday, selling into some inexplicable strength. The S&P 500 is trading at about 25 times trailing 12-month earnings and 19 times forward-looking earnings. Comparing that to 16 for international developed (neutral weight) and 13 for emerging markets (slight overweight), domestic stocks seemed to be the rational area to trim from. It's also worth noting that the BOJ's expanded ETF buying program will continue to support the Japanese stocks that make up 23% of our developed international allocation (SCHF).

A portion of the equity proceeds were used to increase our overweight to TIPS. It's difficult to get exited about TIPS when 10-years were offering only 0.24% in yield (now 0.00%), but alas they are our favorite asset class in the bond space at the moment. Year-over-year inflation (CPI) fell to 0.8% in July, but we expected that to heat up, which it did the following day with the Bureau of Labor Statistics August data release. The suppression effect that gasoline prices have had on inflation will likely diminish over the next two months, flip to positive in November, and continue to add to inflation through February. Barring any major disruptive events to our investment thesis, we plan to hold our extreme overweight to TIPS through at least March 2017.

Overall, we are still firmly underweight in bonds and expect only low single-digit returns at best out of this asset class. The spread on junk bonds is now below 5%. With default rates currently north of that, this bond category is an increasing source of concern.

Gold has done very well for portfolios since we initiated our positions in it back in October. It's difficult to predict whether or not this asset class will continue to do well after such a run-up, but it does fit out inflation thesis and also should do well in an environment where central banks have clearly jumped the shark. For these reasons we have added the remaining proceeds to gold.

I'll leave you with one final thought regarding uncertainty and the upcoming presidential election, that quadrennial insult on the enlightened American minority I have heretofore avoided mentioning in every one of my newsletters and blog posts. Elections create uncertainty and uncertainty has a way of creating negative price swings in the stock market. One certainty, however, is that on November 8 we will elect a president that the majority of Americans don't like or want. That's probably not a good thing.

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About EmeraldSpark

EmeraldSpark Investments, LLC is a registered investment advisor 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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