The Type 2 Investor

January 9, 2019

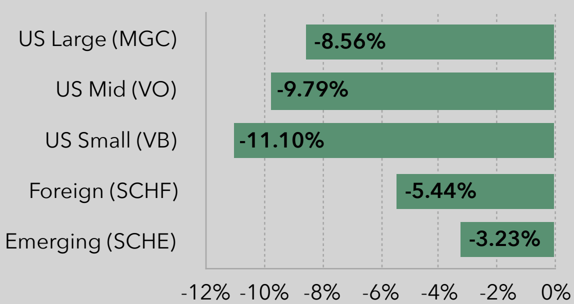
December 2018

Economic Data

- Payrolls surged by 312,000 in December, and wages were up 3.2% y/y; the unemployment rate rose to 3.9%, however, as more people joined the work force
- Inflation (CPI) was flat in November, and y/y growth slowed three-tenths to 2.2%
- Existing home sales rose for the second month in a row in November, climbing 1.9%
- Retail sales were up 0.2% in November, and October's number was revised up to 1.1%

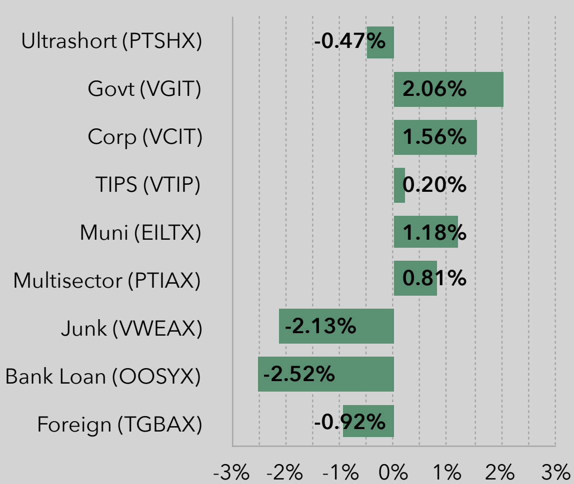
Stocks

December Returns



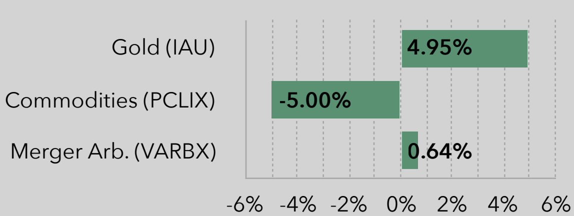
Bonds

December Returns



Alternatives

December 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.

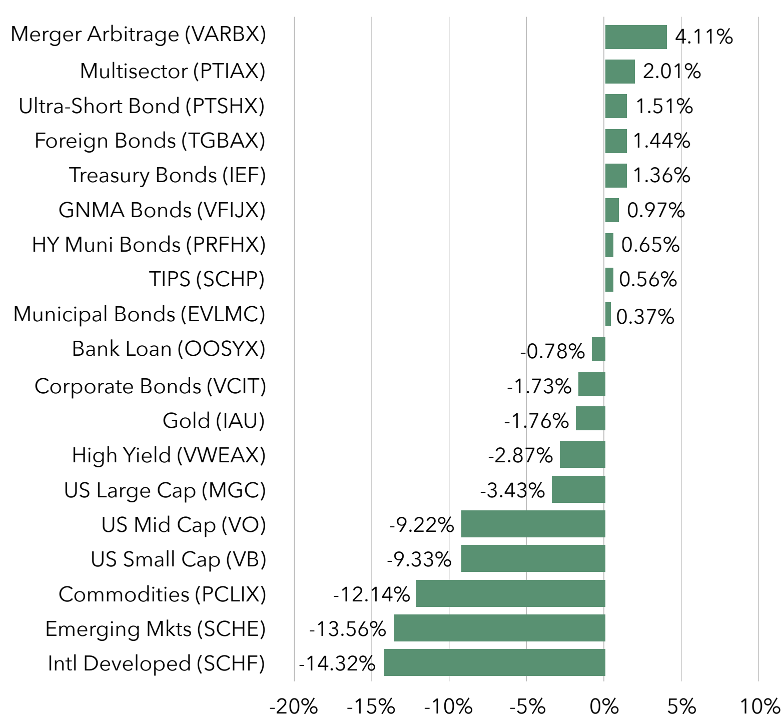
Goodbye 2018

The market entered 2018 like a lion with the S&P 500 up 5.73% in January, and limped out like a wounded lamb with the index closing out the year with a 9.03% rout in December. All told the S&P 500 lost 4.38% in 2018. And that wasn't too bad for stocks, as small and mid-cap stocks, as well as international and emerging markets stocks fared even worse. The MSCI ACWI ex-US was down 14.20%, making international developed stocks the worst-performing asset class in our strategy. We had been underweight stocks coming into the year, and moved to an extreme underweight in May, so clients did not feel the full brunt of the market's fall these past three months. It still hurt, though.

Bonds had a rough year as well, particularly those sensitive to credit risk. Bank loans, corporate debt, and high yield all lost money in 2018. This validated our moves to completely eliminate investment-grade and high yield corporate debt in January, and to cut exposure to bank loans in May before they turned south. The bond positions we did hold this year did relatively well by comparison, albeit with only very low-single digit returns.

Gold was a nice diversifier during the market downturn, up 7.52% in the 4th quarter. Broader commodities (PCLIX), however, were slammed down 20.12% over that period as oil prices plummeted. Missing the exit point there was my worst non-call for the year. Elsewhere in alternatives, however, the overweighted Vivaldi Merger Arbitrage fund (VARBX) was the best performer for 2018. Despite a rocky start due to China's interference in the NXP Semiconductors acquisition, the steadfast fund returned 4.11% for the year.

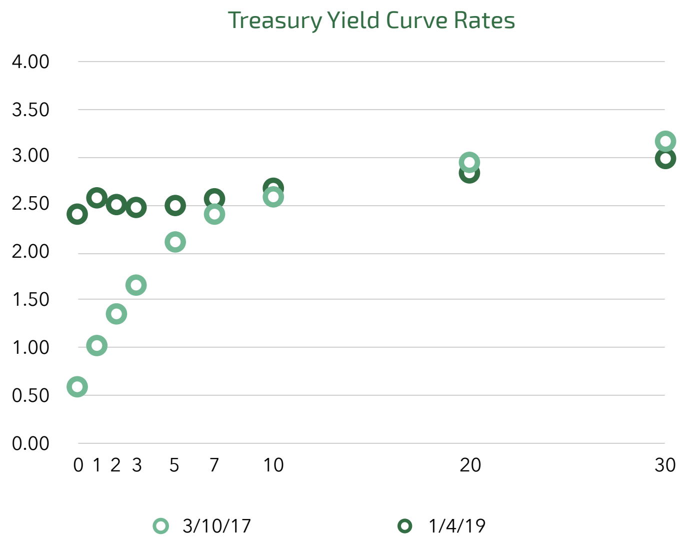
2018 Investment Vehicle Performance



2018: the End of the 'Everything Bubble'?

This is the time of year where I review all my predictions from the previous year, because despite knowing full well humans are bad at predicting the future, I keep doing it anyway. Most predictions are soon forgotten after they are made, and only remembered later if the original prognosticator obnoxiously reminds you of them if he was right. I think it is a worthwhile exercise to also talk about what we get wrong, which helps keep overconfidence in check.

- Let's start with Sears, which I predicted two years ago would go bankrupt and shutter all its doors. And then one year ago, when Sears was still alive, I invoked the "it just hasn't happened yet" defense. Well kids, Sears filed for bankruptcy protection last October. What's more, Sears just asked a bankruptcy judge to allow it to proceed with liquidation after it could not reach an agreement on Eddie Lampert's $4.4 billion takeover bid, according to Reuters. End of an American icon, but **+1 point for me**.
- In the March 2017 I said, *"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."* See chart below. Nailed it. **+1**



- *"Bitcoin will crash. So will Ripple. And Ethereum, and Litecoin, and Dogecoin, and KodakCoin, and every other stupid crypto token out there. It might take years, but the eventual value of each is much closer to zero."* Bitcoin was down 73.56% for the year. Ripple was down 84.66%. Ethereum was down 82.37%. And Litecoin was down 86.87%. You're welcome. **+1**
- *"Unfilled Tesla Model 3 pre-orders will be cancelled en masse later this year after the company hits its 200,000 car limit for the $7,500 federal tax credit. TSLA shares get trounced."* Tesla did hit the 200,000 vehicle mark in July, so the credit is being phased out this year, with $3,750 still available for the first six months. And there was one report around that time from Needham & Co. analyst Rajvindra Gill claiming that over 24% of Model 3 preorders had been cancelled. Despite this, and a myriad of antics from Elon Musk that call his sanity into question, TSLA was actually up 6.89%. **-1**
- *"The economy will continue to grow for at least the next 12 months, as there is no indication of an impending recession."* **+1**
- *"However, combined stimulus from the FED and ECB will turn net negative in the second half of the year, triggering the end of the everything bubble."* See previous page. **+1**
- *"S&P 500 earnings will get a one-time bump of roughly 10% in 2018 from the corporate tax reform, but growth will normalize beyond that. Analysts are estimating S&P 500 earnings growth of 23.5% over the next four reporting quarters (3Q y/y). I think the number will be closer to 14.5%."* Earnings were actually up an impressive 21.7% over that period. Not quite as much as analysts were expecting, but they were a lot closer than I was this time. **-1**
- *"Now for the obligatory 'guess the S&P 500 price by the end of the year' game. The average year-end estimate from strategists surveyed by Bloomberg is just below 2900. If I take my 14.5% earnings growth and apply a 20.7x trailing P/E multiple (right in between the historical average of 15.7 and the current 25.7), I get 2538. That's an 8% decline!"* The S&P ended the year at 2506.85, 1.2% below my forecast. I'm taking the win on account of being much closer than everybody else. **+1**
- On January 19 we initiated a broad commodities position in (PCLIX) because it seemed to me we were in the early stages of a bull market for commodities, which tend to do well in the late stages of the business cycle. This was a great call for a while, and by the end of September the fund was up 10.0% for the year. Then October hit and oil went from a high of $76 to end the month at $65, and kept falling from there. I held the position hoping for a rebound, and with oil at around $50 now I clearly missed the exit. **-1**
- At the same time I said, *"credit spreads are about as tight as they can reasonably be expected to get, so there isn't much reward for taking on credit risk,"* and we eliminated investment-grade and high-yield corporate debt from client portfolios. The option-adjusted bond spreads – the extra yield you get over Treasury bonds to compensate you for credit risk – increased from 3.35% to 5.44% for the BofAML US High Yield Master II and widened from 0.94% to 1.63% for BofAML US Corporate Master since then. **+1**
- On February 8 I wrote, *"We are only two or three rate hikes away from an inverted yield curve."* The yield curve inverted three hikes later. **+1**
- On May 23 we:
  - reduced domestic equity exposure in large and mid cap stocks. **+1**
  - also reduced exposure to leveraged loans as we were growing increasingly concerned about weakening covenants in that space. **+1**
  - slightly increased our allocation to intermediate-term US Treasury bonds. **+1**
  - and we doubled-down on our commodities position. **-1**

Binge Box

Imposters (Netflix)

Ezra (Rob Heaps) is blindsided when his wife of only a few weeks, Ava (Inbar Lavi), disappears with his money. She leaves him with an internet link to a video explaining to him that she is a con-artist and not to try to find her or she will reveal a devastating family secret. The poor sap, driven partly by revenge and partly by his lingering love for her, decides to hunt her down anyway. He is soon joined in this absurd journey by Richard (Parker Young from *Suburgatory*, if you ever saw that little gem), another former husband/mark of Ava's, and Jules (Marianne Rendón), her wife/mark before him. It's sharply written, and manages to strike the difficult balance between comedy and drama.

- On November 7 I said, “I think we are still a ways from calling stocks cheap. I still believe oil will move higher if we are in fact in the twilight of the current business cycle.” These are offsetting, so I award me **zero points.**
- Lastly, I made repeated predictions for a minor recession around late 2019 or early 2020. For this we’ll just have to wait and see.

2019: the Baby '08?

Well that actually went pretty well. Add that up and we get a score of +7. Now that I’m primed with overconfidence, it’s time to delve into some predictions for 2019:

- First up, the Detroit Lions will make it to the playoffs. Perhaps a little too overconfident, you say? I stand by it.
- This will be the longest shutdown of the federal government in US history. That’s not really a bold call, as this is day 19 of the partial government shutdown, and the longest was the 21-day shutdown in 1995-96 during the Clinton administration. That one was most remembered for the Monica Lewinsky scandal. The only thing federal government shutdowns do is remind me how little I need the federal government in my daily life.
- Rate hikes are so 2018. I believe no further rate hikes will happen this year, and the next move is more likely to be a cut in either late 2019 or early 2020.
- The messed up looking yield curve (see chart on previous page) is a harbinger for recession. As mentioned before I think this will be in late 2019 or early 2020, but we won’t officially know until long after that.
- The UK is due to leave the European Union on 29 March, 2019 and still doesn’t have a deal in place. I don’t have any particular expertise on the issue, so your guess is as good as mine as to whether they reach a deal, or get an Article 50 extension, or just change the law and unilaterally decide to stay in the EU under the old terms. So for fun I’ll take the nuclear option and predict that the UK leaves the EU with no deal in place and we see where the chips fall.
- Lastly, it’s time to guess the S&P 500. Analysts are expecting earnings to grow 16.1% (3Q y/y), which would amount to $151.43. Per usual, I think that’s overly optimistic, but let’s go with it. If we apply a 17.8 trailing P/E multiple – halfway between the current 19.9 and historical average of 15.7 – we get 2695. That’s only about a 4% gain, which I would be happy with considering the way 2018 ended. As good a guess as any, I suppose.

Tactical Asset Allocation

Asset Class	Heavy Underweight	Underweight	Neutral	Overweight	Heavy Overweight
Fixed Income			●		
Ultrashort					●
US Govt.		●			
TIPS				●	
Multisector			●		
Bank Loans	●				
Foreign Bonds			●		
Equities	●				
Large Cap	●				
Mid Cap	●				
Small Cap	●				
Developed Intl.		●			
Emerging			●		
Alternatives					●
Commodities					●
Hedging					●

Thanks for reading and have a happy New Year.

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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 personalized financial planning and fiduciary investment management services to 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.