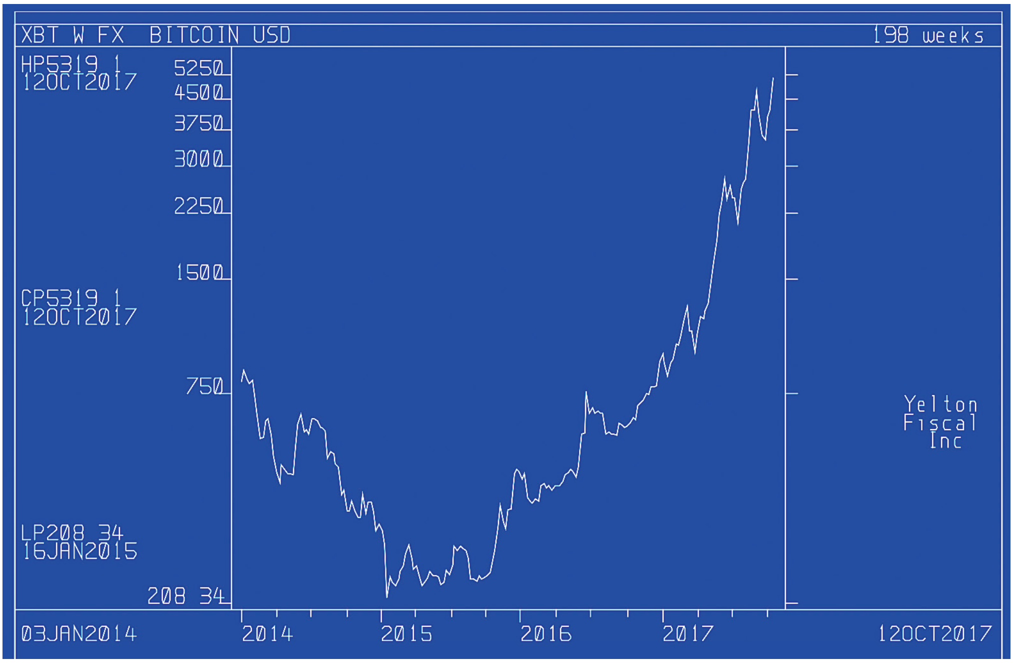
NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

BITCOIN MANIA

In our last piece, *BUBBLE TROUBLE*, we mentioned assets that we thought were in "Bubble Land" such as bonds, real estate in major metropolitan areas, and some stocks, such as Tesla. We concluded, "while there is much discussion about asset bubbles and US stocks reaching full value, we do not see the classic signs of an asset bubble in most stock prices or the likelihood of a major crash of markets around the world". However, we do see a major crash in the next 12 months in bitcoin prices. The price action is riding a parabolic curve that started in 2015 near $200 per bitcoin compared to today's $5600 per bitcoin. The pattern is characteristic of unsustainable price acceleration. It does not mean it has seen the peak but that it is time to be careful. Once a parabolic curve is broken, it breaks for some extended time period.

AVALON
CAPITAL
MANAGEMENT



Bitcoin is a digital currency that runs on a decentralized network of thousands of computers, rather than a centralized ledger under the control of a central bank or government. Therein lies its appeal – outside government control or monitoring. Users can exchange value directly without a middleman such as a bank. When a bitcoin owner transfers a token to another person, he or she posts the transaction to the blockchain, a simple account book floating on the internet, signing it with a unique string of numbers and letters. Bitcoin "miners" verify the transaction by running this number through formulas on high-powered computers and all of the computers in the blockchain must agree. The miners are paid mostly in newly minted bitcoin. The dream of bitcoin advocates is the eventual replacement of currencies for transactions and avoiding government controls.

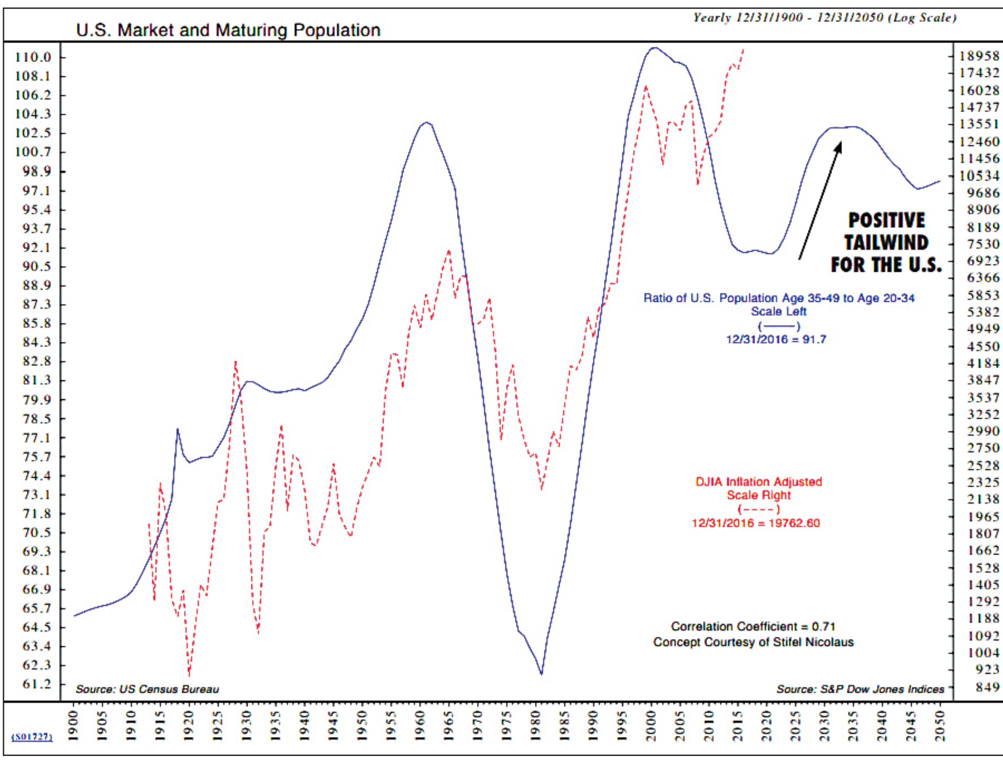
Speculators excitement rose when the price recently rocketed from $1000 per bitcoin to $5000 in six months. It exploded from $208 to $5600, up 27 times in value, over the last 30 months. The story: it will replace currencies, there is no way to value its price and there is unlimited upside as there are a limited supply of coins. Nevertheless, there are some issues that may derail the current form of bitcoins. Price volatility is too high to be a currency; transaction costs are 1% to 2% and there is potential government intervention, such as China's recent shut down of local bitcoin exchanges, causing an immediate 20% decline in prices. However, energy usage may be the final nail in the coffin. As currently configured, ***each transaction*** uses about 200 Kwh of electricity; about what 6 U.S. households use in a day. The cost in electricity is about $25 per transaction. Current usage is equal to 1,700,000 houses a day and rising rapidly. This is unsustainable, but how long it can last is unknown.

Why should you care about a crash in bitcoin prices? The market capitalization of bitcoins and other cryptocurrencies is $180 billion (up roughly 8 times from a year ago) and rising rapidly. Recently the price roared through its old high of $5000. It is attracting media attention, which attracts additional new speculators, which begets higher prices. If the growth rate continues, what is now a relatively small part of global assets could become a significant one! The recent $5600 price will not be the peak price – it could easily get to $10,000 or more and a crash from that price or higher could affect stock markets around the world.

We want to be clear that blockchain technology is here to stay and that cryptocurrencies will replace some paper money over time. Think of it like the internet "promise" in 2000 that got ahead of itself with many individual company failures along the way but the concept and some companies eventually succeeded immensely. Bitcoin is the largest cryptocurrency but there are dozens of others being traded. No way of knowing who the winners will be and who will be the losers. It is pure speculation at this time and we recommend that investors avoid them.

POSITIVE DEMOGRAPHICS

Alejandra Grindal, Ned Davis Research senior international economic analyst, has just published a wonderful study on global demographics. All things being equal, an expanding labor force is positive for economic growth and stock markets. Another way of analyzing the impact of demographics on equity markets is through the Mature-to-Young or MY ratio. While not useful for short time periods it is certainly encouraging to note that this ratio signals a 35 year positive tailwind for U.S. equities through the year 2040!!



The chart above shows the ratio vs. U.S. real equity market performance. The premise behind the relationship is that when there are a large proportion of mature-aged individuals, which are identified as people ages 35-49, relative to the number of young workers, which are classified as 20-34-year-olds, equity markets tend to outperform. The reason is that maturing workers are more productive and generally make more money than when they first entered the workforce. At the same time, they develop a greater awareness of the need to save for retirement. That additional income is subsequently put into equity markets, driving up the price. The MY did an excellent job of identifying secular bull and bear markets in U.S. equities since the 1950s.

The market should have continued to show weakness into 2016 according to MY. We suspect that massive central bank stimulus more than helped offset the negative demographics projected by MY and may have front loaded the change in demographics that was coming. The U.S.'s MY ratio bottomed in 2016 and is set to continue to rise through the year 2040, thanks to a large influx of MIllennials entering mature-working age over that period. **This is nearly a 35-year tailwind for U.S. equities.**

NORTH KOREA AND IRAN?

Tensions have eased, but for how long? For over two decades, the American response to North Korea's pursuit of nuclear weapons has been to seek a diplomatic solution that would give the North Koreans an incentive to abandon their quest. They agreed to suspend production of nuclear material, took the money and other incentives, and then proceeded to develop them anyway. The story with Iran is similar. It is unclear whether the Iranians have truly discontinued their nuclear program, but they assuredly have continued to develop missiles that could deliver nuclear weapons to targets.

George Friedman, founder of Geopolitical Futures, makes the case that in international relations a signed agreement is seen as the beginning of the negotiating process, and not the end. In diplomacy, an agreement's value rests in the ability to enforce it. There is no political entity with the power and WILL to enforce agreements that nations do not want enforced. When an agreement needs to be enforced, you either let it go or go to war. If the risk involved in going to war is too high – militarily, financially, and politically – there are two choices: one is to walk away and let nature take its course or sign a deal, knowing the other side is likely to cheat.

His argument rests on the fact that there is no law of the land between nations, no neutral court, and no judgment that is enforceable. Either North Korea's (and Iran's) having a bomb is unacceptable or it isn't. There is no court but the court of war, and if war isn't an option, then North Korea and Iran know it. Our view is that war is unacceptable and will not happen. Tensions will rise and fall, but the endgame is not war.

RACE FOR THE FED CHAIR

Three weeks ago President Trump promised he would name a new Fed chairman within two or three weeks. Now it is "sometime soon". Central bank's easy monetary policy has been one of the primary factors driving asset markets. In addition to a new Fed chairman in February, there is a reasonable chance that all Fed governors will be different by next summer. However, the Fed chair drives Fed policy.

Kevin Warsh and Jerome Powell are the clear leaders with probabilities of 30-35 per cent each. Jerome Powell is very careful to support the mainstream Yellen/ Fischer view on monetary policy, and clearly favors a gradual increase in interest rates. He has a slightly more supportive view of tax reform and bank deregulation than Yellen. Since he represents little change from current policies, he will be welcomed by markets and the staff at the Fed.

Kevin Warsh is more controversial. He calls for major structural reforms at the Fed, rejecting many of its recent habits, including forward guidance, data determined decisions, support for rising asset prices and blindness toward the financial cycle. Trump likes him because he is a strong supporter of his growth agenda.

Jerome Powell is the safe bet. The President must decide whether he wants to shake up the Fed, and markets with it, by appointing Warsh. Then again he may pick someone entirely different and surprise us all!

TAX REFORM – OR NOT?

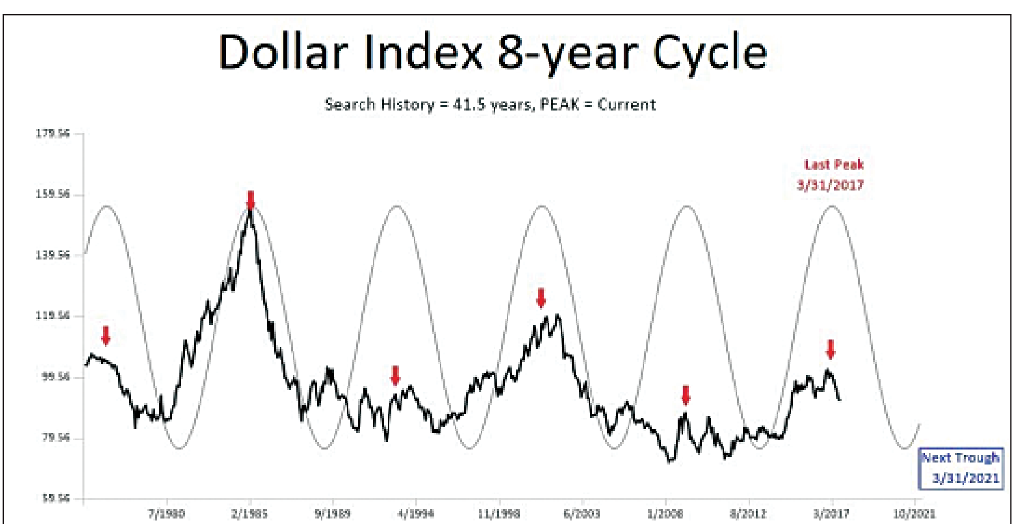
Financial markets celebrated with the prospect for tax cuts. If tax relief passes there is a lot to be excited about. It would lift both profitability and overall economic growth. But at what price and for how long? Whatever passes will not be revenue neutral and will increase the deficit. The U.S. has never cut taxes in the ninth year of a recovery with the unemployment rate nearing 4%, and while the Federal Reserve is tightening monetary policy. The current deficit is already greater at 4.4% of GDP relative to the current unemployment rate than at any time in post-war history. It is not true tax reform because it will not be revenue neutral, does not simplify the tax code nor eliminate many of the loopholes that benefit select groups.

The final bill, when it is passed, will be significantly watered down from the promises being made. It will not pass this year but sometime in the first half of next year. The benefits of tax rate cuts are real but transitory in nature. Suppose a rate cut makes the economy 3% larger than it otherwise would be. Over a decade that would raise annual economic growth by 0.3% before reverting to its old growth rate. It is estimated that lower corporate taxes will go 80% to owners of capital and 20% to workers.

It will boost the overall economy and profits in the short term but the benefits will be unevenly spread among corporations and individuals. The current rally has discounted some of the eventual benefits but probably not all at this point. We recommend that you do not do your tax planning in anticipation of what might happen but wait until a bill is passed and signed.

U.S. DOLLAR BEAR MARKET

Large moves in the U.S. Dollar significantly impact asset classes, industries and individual stocks. The dollar is in a bear market and its effects are important to monitor. Observing the cycles in the dollar, the next important bottom is projected to be 2021.



What are the implications for a weak dollar for this length of time? It exacerbates inflationary pressure, keeps upward pressure on interest rates and helps bolster commodity prices. A weak dollar favors international, natural resource and U.S. big cap stocks. It is not kind to bonds, REITs and U.S. small cap stocks. It supports energy, materials, industrials, and technology and health stocks. It is best to underweight financials, consumer discretionary and staples as well as utilities and telecom.

The dollar declined some 12% for the year into September. The strongest areas for that period supported the weak dollar thesis. They were big cap U.S., international and natural resource stocks. At the sector level it was technology, energy, materials, industrials and health care.

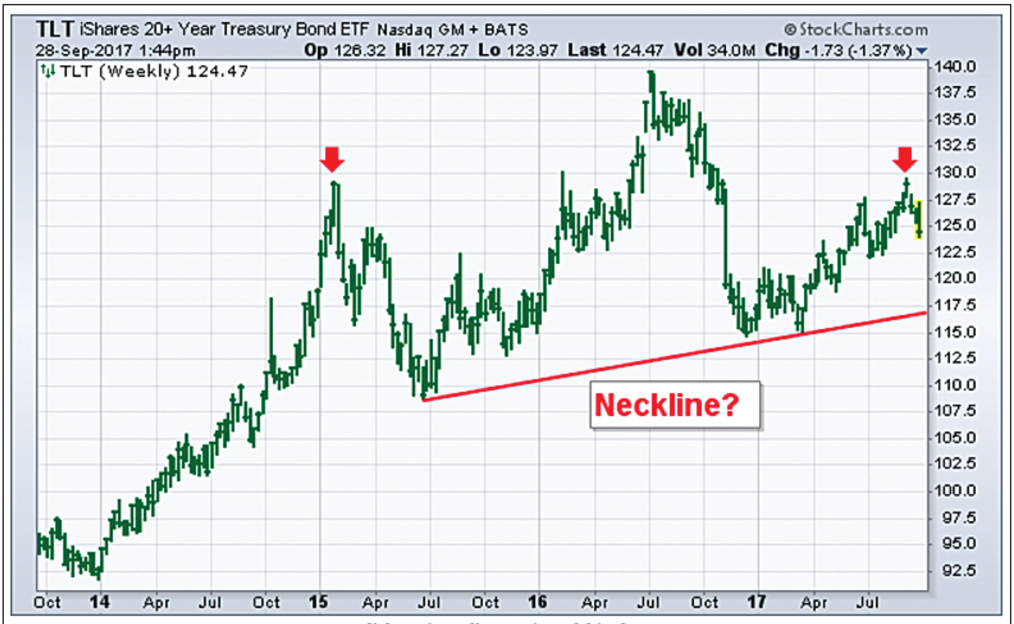
With the recent dollar rally, small caps beat big caps and financials and REITs rebounded. The rally should be over before the end of the year and dollar weakness will begin to dominate markets again.

INVESTMENTS

Globally balanced portfolios performed nicely in the third quarter. September did much better than we expected as it was bolstered by positive IMF projections for global growth and by anticipation of tax-cut legislation. The IMF forecasts global growth to increase in 2018 to 3.7% from 2017's 3.6%. The big surprise was the action of some groups that had lagged recently such as energy, financials, materials and industrials. The rotation kept the major averages steadily climbing in September.

So far concerns have been swept aside and markets continue to advance. Our model agrees with the advancing theme. We are fully invested in equities and have minimal positions in bonds. All equity asset categories are overweight except for REITs. We are overweight financials, technology, industrials and materials.

BONDS – Bonds are in a bear market. They are currently at a price lower than they were two years ago.



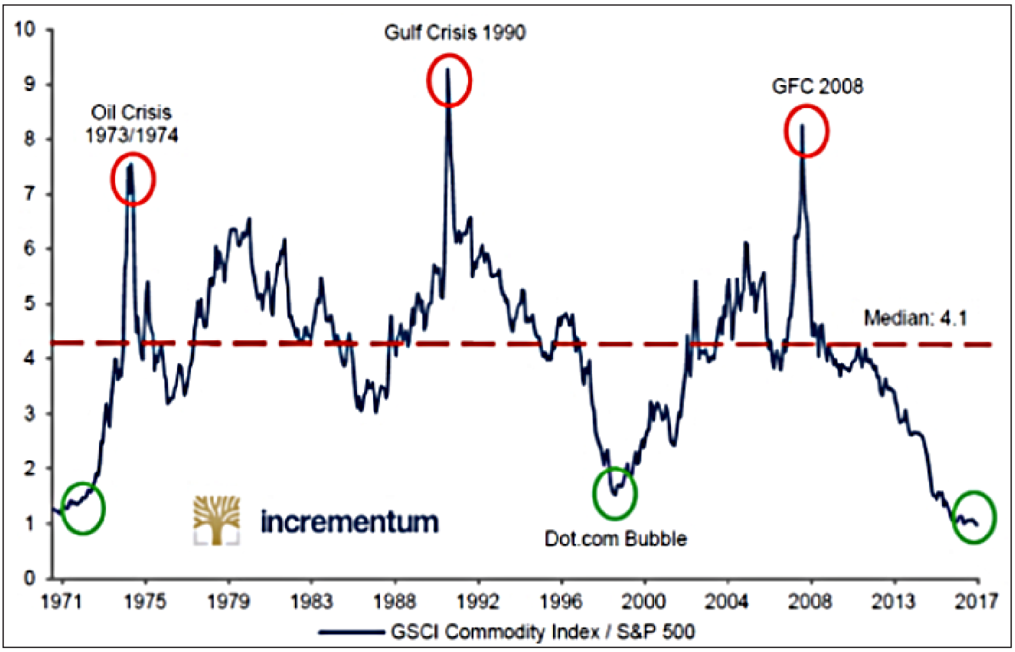
(click to view a live version of this chart)

They will go lower when the dollar resumes its slide. Also a tax cut, which increases the deficit, may force yields higher. The Fed has said they will raise rate one more time this year and 3 times next year which will move longer rates higher. If the neckline is broken the price projects down to 84!

REITS – Stocks that are sensitive to rising interest rates should be avoided. We are underweight this area.

NATURAL RESOURCES – The global economy is growing. This is positive for natural resources. The dollar is weakening and we expect it to weaken for some time. This is also positive for natural resources.

The value of commodities versus equities has reached an extreme, recently hitting a 50-year low.



Source: Incrementum AG

Natural resources have the best values among our asset classes. While such a long term chart cannot be used as a short term timing tool, it certainly tells you that you better keep an eye on this area because it could be a big winner in the future. From a sentiment viewpoint absolutely no one thinks that commodity inflation will come back again. This means most investors have sold and it would just take some incremental buying to reverse the trend of the last 10 years.

INTERNATIONAL STOCKS – We are overweight international stocks. It has been the best asset class so far this year. Global growth is steady and the weak dollar just adds to returns. All markets look good to us and in general we favor emerging markets because of their faster growth. International returns are more favorable when the domestic market faces higher yield risk and when PE valuations are getting stretched in the U.S.

Most foreign economies, and particularly those of emerging markets, are more commodity/ industrial oriented relative to the U.S. If our commodity theme is correct, this will benefit foreign economies more than the U.S. economy. When inflation rises, low stage commodity or producer prices typically accelerate more than consumer prices which helps industrial processes more than consumer based businesses. Since the U.S. is the quintessential consumer based economy, it benefits more from disinflation that has dominated stock market leadership so far in this recovery. However, should overheating intensify, the U.S. stock market may prove a market laggard during the balance of this recovery.

U.S. STOCKS – We are overweight U.S. stocks. Valuations expanded over the last three months but the market keeps chugging along. Slowing earnings momentum and high valuations will eventually become a headwind for this market but until it does we will keep participating.

Sentiment indicators show investor complacency and lack of fear. The volatility index is at all-time lows and mutual fund cash levels are at record lows. The common wisdom is that the Fed has the investors' back and that their primary indicator for Fed policy is the stock market. So if it starts going down they will ease immediately. This may be tested in the coming year, particularly if there is a more hawkish Fed chair! Sentiment indicators, like valuation are not good for precise market timing – only an indication that the environment for investments is getting overconfident and vulnerable to a negative surprise. We are overweight financials, technology, industrials and materials. Given the seasonal tendency to strengthen into the holidays and very depressed valuations, we are also doing a contrarian play in retail themes.

SUMMARY

Bitcoins total value could skyrocket further over the coming year. If it crashes it could have a significant effect on other markets – not because it is so huge relative to other assets but that it could signal that speculation has run its course. We are not there until the parabolic curve breaks. While demographics is positive for the next 35 years, it is more an indication of underlying long-term demand than a forecast for the coming year. We do not think we will go to war with North Korea or Iran and the Fed chair appointment could either bolster investor enthusiasm or pose a worry for markets. Tax cuts will not come until next year and while potentially a short term boost for the economy and stocks, it will not have a lasting effect. Deficits will likely rise. The dollar will be in a bear market until 2021. This will be positive for international, natural resource and U.S. big cap stocks. We are fully invested in equities and have minimal positions in bonds. Improving global growth, rising inflation, rising deficits, a falling US dollar and changes at the FED could all be headwinds for Bonds. All equity asset categories are overweight except for REITs. In the U.S. we are overweight financials, technology, industrials and materials.

Clara Basile **David Rahn** **Bill Oberman**

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