POLICY BASED INVESTING

by Russell Redenbaugh & James Juliano

Monday, August 19, 2019

POSSIBLE POLICY SURPRISES

Many are convinced that a U.S. recession caused by Federal Reserve mistakes and a trade war caused by lack of a China deal will lead to a severe decline in U.S. equity prices. While this outcome is not only possible but deserved if both monetary and trade policies worsen, few are talking about the possibility of upside surprises in both policy domains. We remain cautiously optimistic on U.S. equity prices because of two potential, pro-growth policy surprises. This week we address monetary policy.

Monetary Policy Pivot

As we have been writing for weeks, monetary policy is on the margin. The Federal Reserve is at risk of making a deflationary policy mistake similar to the one made from October-December 2018. Remember, the sharp decline in U.S. stock prices during that period was caused more by what Chairman Powell was saying about future monetary policy than the actual interest rate increases he was affecting. His arrogance and poor choice of language when describing the path forward for monetary policy caused a margin call on risk assets. Investors fled stocks as the threat of a deflationary policy mistake surged.

The two most blatant “open mouth operation” mistakes were Powell’s comments that interest rates were far below neutral and that quantitative tightening was on “autopilot.” Both comments implied a series of guaranteed interest rate hikes and balance sheet reductions that would occur despite any negative change in current economic conditions. It’s no surprise investors fled to safety when the most powerful central banker in the world was promising a reduction in liquidity at a time when global growth was falling and trade tensions were rising.

At the time we wrote clients to not panic as it was likely the Federal Reserve would eventually succumb to market and capital flow pressures to reign in its language. This is exactly what happened as Chairman Powell reversed language about future Fed tightening to be more “data dependent.” U.S. stock prices soared higher from December 24, 2018 through July, 2019 when the S&P500 made a series of new, nominal highs.

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Over the past several weeks the risk of a Fed mistake has again crept into markets. As the bond market screams that further interest rate reductions are needed to satisfy the world's demand for safe haven assets, the Fed missed the mark at its recent meeting. Many cite the 25 basis point rate reduction being insufficient, and claim 50 basis points would have been more appropriate. While we agree, we also think Powell once again made a language mistake when describing the path of future monetary policy.

Powell called the recent 25 basis point reduction a "mid-cycle adjustment." Why would Powell use such a term, one that has never been used to describe Federal Reserve policy before? Investors quickly implied that the Fed would only do one "mid-cycle adjustment" before resuming interest rate hikes "above neutral" and balance sheet reductions "on autopilot." Once again, Powell's arrogant language about the future of monetary policy caused investors to shun risk assets in favor of safe-havens like gold and bonds.

The good news is Powell can once again pivot current monetary policy and improve language about future policy just as he did back in December. We remain optimistic on U.S. equities because we believe Powell will succumb to market pressures and capital flows.

We will know much more by the end of this week. Powell is set to speak Friday at the annual Jackson Hole symposium. If he pivots monetary policy and makes up for his sloppy "mid-cycle adjustment" language we expect a resumption of the uptrend in risk-on assets like U.S. stocks. If Powell misses this opportunity to correct previous policy mistakes we expect investors to once again shun stocks for the safe-haven of bonds and gold. Powell's speech on Friday is one of the most important of his career, and we stand ready to adjust asset allocations accordingly.

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ALLOCATOR

Fixed Income

Bonds are an asset class that does well in a deflationary policy environment (Low Growth & Strong Currency)

We have long said the Treasury bond bubble will pop again as it did from May2013-Jan2014 when long term Treasury bonds fell 18%. With voters choosing Trump's pro-growth agenda to ignite growth, we believe the this is even more likely. Treasury bond prices are at risk to fall 30-50%, and we expect any moves higher in bond prices (lower in yields) to be short-lived. Since most other bonds price off of Treasury yields, fixed income in general is a risky asset class.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Investment Grade	LQD	9/9/2016	$119.00	$127.85	7.4%	
Aggregate Bond	AGG	9/9/2016	$109.00	$113.67	4.3%	
Municipal	MUB	9/9/2016	$111.00	$115.30	3.9%	
TIPS	TIP	9/9/2016	$114.00	$117.22	2.8%	
Extended Duration	EDV	9/9/2016	$128.00	$145.89	14.0%	
US Treasury 3-7 yr	IEI	9/9/2016	$124.00	$127.63	2.9%	
US Treasury 7-10 yr	IEF	9/9/2016	$109.00	$113.61	4.2%	
US Treasury 20+ yr	TLT	9/9/2016	$133.00	$146.13	9.9%	
International Total Bond	BNDX	9/9/2016	$54.40	$59.08	8.6%	
High Yield	HYG	4/12/2016	$77.00	$86.10	11.8%	Act more like equities than bonds, benefit from improving growth

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Commodities

A change in the price of gold is a change in the value of the currency. When gold rises, the currency's value falls and vice versa. Commodities are an asset class that does well when the currency is weak.

If growth is slowing while the currency weakens, there is stagflation. Own precious metals.

If growth is accelerating while the currency weakens, there is an inflationary expansion. Own agriculture, industrial and energy commodities.

Commodities suffered heavy losses in the strong US Dollar environment 2012-2015. In 2016 Dollar weakness was caused by election uncertainty and commodities rallied. That weak Dollar trend was reversed by Election2016. The demand for transactional and asset based Dollars will rise if Trump's pro-growth policies are implemented and fall if his policy agenda fails. Gold's recent decline back below $1,300/oz is a confirmation of better policy and rising growth rates. Capital is beginning to leave safe haven asset classes as policy uncertainty diminishes.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Gold	GLD	10/2/2017	$120.77	$142.78	18.2%	
Silver	SLV	10/2/2017	$15.67	$16.02	2.2%	
Energy	DBE	8/13/2014	$28.97	$13.10	-54.8%	
Oil	USO	7/30/2014	$37.00	$11.40	-69.2%	
Agriculture	DBA	9/13/2011	$32.50	$15.08	-53.6%	
Broad Comm. Index	GSG	8/5/2011	$33.00	$14.72	-55.4%	
Base Metals	DBB	6/17/2011	$23.00	$14.73	-36.0%	

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Real Estate

Real Estate is an asset class that performs well when growth is accelerating. When rising growth is coupled with a strong currency, own real estate tied to business activity (like commercial REITS). When rising growth is coupled with a weak currency, own real estate tied to commodities (farmland).

Commercial RE will be helped by improving real economic growth. RE properties leveraged to businesses & economic growth are preferred under pro-growth US policies.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/ Loss	Policy Notes
Residential	REZ	12/21/2016	$61.00	$78.01	27.9%	Real estate assets have declined as higher interest rates expectations lower the perceived attractiveness of housing demand and real estate's dividend yield.
Building/Construction	ITB	12/21/2016	$28.00	$39.14	39.8%	
Mortgage REIT	REM	4/1/2016	$35.00	$41.78	19.4%	
REIT	VNQ	3/7/2016	$75.50	$91.18	20.8%	

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ALLOCATOR

US Equity

We have been waiting for a 1980s/90s type of policy driven equity bull market for sixteen years. The 2014 midterm House/Senate/gubernatorial election shifts put us on the path as pro-growth candidates propelled the GOP to majorities. It was a repudiation of anti-growth economic policies and a big step toward a Reagan/Clinton type of equity bull market. Despite the voters' growth signal, Obama doubled down on his tax/spend/regulatory (EPA) agendas in 2015 causing stocks to be range bound and volatile. As 2016 began, policy uncertainty ahead of November's elections became the biggest threat to equities. The ebb and flow of the presidential political season moved markets in both directions as investors waited to learn which policy theme would prevail in November – growth vs. redistribution. Voters decisively made their choice in Election2016, and growth won. Trump's pro-growth policy agenda beat Hillary's anti-growth policy agenda in landslide fashion. Republicans retained control of the Senate, House and increased their control of governorships by three. The policy stage is now set for Trump and Congress to keep delivering pro-growth tax, regulatory and monetary policies. As they do, a bull market in U.S. equities will ignite to rival the 1980s/90s

US Equity - Cap Size

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Micro	IWC	7/11/2016	$72.00	$86.84	20.6%	Most tied to domestic policy / growth
Total Market	IWV	5/19/2016	$117.00	$169.46	44.8%	
Large	IWB	5/19/2016	$111.00	$160.42	44.5%	Large caps should underperform smaller caps as domestic economic growth accelerates
Small Cap	IJR	5/19/2016	$54.00	$75.64	40.1%	Most tied to domestic policy / growth
Mid Cap	IWR	4/6/2016	$38.57	$54.58	41.5%	More tied to domestic policy / growth

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US Equity - Style

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Large Growth	IWF	7/11/2016	$101.00	$157.84	56.3%	Growth outperformed value in 2017 across all cap sizes. Trend will continue as tax cuts get implemented.
Small Growth	IWO	7/11/2016	$140.00	$194.86	39.2%	
Small Value	IWN	5/19/2016	$92.00	$113.82	23.7%	
Mid Growth	IWP	5/9/2016	$90.00	$141.66	57.4%	
Large Value	IWD	4/6/2016	$95.00	$123.40	29.9%	
Mid Value	IWS	4/6/2016	$68.00	$85.89	26.3%	

US Equity - Sector

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Staples	XLP	6/5/2017	$57.00	$60.21	5.6%	Defensive sector hurt by rising growth
Utilities	XLU	6/5/2017	$54.00	$61.38	13.7%	Defensive sector hurt by rising growth
Metals/Mining	XME	5/8/2017	$29.00	$24.98	-13.9%	Tied to commodity prices, hurt by strong Dollar
Energy	XLE	3/13/2017	$69.00	$57.02	-17.4%	Tied to commodity prices, hurt by strong Dollar
Healthcare	XLV	2/8/2017	$71.00	$90.55	27.5%	
Discretionary	XLY	11/14/2016	$79.00	$115.89	46.7%	Consumer strong w/ rising growth expectations
Financial	XLF	7/18/2016	$19.00	$26.57	39.8%	Helped by Trump deregulation (Dodd Frank) & rising interest rates
Materials	XLB	4/6/2016	$44.00	$56.62	28.7%	Global growth
Industrial	XLI	3/14/2016	$52.00	$74.30	42.9%	Global growth
Technology	XLK	3/7/2016	$41.00	$78.28	90.9%	Repatriation tax reform huge plus for tech companies

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Foreign Equity

Country	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
China	FXI	8/5/2019	$39.86	$38.60	-3.16%	China's currency devaluation policy is a growth killer
Hong Kong	EWH	7/6/2016	$24.08	$23.25	-3.45%	
Mexico	EWW	10/1/2018	$51.23	$39.12	-23.64%	Freer and fairer trade agreements are pro-growth for all parties involved
Canada	EWC	10/1/2018	$28.78	$27.72	-3.68%	
Denmark	EDEN	7/2/2018	$63.89	$60.34	-5.56%	European polices not improvng despite anti-austerity movements across the Euro Zone. Capital is fleeing. A zero trariff trade deal with the U.S. would reverse course and be very pro-growth for European economies.
Switzerland	EWL	7/2/2018	$32.58	$36.96	13.44%	
Netherlands	EWN	7/2/2018	$30.51	$29.90	-2.00%	
Sweden	EWD	7/2/2018	$30.51	$27.71	-9.18%	
Eurozone	EZU	7/2/2018	$41.01	$37.03	-9.70%	
Spain	EWP	7/2/2018	$30.35	$26.61	-12.32%	
Poland	EPOL	7/2/2018	$21.78	$20.39	-6.38%	
France	EWQ	7/2/2018	$30.52	$28.73	-5.87%	
Germany	EWG	7/2/2018	$29.98	$25.60	-14.61%	
Italy	EWI	7/2/2018	$28.89	$25.66	-11.18%	
Austria	EWO	7/2/2018	$22.65	$18.67	-17.57%	
Israel	EIS	2/26/2018	$52.41	$53.22	1.55%	
Vietnam	VNM	10/9/2017	$14.99	$15.58	3.94%	Demographic leverage to US economic growth policies
Indonesia	EIDO	7/24/2017	$26.78	$24.81	-7.36%	Demographic leverage to US economic growth policies
Ireland	EIRL	1/26/2017	$39.00	$39.26	0.67%	
Singapore	EWS	1/11/2017	$21.00	$22.91	9.10%	
World Ex US	VEU	11/15/2016	$43.50	$48.10	10.57%	Global growth reset higher after US Election2016
Norway	ENOR	8/20/2016	$20.00	$22.10	10.50%	
UK	EWU	8/4/2016	$30.50	$29.80	-2.30%	Brexit was a vote for growth

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Japan	EWJ	7/15/2016	$47.00	$53.41	13.64%	
South Korea	EWY	7/13/2016	$52.00	$52.20	0.38%	
Hong Kong	EWH	7/6/2016	$19.00	$23.25	22.37%	
Frontier Mkts	FRN	7/5/2016	$10.50	$13.99	33.24%	Highly levered to Eurozone growth movement
Peru	EPU	6/29/2016	$30.50	$33.33	9.28%	
South Africa	EZA	6/29/2016	$51.00	$46.52	-8.78%	
India	EPI	6/27/2016	$19.00	$23.34	22.84%	Strong Dollar emerging market, tied to US growth
Taiwan	EWT	6/21/2016	$27.00	$34.23	26.78%	
Thailand	THD	5/20/2016	$64.00	$87.73	37.08%	
Belgium	EWK	3/16/2016	$16.50	$18.24	10.55%	
New Zealand	ENZL	3/5/2016	$36.00	$52.13	44.81%	
Philippines	EPHE	8/5/2015	$37.00	$33.46	-9.57%	
Qatar	QAT	12/1/2014	$24.00	$16.47	-31.38%	
Malysia	EWM	10/3/2014	$41.00	$27.95	-31.83%	
Australia	EWA	9/16/2014	$22.50	$21.23	-5.64%	
Greece	GREK	7/14/2014	$20.00	$8.44	-57.80%	
Portugal	PGAL	6/4/2014	$15.00	$9.72	-35.20%	
Columbia	ICOL	6/27/2013	$21.00	$12.51	-40.43%	
Turkey	TUR	6/1/2013	$58.00	$24.72	-57.38%	
UAE	UAE	5/20/2013	$23.00	$13.72	-40.35%	
Russia	RSX	8/7/2011	$30.00	$19.97	-33.43%	Weak Dollar emerging market
Brazil	EWZ	7/14/2011	$60.00	$41.65	-30.58%	Weak Dollar emerging market
Chile	ECH	3/1/2011	$61.00	$36.51	-40.15%	
Egypt	EGPT	2/23/2004	$64.00	$31.30	-51.09%	

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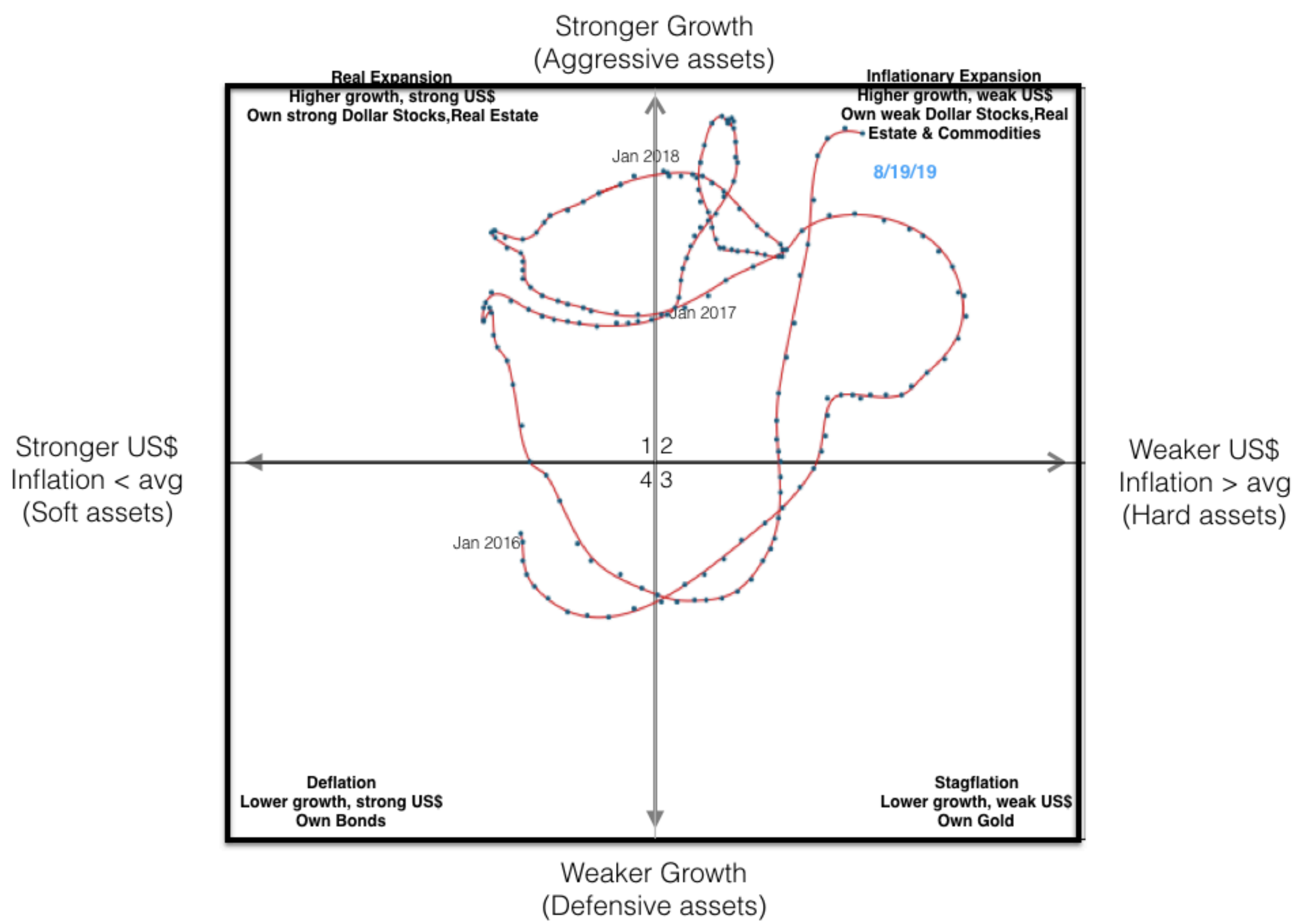
POLICY MAP

Growth decreased versus last week (1.96 to 1.93): Despite pro-growth tax and regulatory policy improvements since 2016, growth has tipped into negative territory over fears of a 2008-style, deflationary monetary policy mistake.

Value of US$ was decreased versus last week (0.97 to 1.06): Dollar had been stable between gold $1,300-$1,375/oz, and strengthened to $1,230/oz. giving the Fed a strong Dollar signal to pause rate hikes until economic and market data calm down. Recent Dollar weakness above $1,400 is concerning but likely has some temporary geopolitical causes like Iran.



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BOND YIELD COMPONENT ANALYSIS

Nominal Yield: 1.55% **(-11%)** **Inflation Expectation Component: 1.54%** **(-8%)** **Real Growth Component: 0.01%** **(-88%)**

Real growth expectations embedded in the Treasury bond market have been dislocated from equity markets in 2019. Some of the collapse in real growth has been caused by global bond market dynamics with negative interest rates across the globe. But now the risk of a serious deterioration in U.S. policy is also weighing on growth. With trade policy still uncertain, the Fed disappointed with only a 25bp cut at their last meeting. A Q42018-type deflationary policy mistake is back on the table.