POLICY BASED INVESTING

by Russell Redenbaugh & James Juliano

Monday, December 2, 2019

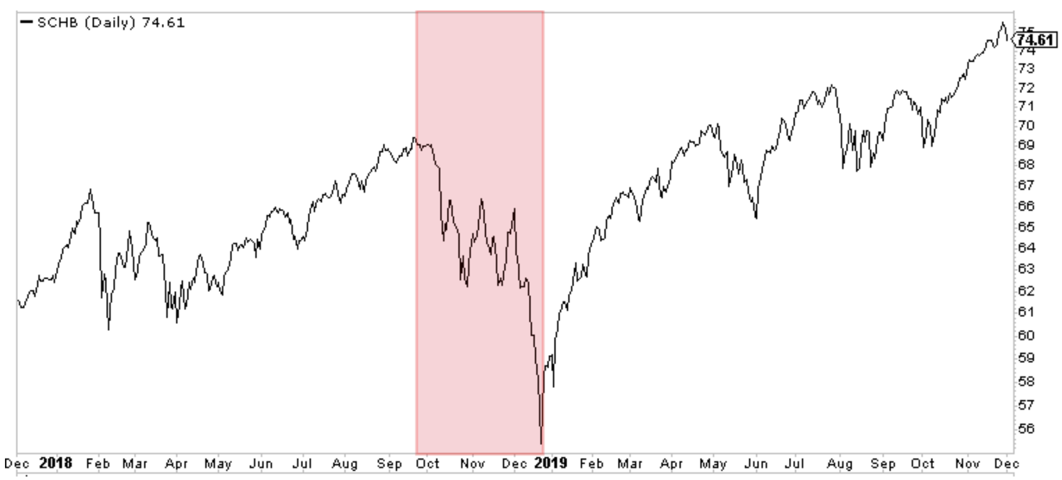
A DIFFERENT DECEMBER

Just one short year ago financial markets were in a panic caused by the threat of deflationary monetary policy from the Federal Reserve. This year expect a very different December.

Investors lulled into sense of complacency after recent stock market gains may forget the panic and capital destruction that occurred last December. That destruction actually began in October 2018. On October 3, 2018 Federal Reserve Chairman Powell said the central bank is “a long way from getting rates to neutral.” This was a fresh sign that he believed aggressive interest rate hikes were coming. With no inflation to be seen and growing trade policy threats to domestic growth rising, Powell’s arrogant words caused damage.

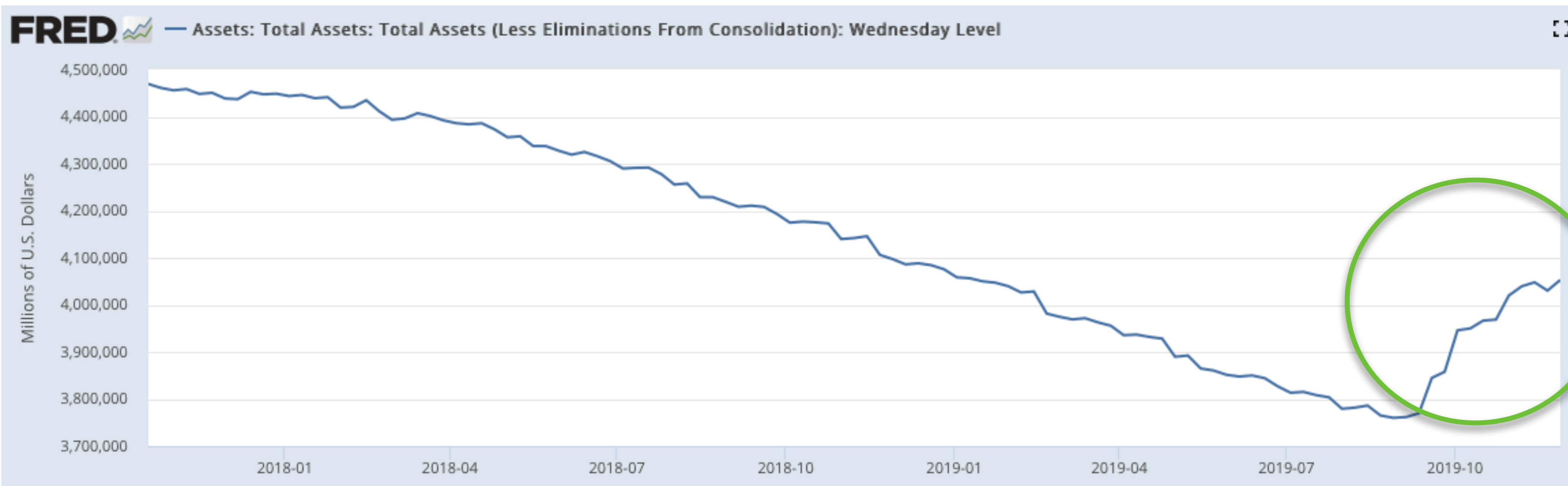
Capital began reacting to the new possibility of a deflationary policy mistake right away as the broad U.S. stock index fell 10% in thirty days following Powell’s comments. Markets were volatile but traded in a range for most of November 2018 as multiple Federal Reserve presidents and voting members gave public speeches softening Powell’s tone about aggressive interest rate hikes. But instead of softening his own arrogant talk, Powell continued with “open mouth operations” causing further deflationary panic. The Fed raised interest rates at its December meeting followed by Chairman Powell’s comments that balance sheet reduction was on “autopilot.” Markets crashed following these continued deflationary threats, falling 10% from December 3 through December 24.

Overall U.S. stocks declined 21% from early October through Christmas Eve 2018 because of deflationary monetary policy fears. It is important to note these declines happened not from implemented policy changes but from Powell’s rhetoric about the path of future policy. Monetary policy and the Fed officials in charge of articulating it are extremely powerful and can move markets quickly. Can the same happen this December?



Not likely. The threat of a deflationary monetary policy mistake has been absent since early January 2019, when Chairman Powell finally pivoted his language about future monetary policy tightening to a more data dependent, wait and see approach. The Fed has actually lowered the federal funds rate three times in 2019, something that seemed impossible during Powell's righteous rants last December. Even the Fed's balance sheet has reversed course. Far from balance sheet reduction on "auto pilot" that Powell promised last December, the Fed's balance sheet has been expanding since September 2019.

There is no deflationary monetary policy threat at the moment and, therefore, little chance this December looks like last December's capital market panic. The biggest lesson for investors is to pay close attention to what policymakers say, especially about monetary policy. When capital markets begin not liking what they say, follow market signals instead of politicians' promises.



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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	$127.97	7.5%	
Aggregate Bond	AGG	9/9/2016	$109.00	$112.86	3.5%	
Municipal	MUB	9/9/2016	$111.00	$114.05	2.7%	
TIPS	TIP	9/9/2016	$114.00	$116.38	2.1%	
Extended Duration	EDV	9/9/2016	$128.00	$138.38	8.1%	
US Treasury 3-7 yr	IEI	9/9/2016	$124.00	$126.31	1.9%	
US Treasury 7-10 yr	IEF	9/9/2016	$109.00	$111.57	2.4%	
US Treasury 20+ yr	TLT	9/9/2016	$133.00	$140.42	5.6%	
International Total Bond	BNDX	9/9/2016	$54.40	$58.16	6.9%	
High Yield	HYG	4/12/2016	$77.00	$86.94	12.9%	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	$137.86	14.2%	
Silver	SLV	10/2/2017	$15.67	$15.92	1.6%	
Energy	DBE	8/13/2014	$28.97	$13.85	-52.2%	
Oil	USO	7/30/2014	$37.00	$11.62	-68.6%	
Agriculture	DBA	9/13/2011	$32.50	$16.15	-50.3%	
Broad Comm. Index	GSG	8/5/2011	$33.00	$15.23	-53.8%	
Base Metals	DBB	6/17/2011	$23.00	$14.90	-35.2%	

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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	$77.44	27.0%	
Building/Construction	ITB	12/21/2016	$28.00	$45.53	62.6%	
Mortgage REIT	REM	4/1/2016	$35.00	$43.91	25.5%	
REIT	VNQ	3/7/2016	$75.50	$93.07	23.3%	

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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	$94.61	31.4%	
Total Market	IWV	5/19/2016	$117.00	$184.23	57.5%	
Large	IWB	5/19/2016	$111.00	$174.39	57.1%	
Small Cap	IJR	5/19/2016	$54.00	$81.81	51.5%	
Mid Cap	IWR	4/6/2016	$38.57	$58.60	51.9%	

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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	$171.43	69.7%	
Small Growth	IWO	7/11/2016	$140.00	$209.97	50.0%	
Small Value	IWN	5/19/2016	$92.00	$125.12	36.0%	
Mid Growth	IWP	5/9/2016	$90.00	$151.05	67.8%	
Large Value	IWD	4/6/2016	$95.00	$134.08	41.1%	
Mid Value	IWS	4/6/2016	$68.00	$92.56	36.1%	

US Equity - Sector

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Staples	XLP	6/5/2017	$57.00	$62.00	8.8%	
Utilities	XLU	6/5/2017	$54.00	$63.05	16.8%	
Metals/Mining	XME	5/8/2017	$29.00	$27.66	-4.6%	Tied to commodity prices, hurt by strong Dollar
Energy	XLE	3/13/2017	$69.00	$58.89	-14.7%	Tied to commodity prices, hurt by strong Dollar
Healthcare	XLV	2/8/2017	$71.00	$99.49	40.1%	
Discretionary	XLY	11/14/2016	$79.00	$122.45	55.0%	Consumer strong w/ rising growth expectations
Financial	XLF	7/18/2016	$19.00	$30.15	58.7%	Helped by Trump deregulation (Dodd Frank)
Materials	XLB	4/6/2016	$44.00	$60.04	36.5%	
Industrial	XLI	3/14/2016	$52.00	$82.04	57.8%	
Technology	XLK	3/7/2016	$41.00	$88.16	115.0%	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	$40.94	2.71%	China's currency devaluation policy is a growth killer
Hong Kong	EWH	7/6/2016	$24.08	$23.54	-2.24%	
Mexico	EWW	10/1/2018	$51.23	$43.52	-15.05%	Freer and fairer trade agreements are pro-growth for all parties involved
Canada	EWC	10/1/2018	$28.78	$29.63	2.95%	
Denmark	EDEN	7/2/2018	$63.89	$65.26	2.14%	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	$38.90	19.40%	
Netherlands	EWN	7/2/2018	$30.51	$32.60	6.85%	
Sweden	EWD	7/2/2018	$30.51	$31.72	3.97%	
Eurozone	EZU	7/2/2018	$41.01	$40.79	-0.54%	
Spain	EWP	7/2/2018	$30.35	$28.37	-6.52%	
Poland	EPOL	7/2/2018	$21.78	$20.99	-3.63%	
France	EWQ	7/2/2018	$30.52	$31.66	3.74%	
Germany	EWG	7/2/2018	$29.98	$28.94	-3.47%	
Italy	EWI	7/2/2018	$28.89	$28.89	0.00%	
Austria	EWO	7/2/2018	$22.65	$20.30	-10.38%	
Israel	EIS	2/26/2018	$52.41	$58.79	12.17%	
Vietnam	VNM	10/9/2017	$14.99	$15.94	6.34%	Demographic leverage to US economic growth policies
Indonesia	EIDO	7/24/2017	$26.78	$24.03	-10.27%	Demographic leverage to US economic growth policies
Ireland	EIRL	1/26/2017	$39.00	$45.02	15.44%	
Singapore	EWS	1/11/2017	$21.00	$24.08	14.67%	
World Ex US	VEU	11/15/2016	$43.50	$52.16	19.91%	Global growth reset higher after US Election2016
Norway	ENOR	8/20/2016	$20.00	$23.38	16.90%	
UK	EWU	8/4/2016	$30.50	$32.93	7.97%	Brexit was a vote for growth

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Finland	EFNL	7/26/2016	$33.00	$36.73	11.30%	
Japan	EWJ	7/15/2016	$47.00	$59.43	26.45%	Trade deal with U.S. is pro-growth
South Korea	EWY	7/13/2016	$52.00	$58.47	12.44%	
Hong Kong	EWH	7/6/2016	$19.00	$23.54	23.89%	
Frontier Mkts	FRN	7/5/2016	$10.50	$14.51	38.19%	Highly levered to Eurozone growth movement
Peru	EPU	6/29/2016	$30.50	$34.35	12.62%	
South Africa	EZA	6/29/2016	$51.00	$49.55	-2.84%	
India	EPI	6/27/2016	$19.00	$24.55	29.21%	Strong Dollar emerging market, tied to US growth
Taiwan	EWT	6/21/2016	$27.00	$39.45	46.11%	
Thailand	THD	5/20/2016	$64.00	$87.44	36.63%	
Belgium	EWK	3/16/2016	$16.50	$19.49	18.12%	
New Zealand	ENZL	3/5/2016	$36.00	$55.88	55.22%	
Philippines	EPHE	8/5/2015	$37.00	$33.96	-8.22%	
Qatar	QAT	12/1/2014	$24.00	$17.50	-27.08%	
Malysia	EWM	10/3/2014	$41.00	$27.54	-32.83%	
Australia	EWA	9/16/2014	$22.50	$22.83	1.47%	
Greece	GREK	7/14/2014	$20.00	$9.92	-50.40%	
Portugal	PGAL	6/4/2014	$15.00	$10.77	-28.20%	
Columbia	ICOL	6/27/2013	$21.00	$12.52	-40.38%	
Turkey	TUR	6/1/2013	$58.00	$26.54	-54.24%	
UAE	UAE	5/20/2013	$23.00	$13.43	-41.61%	
Russia	RSX	8/7/2011	$30.00	$19.97	-33.43%	Weak Dollar emerging market
Brazil	EWZ	7/14/2011	$60.00	$42.47	-29.22%	Weak Dollar emerging market
Chile	ECH	3/1/2011	$61.00	$29.99	-50.84%	
Egypt	EGPT	2/23/2004	$64.00	$29.78	-53.47%	

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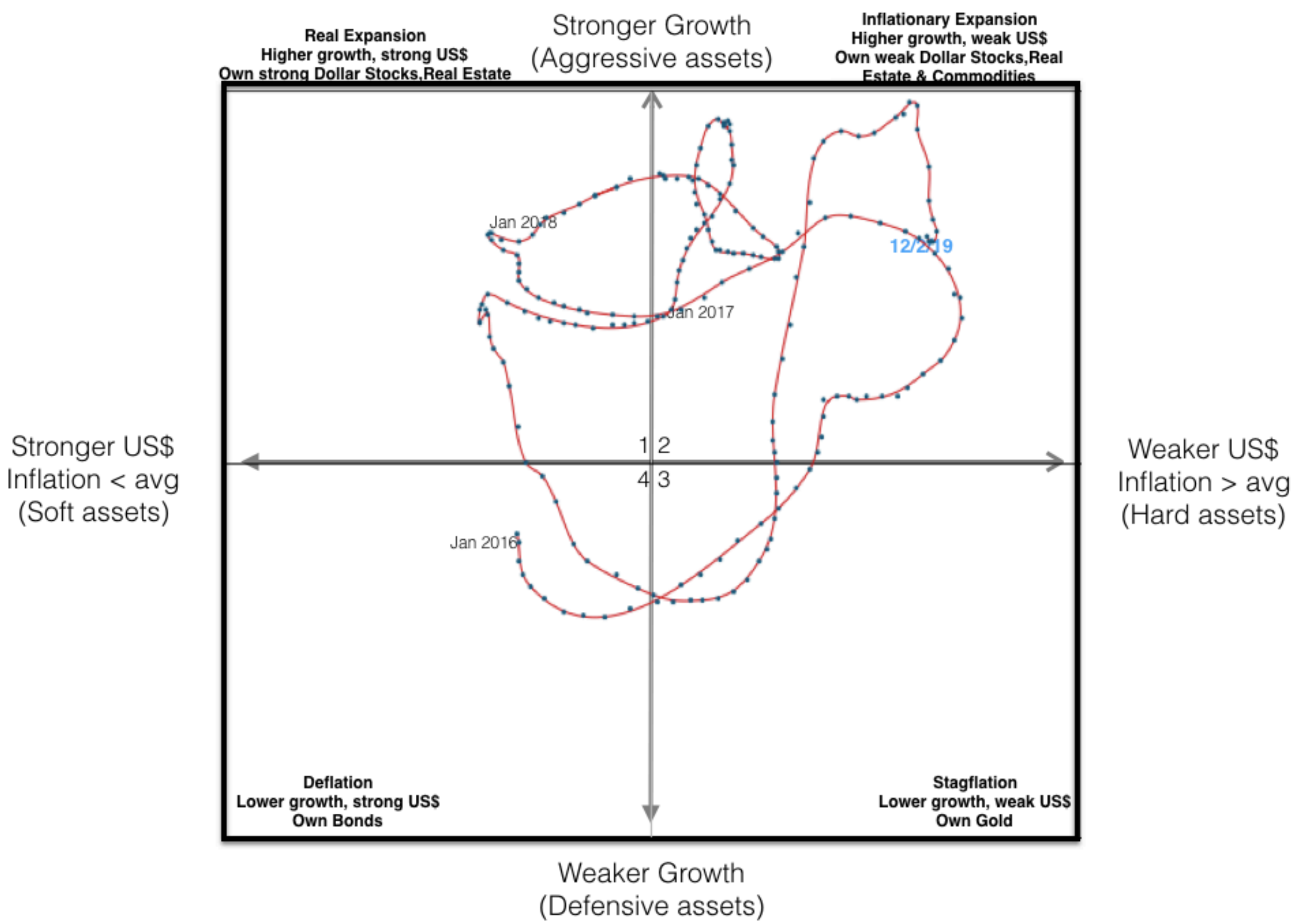
POLICY MAP

Growth increased versus last week (1.31 to 1.34): 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$ strengthened versus last week (1.42 to 1.41): 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: 1.78% (+1%) **Inflation Expectation Component: 1.61%** (-1%) **Real Growth Component: 0.17%** (-13%)

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. For now a Q42018-type deflationary policy mistake seems unlikely..