
YEAR IN REVIEW

This week we share with you the year end letter we recently wrote to our investment advisory clients. We think it summarizes well where policy and markets have been over the past year, and more importantly, what is ahead for asset class returns and policy in 2019.

2018 Year in Review:

During the extreme global asset class turmoil of the fourth quarter we decided not to sell into the panic, because we did not assess an enduring economic policy error to be occurring. That decision to not sell into panic is so far proving wise, as the predominant portfolio asset class holding, U.S. equities, has rallied back over 15% since Christmas Eve 2018.

During the fourth quarter and especially in December, the world feared a deflationary monetary policy error similar to 2008. Investors fled all asset classes. Foreign stocks and commodities, two asset classes we have not owned in several years, led the decline falling 15% and 14% respectively in 2018. REITS fell 8% on the year. Bonds were the only safe haven asset class in 2018 and declined only 0.31%. Even U.S. equities, the preferred asset class for global capital since 2016, suffered with the S&P500 declining 5% and domestically levered small caps declining 11.5%.

This “sell everything” mentality is what happens when investors fear a policy mistake so large that a system wide margin call on non-cash assets seems likely. As we assessed the policy landscape in real time during October, November and December we saw the fear and panic selling, but we did not see an actual economic policy mistake warranting such panic selling in U.S. growth assets. Tax policy remained pro-growth. Regulatory policy remained pro-growth. Trade policy, especially with China, was uncertain but not yet anti-growth. The wildcard was monetary policy.

Beginning in October, Federal Reserve Chairman Jerome Powell began commenting in speeches and Q&A sessions that interest rates were a “long way from neutral” and even suggested that the Fed could overshoot on the upside when raising rates. With U.S. economic growth expanding and inflation nowhere to be found, these comments were imprudent. Powell continued his arrogant talk through mid December, when he said that the Fed’s balance sheet reduction plan was

POLICY BASED INVESTING

by Russell Redenbaugh & James Juliano

Monday, February 4, 2019

on “auto-pilot.” While the Fed’s actual monetary policy decisions were not wrong, their arrogant language spooked investors to expect a 2008-style deflation in the near future. We disagreed, and expected the Fed chairman to reign in his comments. This is exactly what happened on January 4, 2019.

On January 4th during a public roundtable with former Fed leaders Yellen and Greenspan, Powell effectively apologized for not listening to markets up to that point. He said the U.S. economy has “good momentum,” but the central bank will be “patient” about raising interest rates in 2019 and is “listening carefully to the markets.” He added, “With the muted inflation readings that we’ve seen coming in, we will be patient as we watch to see how the economy evolves. We’re always prepared to shift the stance of policy and to shift it significantly if necessary.” This was exactly the assurance investors were looking for and we were expecting. The deflationary panic of late 2018 is now over, finally ended by the Federal Reserve’s ability to walk back arrogant language and pivot monetary policy to a more data dependent approach.

Overall, the U.S. economy is nowhere near conditions of the Great Depression or Great Recession of 2008, despite what many fear-mongering headlines claim. The economy is growing near a solid 3% pace and job growth has reached historic levels. Quality and swap spreads in fixed income markets show little to no systemic stress in the financial system, the opposite of conditions pre-2008. Tax and regulatory policies are unlikely to turn restrictive any time soon, despite any boisterous efforts by newly elected House Democrats to undo pro-growth policies of the past two years (for example Congresswoman Alexandria Ocasio Cortez, D-N.Y., recently announced that Democrats should increase the top personal income tax rates as high as 70 percent. That would be the highest income tax rate in the developed world, higher than all of our major trading partners and competitors.)

There is so much policy-wise that is going or could go right for U.S. assets. All Federal Reserve Chairman Powell needed to do was finally succumb to market signals and telegraph to investors that the Fed would not cause another 2008-style deflationary blackout. Thankfully, that is exactly what Powell did.

2019 Outlook:

Some are calling for 2019 to be another 2008. We don’t think that is likely. We already had a 2008-style panic from October 4th through December 24th 2018, and the Federal Reserve recently ended it. Deflationary monetary policy

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mistakes like 2008 are the worst kind of policy error. The Federal Reserve is usually too slow to inject Dollar liquidity into markets screaming for it. Asset markdowns and margin calls happen quickly. The Fed has halted fear of a 2008-style liquidity freeze repeating itself. As a result of this monetary policy shift capital has been and should continue flowing back into pro-growth, risk assets like U.S. stocks.

We believe 2019 will be a binary year for policy and asset class performance. Either the Fed will stay true to its recent shift towards data driven monetary policy and risk-on assets like U.S. stocks will perform well, or the Fed will revert to failed Phillips curve arrogance and risk-off, safe haven assets like bonds and gold will perform well. The portfolios are positioned for a return to normalcy and a continuation of the pro-growth trends that benefit U.S. equities. However, if the Fed strays from its recent monetary policy promises we are prepared to move capital from growth asset classes into safe haven asset classes like cash, fixed income and gold.

As always, we follow our investment process of allocating capital across five very different global asset classes, with cash being the sixth asset class. The goal is to invest capital in those asset classes with improving policies and avoid asset classes with ambiguous or deteriorating policies. Following our investment process and watching the “Footprints of Policy” will tell us what future is unfolding and what actions to take.

Sincerely,

Russell Redenbaugh & James Juliano

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	\$116.08	-2.5%	
Aggregate Bond	AGG	9/9/2016	\$109.00	\$106.97	-1.9%	2017 rise in Treasury bond prices (decline in yields) due to inflation expectation falling while growth expectation flat. This is a positive combination for future economic growth. Bonds remain a risky asset class that could decline 30-50% as real growth normalizes higher.
Municipal	MUB	9/9/2016	\$111.00	\$109.07	-1.7%	
TIPS	TIP	9/9/2016	\$114.00	\$110.71	-2.9%	
Extended Duration	EDV	9/9/2016	\$128.00	\$112.92	-11.8%	
US Treasury 3-7 yr	IEI	9/9/2016	\$124.00	\$121.41	-2.1%	
US Treasury 7-10 yr	IEF	9/9/2016	\$109.00	\$104.14	-4.5%	
US Treasury 20+ yr	TLT	9/9/2016	\$133.00	\$120.99	-9.0%	
International Total Bond	BNDX	9/9/2016	\$54.40	\$54.73	0.6%	
High Yield	HYG	4/12/2016	\$77.00	\$84.67	10.0%	Act more like equities than bonds, benefit from improving growth

ALLOCATOR

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	\$124.60	3.2%	
Silver	SLV	10/2/2017	\$15.67	\$14.94	-4.7%	
Energy	DBE	8/13/2014	\$28.97	\$13.96	-51.8%	
Oil	USO	7/30/2014	\$37.00	\$11.63	-68.6%	
Agriculture	DBA	9/13/2011	\$32.50	\$16.93	-47.9%	
Broad Comm. Index	GSG	8/5/2011	\$33.00	\$15.38	-53.4%	
Base Metals	DBB	6/17/2011	\$23.00	\$16.32	-29.0%	

ALLOCATOR

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	\$68.18	11.8%	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	\$34.08	21.7%	
Mortgage REIT	REM	4/1/2016	\$35.00	\$43.49	24.3%	
REIT	VNQ	3/7/2016	\$75.50	\$82.70	9.5%	

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	\$90.98	26.4%	Most tied to domestic policy / growth
Total Market	IWV	5/19/2016	\$117.00	\$159.38	36.2%	
Large	IWB	5/19/2016	\$111.00	\$150.12	35.2%	Large caps should underperform smaller caps as domestic economic growth accelerates
Small Cap	IJR	5/19/2016	\$54.00	\$76.56	41.8%	Most tied to domestic policy / growth
Mid Cap	IWR	4/6/2016	\$38.57	\$51.59	33.7%	More tied to domestic policy / growth

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	\$142.25	40.8%	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	\$187.62	34.0%	
Small Value	IWN	5/19/2016	\$92.00	\$119.31	29.7%	
Mid Growth	IWP	5/9/2016	\$90.00	\$127.32	41.5%	
Large Value	IWD	4/6/2016	\$95.00	\$119.81	26.1%	
Mid Value	IWS	4/6/2016	\$68.00	\$84.24	23.9%	

US Equity - Sector

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Staples	XLP	6/5/2017	\$57.00	\$53.17	-6.7%	Defensive sector hurt by rising growth
Utilities	XLU	6/5/2017	\$54.00	\$54.48	0.9%	Defensive sector hurt by rising growth
Metals/Mining	XME	5/8/2017	\$29.00	\$30.44	4.9%	Tied to commodity prices, hurt by strong Dollar
Energy	XLE	3/13/2017	\$69.00	\$64.71	-6.2%	Tied to commodity prices, hurt by strong Dollar
Healthcare	XLV	2/8/2017	\$71.00	\$90.69	27.7%	
Discretionary	XLY	11/14/2016	\$79.00	\$107.09	35.6%	Consumer strong w/ rising growth expectations
Financial	XLF	7/18/2016	\$19.00	\$26.02	36.9%	Helped by Trump deregulation (Dodd Frank) & rising interest rates
Materials	XLB	4/6/2016	\$44.00	\$53.43	21.4%	Global growth
Industrial	XLI	3/14/2016	\$52.00	\$71.80	38.1%	Global growth
Technology	XLK	3/7/2016	\$41.00	\$66.58	62.4%	Repatriation tax reform huge plus for tech companies

Foreign Equity

Country	ETF	Action Date	Red Sell/Green Buy	Current Price	% Gain/Loss	Policy Notes
Mexico	EWX	10/1/2018	\$51.23	\$44.88	-12.40%	Freer and fairer trade agreements are pro-growth for all parties involved
Canada	EWC	10/1/2018	\$28.78	\$27.09	-5.89%	
Denmark	EDEN	7/2/2018	\$63.89	\$59.96	-6.15%	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	\$33.19	1.86%	
Netherlands	EWN	7/2/2018	\$30.51	\$28.44	-6.78%	
Sweden	EWD	7/2/2018	\$30.51	\$29.86	-2.13%	
Eurozone	EZU	7/2/2018	\$41.01	\$37.37	-8.88%	
Spain	EWP	7/2/2018	\$30.35	\$28.35	-6.59%	
Poland	EPOL	7/2/2018	\$21.78	\$24.14	10.84%	
France	EWQ	7/2/2018	\$30.52	\$28.24	-7.47%	
Germany	EWG	7/2/2018	\$29.98	\$26.79	-10.64%	
Italy	EWI	7/2/2018	\$28.89	\$25.93	-10.26%	
Austria	EWO	7/2/2018	\$22.65	\$20.00	-11.70%	
Israel	EIS	2/26/2018	\$52.41	\$53.99	3.01%	
Vietnam	VNM	10/9/2017	\$14.99	\$15.56	3.80%	Demographic leverage to US economic growth policies
Indonesia	EIDO	7/24/2017	\$26.78	\$27.41	2.35%	Demographic leverage to US economic growth policies
Ireland	EIRL	1/26/2017	\$39.00	\$40.34	3.44%	
Singapore	EWS	1/11/2017	\$21.00	\$23.39	11.38%	
China	FXI	1/6/2017	\$35.50	\$42.79	20.52%	Strong Dollar emerging market, tied to US growth
World Ex US	VEU	11/15/2016	\$43.50	\$48.90	12.40%	Global growth reset higher after US Election2016
Norway	ENOR	8/20/2016	\$20.00	\$24.81	24.05%	
UK	EWU	8/4/2016	\$30.50	\$31.55	3.44%	Brexit was a vote for growth
Finland	EFNL	7/26/2016	\$33.00	\$38.26	15.94%	

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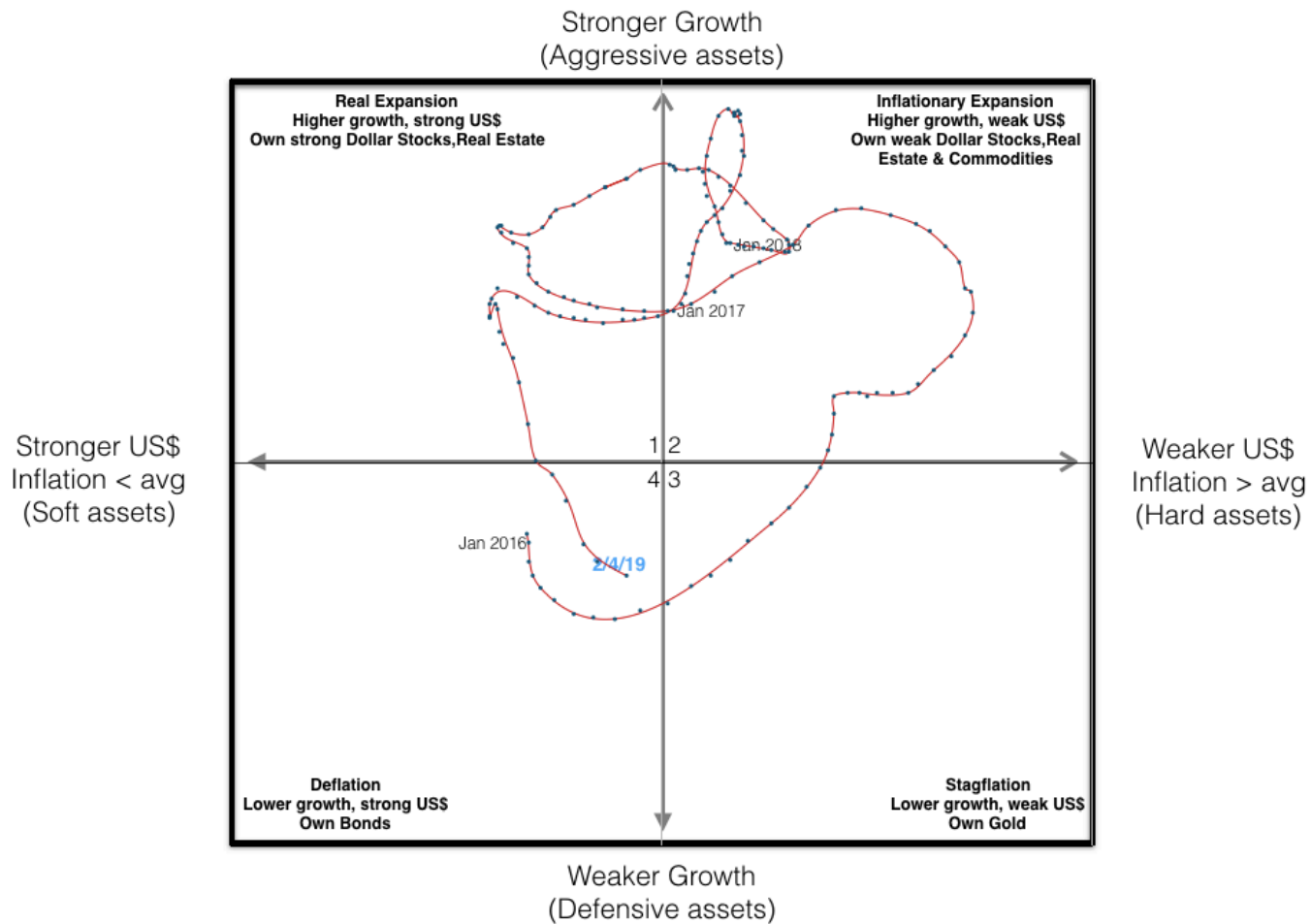
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Japan	EWJ	7/15/2016	\$47.00	\$54.01	14.91%	
South Korea	EWY	7/13/2016	\$52.00	\$64.04	23.15%	
Hong Kong	EWH	7/6/2016	\$19.00	\$24.42	28.53%	
Frontier Mkts	FRN	7/5/2016	\$10.50	\$12.96	23.42%	Highly levered to Eurozone growth movement
Peru	EPU	6/29/2016	\$30.50	\$37.92	24.33%	
South Africa	EZA	6/29/2016	\$51.00	\$56.43	10.65%	
India	EPI	6/27/2016	\$19.00	\$23.78	25.16%	Strong Dollar emerging market, tied to US growth
Taiwan	EWT	6/21/2016	\$27.00	\$32.98	22.15%	
Thailand	THD	5/20/2016	\$64.00	\$90.87	41.98%	
Belgium	EWK	3/16/2016	\$16.50	\$17.73	7.42%	
New Zealand	ENZL	3/5/2016	\$36.00	\$48.28	34.11%	
Philippines	EPHE	8/5/2015	\$37.00	\$34.90	-5.68%	
Qatar	QAT	12/1/2014	\$24.00	\$19.28	-19.67%	
Malaysia	EWM	10/3/2014	\$41.00	\$30.56	-25.48%	
Australia	EWA	9/16/2014	\$22.50	\$20.56	-8.64%	
Greece	GREK	7/14/2014	\$20.00	\$7.31	-63.45%	
Portugal	PGAL	6/4/2014	\$15.00	\$10.79	-28.09%	
Columbia	ICOL	6/27/2013	\$21.00	\$12.99	-38.16%	
Turkey	TUR	6/1/2013	\$58.00	\$28.39	-51.05%	
UAE	UAE	5/20/2013	\$23.00	\$14.19	-38.30%	
Russia	RSX	8/7/2011	\$30.00	\$19.97	-33.43%	Weak Dollar emerging market
Brazil	EWZ	7/14/2011	\$60.00	\$45.38	-24.38%	Weak Dollar emerging market
Chile	ECH	3/1/2011	\$61.00	\$46.81	-23.26%	
Egypt	EGPT	2/23/2004	\$64.00	\$31.25	-51.17%	

POLICY MAP

Growth decreased versus last week (-.57 to -.65): 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\$ decreased versus last week (-0.33 to -0.18): Dollar had been stable between gold \$1,300-\$1,375/oz, and recently strengthened to \$1,230/oz. This strong Dollar signal should give the Fed room to pause rate hikes until economic and market data calm down.



BOND YIELD COMPONENT ANALYSIS

Nominal Yield: 2.70% (-1%) Inflation Expectation Component: 1.88% (+4%) Real Growth Component: 0.82% (-14%)

Bond market became less pessimistic about pro-growth policy outcome in 2017. After 2017 tax cut bill real growth exited the range of .30-.70 to the upside. Growth expectations are holding near 1%, while inflation expectations have drifted down over the past five years and are now below 2%. Rising growth with falling inflation is the perfect recipe for prosperity.

