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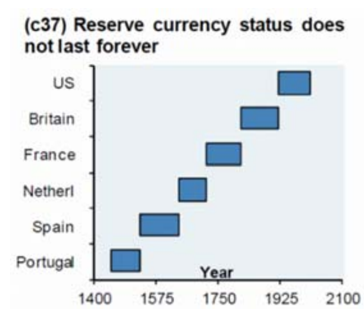
October 23, 2018

Dear Investor,

Well … there is no need to hunt for **Red October** … we found it. We're going to jump right into the behavior of the major market indices and cover the major macro issues driving their volatility and declines … a bit of a format change. We have covered these issues for years, and while they long ago signaled they would matter one day, they have mattered little, perhaps until now.

YTD performance numbers themselves are not at all scary. At least not for the major indices that the public is given to follow. Many other important indices, those most sensitive to interest rates and to turns in the economy are plummeting however, and the pace at which they are diving ***is*** legitimately concerning. While Nasdaq index remains in positive territory today, and not too far from their all-time highs we suppose, the S&P 500 and Dow Jones Industrials went negative today, at least temporarily. Many other indices are not in such good shape at all. From decent positive positions only weeks prior, several major indices reached all the way into negative year-to-date territory only to bounce a bit last week. At their lows Friday the 12th or Tuesday the 22nd, the Dow Transports were **-2.3%** on the year, Dow Utilities **-0.9%**, Small Caps **-2.2%** (from up 13%). Looking overseas Japan is down **-1.9%** and China is down **-27%** year to date, succumbing but not surrendering to Trump's trade wars [i].

The most important issue that investors should follow is this: the world is run by central banks and those central banks determine which way 'markets' go. **Period**. The solution to the central-bank enabled Crash in 2008/2009 was for them to repeat their past policies on an even larger scale: generate more debt-based money, then spread it around, primarily to those who caused the problem in the first place. The global debt that now exists dwarfs anything that has gone before us in history. **Key point**: this tactic worked because the central banks of different countries collaborated. Many longer term clients will recall the two pictures below:



The first represents the collaboration of the major G4 countries' central banks (add a fifth: China) as being both a requirement and ***the factor*** for the rally since 2008 in our view. Importantly, central banks are now doing the ***exact opposite*** of what they have done for the past ten years. Our view is that they ***cannot*** do so without bringing down markets substantially. The second shows the historic lifetime of 'reserve currency', the currency the world has the most faith and therefore uses to conduct trade. There is obviously a limited lifespan of a reserve currency as greedy and incompetent *or* corrupt leadership of the host country inevitably exploits and abuses such a power to the point it fails. The market can rally again, but the keys will be: 1) do central banks want to reverse their restrictive actions and prolong their system, or 2) is it past that point? We'll re-hash these important issues in the detail that follows, and additional detail is available. Do call us at (614) 734-WLTH (9584) if you'd like to adjust your strategy or allocations.

Best Regards,

Mike Sullivan, President, CFP®

Perspective & Outlook:

Yes, that was a rather blunt, big picture introduction for this quarter's letter, but there is good reason for it. The Fed has built the same type of system that central banks have built throughout history: one that serves bankers, close associates, and politicians, at the expense of the public, then fails. Anyone who does not want to ride a repeat of 2009 should understand how it works. Its not fun, but may be timely and the concept is important if you like your money.

But first, let's pretend the central bankers will choose to comply now and 'markets' will settle down so we can simply consider how the stocks of many companies reporting earnings this week might be assessed … like we might assess football teams. From our friends at Earnings Scout:

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Same records but headed in different directions

- The Cleveland Browns and Pittsburgh Steelers have identical records in 2018.
- Fans in Cleveland are ecstatic, while fans in Pittsburgh are grumbling.
- If the Browns were a stock, their shares would be rising, while the Steeler's stock would be plummeting. Why?

- It's all about the delta on expectations.
- The Brown went 0-16 last year and 1-15 the year before that. So, let's face it, the Browns were a penny stock coming into this year.
- This year, with a confident 23-year old quarterback in Baker Mayfield, the future is looking significantly brighter in Cleveland and demand for Browns tickets is rising.
- The Pittsburgh Steelers, on the other hand, went 13-3 last year and 11-5 the year before that and were expected by many pundits to represent the AFC in this year's Super Bowl.
- This year's Steelers do not look or act like a Super Bowl team. Their star player, Antonio Brown, tweeted "trade me" after a game and their star running back is refusing to play. Throw in a 36 years old quarterback and the future is starting to appear less bright for Steelers.
- In other words, the delta on Cleveland's expected wins is improving. The Steelers delta is negative.

So, if the Browns were a stock the market would likely bid them up, while the Steelers might be sold off or simply hover around its current value. Since that analogy, however, Cleveland dropped two games (both were close though), and Pittsburgh won one while they took last week off. So Cleveland would be sold, while Pittsburgh might be a 'hold' for now.

But … what about the 'delta' (change) in earnings expectations Earnings Scout referenced for companies and markets? So far in Q3, earnings are solid *and* expectations for future earnings are postive. Recall Q2 earnings period finished with an explosive 25% growth rate, mostly on the back of the Tax Cuts & Jobs Act that kicked in this year. Earning Scout's expected growth rates for earnings in forthcoming quarters are: Q3 2018 … **+21%**%; Q4 2018 … **+15%**; Q1 2019 … **+9%**; Q2 2019 … **+6%**. (But, do notice that the rate of growth levels out this quarter, then returns to a more normalized level after the tax cuts will have been in play for a year plus.)

While bottom lines continue to improve dramatically as a result of the tax cuts, corporate *top lines* have also been expected to continue growing: Q3 2018 revenues are expected to rise 10%+.

So, why the turmoil now in the markets? Is the concern legitimate or unfounded? Are we still in a supportive market environment where we can calmly evaluate earnings? Do the markets now perhaps have a case of "*that is as good as it gets*" and it is all downhill from here? Or is this just another minor speed bump in the bull market, with more new highs ahead?

First, lets look at how the 'markets' have behaved after prior sell-offs like this October surprise. This spooky October caused optimism as tracked by the American Association of Individual Investors (AAII) to plummet by more than 15 percent. That has happened five times since 2009 and we see that in all five instances the S&P 500 saw nice rebounds afterwards [ii]:

SPX After AAII Bulls Decline by 15 Percentage Points (since 2009)						
	1 Week	2 Weeks	1 Month	2 Mts	3 Mts	6 Mts
Occurrences	5	5	5	5	5	5
Average	0.9	1.3	2.6	3.6	6.2	9.7
Median	1.3	2.0	3.8	5.2	8.0	10.2
PercentPositive	80	80	80	80	100	100
Std_Deviation	2.6	1.5	5.1	5.2	3.6	2.9

SPX Returns At Anytime						
	1 Week	2 Weeks	1 Month	2 Mts	3 Mts	6 Mts
Average	0.2	0.3	0.7	1.3	2.1	4.3
Median	0.3	0.5	1.0	1.8	2.9	5.3
PercentPositive	58	59	63	66	69	74
Std_Deviation	2.2	3.0	4.2	5.8	7.4	10.7

In fact, on average the S&P 500 was 6.2% higher three months later, and 9.7% six months later. It is important to recognize, however, that all five of the above instances occurred ***after*** 2009 … and ***during*** this historic monetary experiment where rates were lowered and money printed.

Since December 2015, when it first raised interest rates, the Federal Reserve has been doing the exact ***opposite*** of what it did from 2009 until then. With the Fed and other central banks now firmly in reverse gear, we will soon know whether the above AAII chart is even relevant.

So, on the one hand, thanks to the Tax Cuts & Jobs Act, corporate earnings and estimates revisions have not been this strong since 2010 (when the Fed-led bail outs were rocking and rolling). Instead of Fed stimulus, we now have fiscal stimulus goosing earnings and asset prices!

And, since we have said forever that markets are all about earnings, we will acknowledge that another leg up on this long-term rally is indeed possible.

Unfortunately, earnings are really ultimately just about central banks anymore. So, if they are not onboard to resume their manipulations, that earnings growth may be hard to achieve.

The 'markets' are telling us that the very factors that we have written about for years are all manifesting themselves lately … these are the same factors responsible for 'rescuing' the financial system when it had essentially been murdered in 2008. Note that the factors are not necessarily 'good things', the system as it is just happens to require them.

As a reminder, here are the factors, along with an update on their status:

1. Central Banks must continue to mint money and buy stoc ks – ***backing off hard now***
2. Major economic powers must continue to cooperate – ***China/US increasingly hostile***
3. 'Growth initiatives' by Trump must be funded – ***Not funded – $1T projected deficit***
4. The public must continue to be influenced to continue borrowing and buying – ***neutral***

Unfortunately, those factors are now beginning to fail, and quite visibly.

Numerous current events are springing from the factors and most are negative. To the extent they might negatively impact earnings, they at a minimum may present a problem for stock markets near term. To the extent they alter global relations, they could derail the U.S. from holding the privilege of having the U.S. dollar serve as the world's reserve currency. That could dramatically change not only near term investment balances for Americans, but the overall long term quality of life the U.S. So, the issues below are most certainly worth understanding:

1: **CENTRAL BANKS**

- The Fed raised interest rates for the 8th time on September 26th, where markets peaked
- Fed 'minutes' indicate they will continue to raise rates in months ahead
- Wall Street punishes markets when the Fed raises rates or stops printing money
- The European Central Bank ceases printing $80 Billion/month in December
- The European Union is warning Italy its markets will be punished via ECB policy
- China's central bank is intervening in their crashing market, without success yet

2: **GEO POLITICS** (impact on revenues and earnings *and* U.S. Dollar reserve status)

- Despite China's markets crashing **-27%** YTD, they refuse trade concessions to Trump
- The SWIFT system, which 'clears' most global financial transactions, is being partially replaced by a Russian system now, and later by a new one Europe is now building.
- The U.S. dollar is being thrown out of vast sums of trade, lately between Russia/China
- Saudi Arabia, who 'saved' the dollar in the '70s by selling OPEC oil in USD only, is under fire for the murder of a Washington Post journalist inside its consulate in Turkey
- The U.S. and Saudi Arabia are threatening each other over the journalist's murder

3: **FUNDING/DEFICITS**

- Trump's growth initiatives are nowhere close to being funded, perhaps underfunded by as much as $1 Trillion, unprecedented deficits in a strong economy.
- The national debt (the accumulation of all of the annual deficits) is nearly $22 Trillion, larger than our $21 Trillion Gross Domestic Product[iii]
- Unfunded Liabilities, to cover deficits, Social Security and Medicare promises, etc. exceed $115 Trillion, more than $944,000 per taxpayer

4: **CONSUMER BORROWING & SPENDING**

- Consumer borrowing is 'neutral' presently based on Consumer activity, however:
- Auto sales are slowing while loan defaults are rising
- Home sales are slowing while loan activity is falling
- Student loan defaults are climbing and at all-time highs

So, in a nutshell, while we would much prefer to simply worry about sustainability of earnings, vis-a-vis Earnings Scout, company by company or even for the markets overall, the debt-based monetary systems and absence of collaboration across countries seem to be very unsupportive .

Already we know the following are required for our markets to rise:

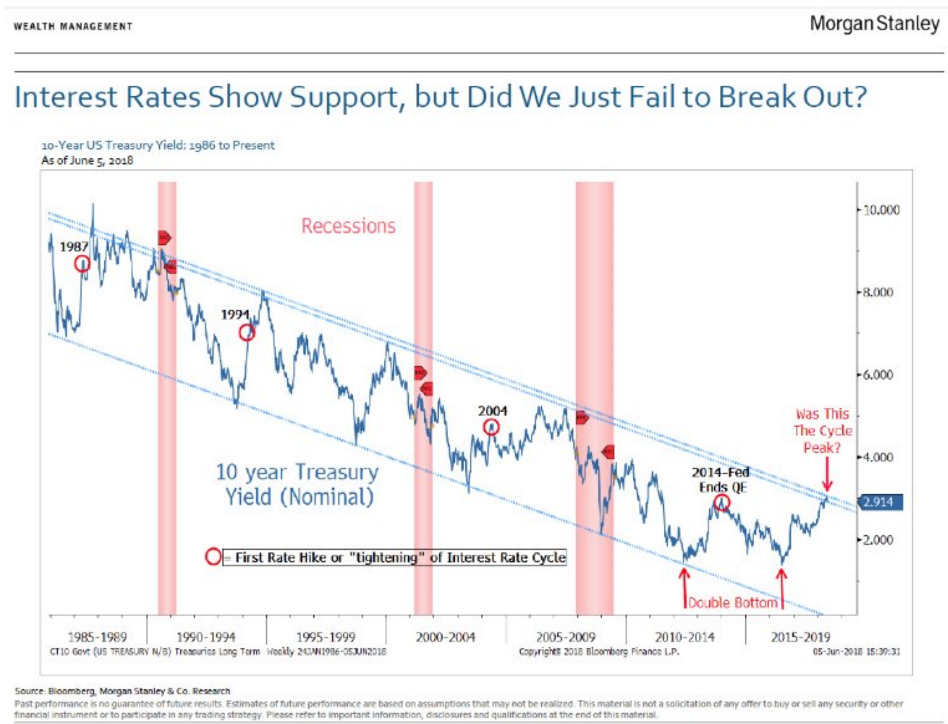
1. Global collaboration across major countries and their central banks must exist
2. Endless debt must be generated by nations to fund current consumption
3. Interest rates must be suppressed endlessly, or asset prices will most likely fall
4. Loan terms must be extended over longer and longer terms to support rising prices
5. The major Wall Street players (primarily self-serving to the deteriment of the country and profitable in up and down markets) *must* be rewarded by criteria 1-4 at all times

At some point, all these criteria that rising markets demand are *negatives*, not positives … because they result in a mathematically unsustainable, unhealthy system like the one we likely now have. Holding historic debt at a time when we are *challenging* other countries instead of collaborating with them in the 'pillage-the-treasuries' game makes these dangerous times.

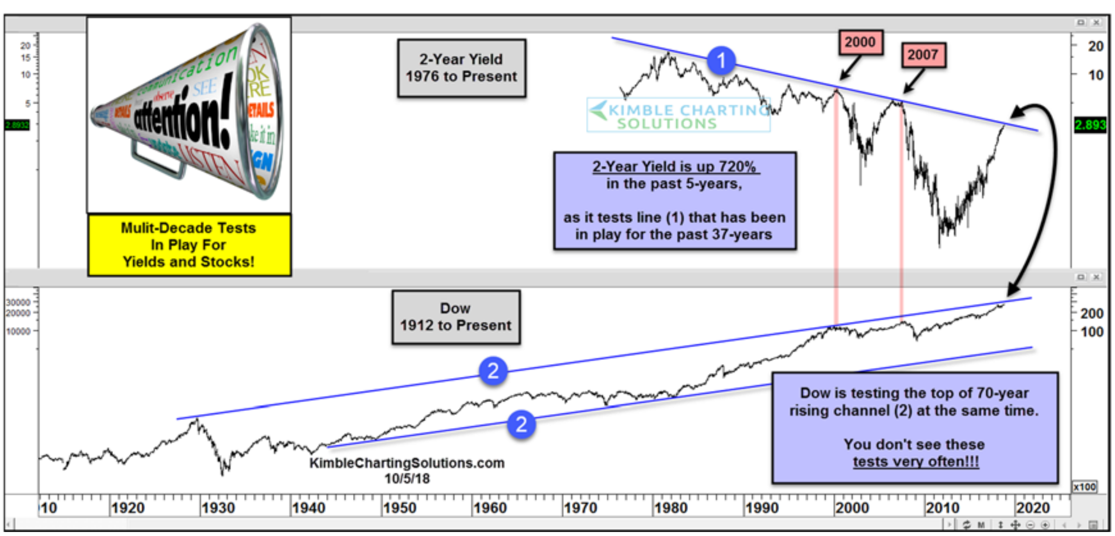
The positions Trump is taking on trade may indeed be the right ones in terms of fairness, but the condition the country is in financially is no longer one of strength. Our strength was long ago squandered as the treasury was depleted and used for global dominance, now unwelcome.

Since 'a picture is worth a thousand words', following are several charts that illustrate the pivotal point that may be upon us, and how the Wall Street machine is punishing assets now.

First, here is why: the 10-year Treasury yield cannot seem to exceed even a measly 3% without the system derailing. It recently hit 3.25%, and the wheels were knocked off the bus …



… the same goes for the 2-year Treasury yield, now nearing 3% as well and setting off alarms. The same goes for the Dow Jones Industrial Average, being rebuffed from its 70-year uptrend.



Now take a look at the punishment being dealt out to small companies, represented by the Russell 2000 small company index:

Small companies, those most dependent on cheap money (low interest rates) have been crushed since Labor Day. Here we see the Russell 2000 index on the 22nd fell below the uptrend line that has held it since 2009. Only ***once*** did the Russell drop meaningfully below the line, in January 2016, 'the worst start to a year ever'. That followed the Fed's first rate hike in nearly a decade and the markets were rescued from the Wall Street thugs ***only*** after Chairwoman Yellen called European Central Bank Mario Draghi and solicited the ECB to embark on a money-printing binge. That binge, to the tune of $80B/month began in January of 2016. It is scheduled to end this December of 2018. Hence, it is time to queue the central-bank-programmed financial terrorism machine that requires endless debt from national treasures … at all costs … or else. The Fed's system reminds us of a quote from a famous American businessman:

"*It is well enough that people of the nation do not understand our banking and monetary system, for if they did I believe there would be a revolution before tomorrow morning.*" – Henry Ford

That revolution may not be far away. Here is Wall Streets' work on other interest-sensitive, debt-dependent industries: housing and autos. Homebuilders first, since mortgages are pegged to the 10-year Treasury: … losing support then selling off like there is no end in sight … ouch.

And … then there's autos … not liking the removal of 0% car loans … ouch again.

This look at smaller companys and sector indices reveals a different story from what the major indices suggest, yes? A look at the NYSE Composite, a broad composite of thousands of companies of all sizes that trade on the New York Stock Exchange, tells us the same:

NYSE Composite 'tops' in January?

New 'highs' minus new 'lows' notably weaker during rebound.

Elliott Wave, who charted the NYSE index above, believes we have just seen not a 'top' per se, but a multi-generational top at that. NYSE topped in January, and unlike the S&P 500, the NASDAQ, and Dow Jones which emphasize FAANG (Facebook, Apple, Amazon, Netflix, and Google accounted for nearly 40% of the rise through Q2), NYSE includes almost everything.

We know … the S&P 500, Dow Jones Industrials, and Nasdaq are down only somewhat, seemingly nothing to get worked up about. However, the other charts suggest caution now. Following is the technical backdrop on the indices discussed above, as of the close on the 22nd:

- The small-cap Russell 2000 has dropped **-13%** from its high, sits below its 200 day moving average (a sign the long term trend is potentially heading downward), and has broken that upward trendline that has lifted in since 2009. It has dropped since Labor Day, albeit modestly until October, and virtually every attempt to rise has been met with heavy selling. It sits 5 percent *below* the 50 Week average that saved January ‘16.
- The interest rate sensitive indices continue to be pounded similarly: housing, autos, transportation, regional banks and other indices are in relative free-fall.
- Large cap indices that hid carnage in the smaller and interest-sensitive markets for a while (the Dow, Nasdaq & S&P500) are all sitting below their 200 day moving averages.
- Of note, most international indices turned down before the U.S. indices. The U.S. has been considered the ‘safe harbor’ for anyone anywhere who is required to invest in stocks. Either the U.S. markets are going to rebound here, or they’re assuredly going to join the rest of the world to the downside. Things are quite precarious.

Central bank policy mistakes (accidental or deliberate), the conflict with China and Saudi Arabia, and most importantly, the self-serving ruinous power of the Wall Street machine can create major market declines. Mainstream media will observe these are simply ‘market’ moves and truthfully, all markets *do* contain self-serving participants, both ethical and unethical, so we suppose technically that could be a somewhat honest statement. The narrative is that the ‘markets’ are worried that the Fed is making a policy error by committing to raising rates too high. That too is true. It is very sad that it can be true at 3%, but it almost surely is true

We have no love lost for the Fed, nor the malignant system it has created. It caters to those who demand profit by constant pillaging of our long-ago empty national treasury, delivered by highly conflicted people who control its purse strings. We have less love lost for the international and western banking institutions, in particular the World Bank and the International Monetary Fund (IMF) who use printed money as a weapon to dominate entire countries. Of note, the IMF released a report in August titled: “Large challenges loom for the global economy to prevent a second Great Depression”.[iv] A report from an institution that creates the very problem it warns about, would be amusing if not so disturbing. It looks like the rats may be fleeing the ship.

We would much prefer to simply assess earnings trajectories in a healthy economy backed by sound money than to cover these topics once more. However, regrettably with the system we have, we know that at some point more money will be extorted from the central banks, or asset prices will dive. Here is an interesting chart that suggests it may have finally started:

Source: Zerohedge.com

Large institutional money (Wall Street) has been heading for the exits all yeer.

Thus, if we want to see new highs beyond those that were achieved August and September for the popular indices, there are two primary things to look for … and relatively soon:

1. The Fed and other central banks must cave to the market's warning via this recent beat-down, and deliver additional money-printing and/or lower interest rates, and
2. China and the U.S. must reduce hostilities and meet at the bargaining table to hash out more even trade terms

So, unfortunately that is the game at hand: more extortion of the central banks to receive more debt-based support must succeed. You are witnessing it live today.

We all wish the task was more akin to figuring out which way our favorite football team or company might be trending, or assessing whether we'll just have a mild earnings cooling period before resuming the rally of the past ten years, or whether a natural slow-down is under way, but it is not. This is the system the central banks have built. And all of its fallacies are emerging from behind the curtain at last, peeking out for everyone to see.

Do you see them?

We have covered the topics for a long time, and they have not mattered … yet. But we have also long said that when they finally matter, they will matter … big-time.

This may not be ***that*** time, but it is certainly worth being vigilant here. It has been a large run since the dark days of 2009. Safe almost certainly seems more prudent than sorry here. Do call us if we can be of assistance.

[i] www.yahoo.com
[ii] www.schaefferinvestment.com
[iii] http://usdebtclock.org/
[iv] https://news.goldcore.com/ie/gold-blog/imf-issues-dire-warning-great-depression-ahead/