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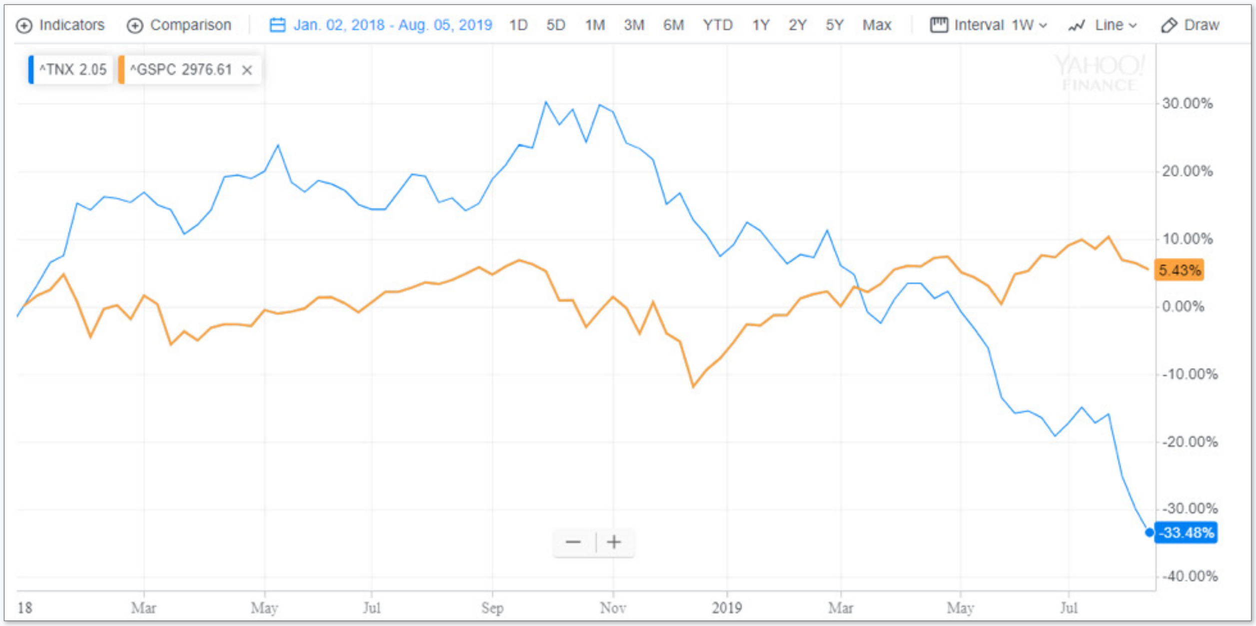
SUMMER 2019 INVESTMENT COMMENTARY

THESE ARE NOT NORMAL TIMES ...SOMETHING HAS TO GIVE

The average investor spends 90% of their time focused on the major U.S. equity indices, particularly the S&P 500. Today, many individuals who I speak with feel like the U.S. equity market has been doing remarkably well for the last couple of years because it is reported in the news that we keep hitting all-time record highs. The reality is that since the beginning of 2018, the S&P 500 is up 5.43% (orange line) as of August 5, 2019.

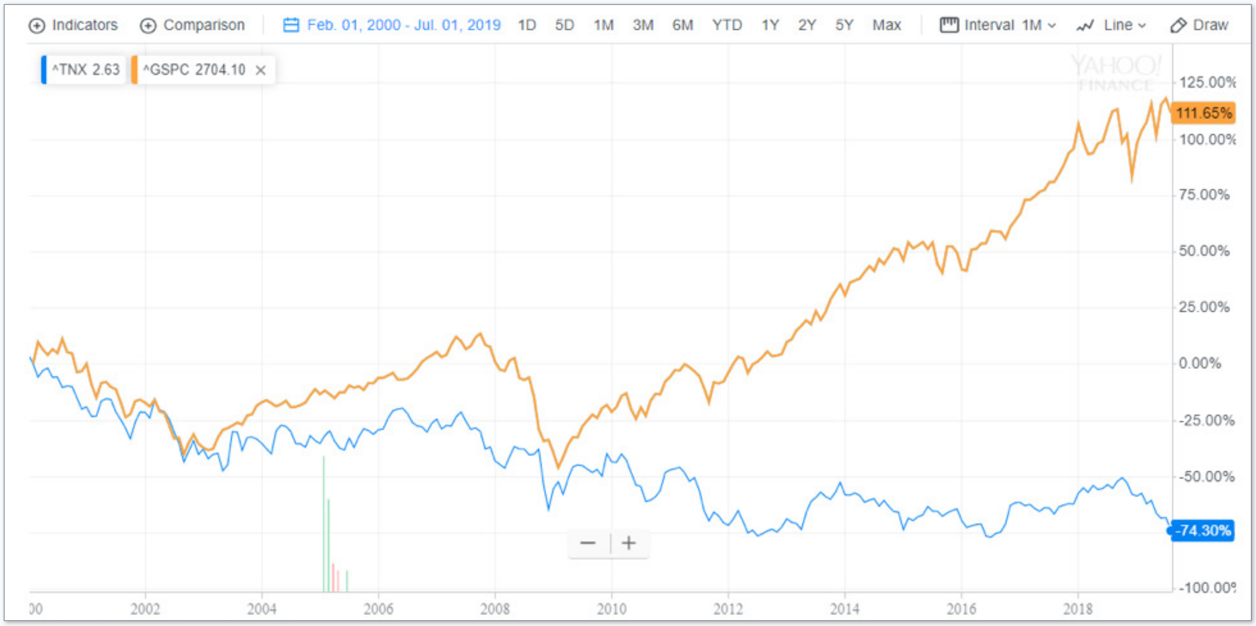


Recently, the prevailing narrative is that the bull market has shifted into a higher gear as the public has been continually reminded of "all-time record highs" whenever the market eclipses a previous high. The reality is that the S&P 500 eclipsed its pre-financial crisis high in 2013 and the S&P 500 continually hit all-time new record highs from mid-2013 through late 2017. For many years following the financial crisis, investors remained very skeptical of the bull market. On the bull market's eighth anniversary as of March 9, 2017, the bull market ranked #2 in duration and percent gain of all time (249%). Today's aging bull market is a continuation of the historic bull market that began in 2009.

What is far more important for investors to pay attention to are plummeting sovereign bond yields around the world, counter-intuitive monetary and fiscal policy actions, and the extremely abnormal trade policy and geopolitical actions that have roiled international relationships and global commerce. When using the stock market indices as a barometer of risk and future expectations, one misses just how abnormal our economic, political, and market environment is today.

The following chart shows just how dramatic of an effect the financial crisis and monetary policy reaction had on the relationship between interest rates and the stock market. Before the financial crisis, interest rates as illustrated below by the 10-year U.S. Treasury Bond yield, and stock market price levels were positively correlated. Following the crisis, the introduction of zero interest rates and quantitative easing broke this historical positive correlation. The Federal Reserve began to reverse its extraordinary stimulus measures adopted in response to the financial crisis beginning at the end of 2015. This reversal in monetary policy was followed by a slowing of economic growth and a pause in the stock bull market that began March 2009.

In 2017, with the prospect of a tax cut, economic growth began to accelerate once again. Post tax cut, economic growth temporarily rose to near three percent for 2018. However, by mid-2018 the temporary above trend economic growth began to show signs of slowing in the face of continuing monetary policy tightening and trade tensions. The stock market reacted to slowing growth and tightening monetary policy with a near 20% sell-off between October and December last year.



Following the late 2018 market sell-off and significant condemnation and chastising from the President, the Federal Reserve reversed course and finally, last month, cut interest rates. This cut in interest rates was the first cut since 2008 when the Federal Reserve cut rates to zero in response to the financial crisis. So, where does this leave us today? The answer is, uncharted territory without historical precedent as a guide.

Many market followers disagree about where our economy is in the economic cycle. There are indicators and actions which can be pointed to make the case that we are early cycle, mid-cycle, or late-cycle. I cannot recall a time when so many experienced and informed people disagreed about where the economy is in terms of the economic cycle. It is important to have some consensus regarding whether an economy is an early cycle, mid-cycle or late-cycle when it comes to the actions of central banks, policymakers, and investors. Making interest rate policy decisions, governmental fiscal spending decisions, and investment decisions without the benefit of some level of clarity regarding what the next 12 to 24 months holds for consumer spending, employment, corporate profits, and tax revenue is akin to flying a commercial aircraft full of passengers at 700 mph halfway around the world without instruments.

Historically, we have never had total certainty regarding the timing of the economic cycle. However, we generally knew, based upon certain economic indicators and trends, whether we were in the early stages, middle period, or late stages of an economic cycle. This knowledge provides, based upon the study of prior cycles, guidance whether monetary stimulus or tightening is prudent, whether the Federal government should be expanding deficit spending or reining it in, and whether investors should be gravitating toward investments that are sensitive to the economy cycle or those which have a more resilient business model.

Today we have the Federal Reserve, in the face of full employment, slightly below-target inflation, and economic growth slightly above the long-term potential growth rate for the economy, cutting interest rates. During his July press conference, Fed Chairman Powell struggled to explain why they were adding stimulus under these conditions, and whether or not the July rate cut was a major reversal of policy or simply a minor adjustment.

In response to the July rate cut, the market pushed the rate on longer-duration government bonds down sharply to levels last seen in mid-2016. We see the European central bank abandoning any appearance of attempting to extract themselves from their long-standing aggressive easing stance. The UK economy recently showed signs of contraction in the face of extreme uncertainty involving Brexit.

On the other hand, the U.S. consumer is not showing any clear signs of slowing down, and employers continue to hire at an average pace of around 180,000 per month. This hiring pace is down from last year when the monthly averages were around 200,000, and down from the last four years of the Obama administration when the average was running at around 225,000 per month. We hear from Trump administration officials and some economic pundits and corporate executives that the U.S. economy is the best that it has ever been or at least for a very long time.

Like a pilot flying blind, Investors and policy makers have no reliable instruments, and the air traffic controllers are sending confusing and conflicting instructions. Any responsible pilot under these circumstances would realize that they need to control what is controllable and rely only upon what they can see with their own eyes. Thus, all of the simulation training, autopilot technology, and manual procedure troubleshooting are rendered useless. A pilot in this situation needs to fall back upon human skill, experience, and basic principles of risk management.

As a professional investor today, the only things that I can rely upon are my twenty-one years of experience, fundamental security selection, and a heightened level of risk management. It is foolish today to allocate capital based upon many of the “signals” and patterns that investors have come to rely upon in the past. No investor, human or programmatic trading program, can today successfully predict the direction of interest rates, the likely future policy decisions by politicians, or the strength and trajectory of the economy in today’s abnormal environment.

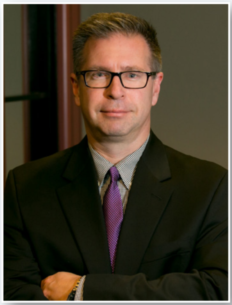
Just like the pilot without instruments or reliable air traffic controllers, at Seven Summits Capital we are 100% focused only on those things that we can understand and reasonably forecast regardless of the forces that obscure those guideposts that have been useful in the past. We believe that this environment calls for avoiding most securities which are overly dependent on a strengthening economy, the direction of interest rates, and the actions of legislators and regulators. Additionally, we assume that the broad equity market downside risk greatly outweighs the upside opportunity over the next several years from today's level. Such a risk-return balance calls for increasing portfolio income yield, using hedge securities when the markets are near all-time highs, and seeking out special opportunity and under-appreciated growth opportunities which have price drivers that are catalyst driven, not market or economy driven.

I have occasionally been challenged in the past regarding the benefits of active management versus passive investing. Today's highly uncertain environment is very precarious for the "just buy the market" investor. Without the benefit of traditional signals and trend analysis, passive investors now find themselves flying blind and relying upon hope alone. Blind hope is not an investment strategy. Nor is it something on which anyone should be comfortable betting their life's savings.

We may be in uncharted territory, but we cannot look away to avoid what is uncomfortable. We have to pay attention to U.S. Treasury yields that have plummeted over the last nine months. The Fed reversed course after forecasting at least three rate hikes in the coming year and instead cut interest rates in July. Negative interest rates are prevalent in Europe and Japan. The U.S. is weaponizing of the size and influence of the U.S. economy and influence over the global financial system to threaten trading partners. Aggressively using our inherent leverage has angered friend and foe alike and riled the capital markets. Large fiscal stimulus and high government spending comes during a time of full employment, 200,000 per month average job growth, and an economy growing at potential and has resulting in a return to one trillion dollar fiscal deficits.

We are witnessing unprecedented public criticism and chastising of the independent Federal Reserve by the President of the United States, which erodes confidence in the independence of the Fed. We regularly see public shaming of private sector businesses over their capital investment decisions by senior members of the Executive Branch of the federal government, which threatens to distort a capitalistic marketplace. A $50 + Trillion covenant-lite unregulated U.S. shadow banking system has developed and is an opaque risk that needs to be heeded. Our allies are working with our adversaries to develop ways to minimize U.S. leverage over the global financial system by developing non-U.S. dollar payment systems .

We are in uncharted territory. Capital market pricing is distorted, imbalances are unquantifiable, and global trade, geopolitical tensions, and the partisan political divide are causing fragility at an unprecedented level.



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