February 14, 2018

> "PERSONS attempting to find a motive in this narrative will be prosecuted; persons attempting to find a moral in it will be banished; persons attempting to find a plot in it will be shot."
>
> - Mark Twain's "notice" to readers of *Huckleberry Finn*

Dear Client,

On Friday, December 29, the S&P 500 index closed the year 2017 at 2,674 within a few points of the all-time high it reached just days earlier. In January, the index proceeded to rally further – almost 6%, supposedly (but who really knows) in reaction to the tax legislation signed by President Trump on December 22. The end of 2016 through the beginning of 2018 had been one of the least volatile periods in recorded stock market history. It was THE least volatile by one measure – for the 404 trading days through the beginning of February, the market never had a five percent correction – the longest streak on record.[1]

The streak has ended. From the end of January through Friday, February 9, the S&P 500 lost just over 7%. (From the January high through the low on Friday, the correction was more than 10%.) Given the length of the proceeding period of calm, the modest move lower felt violent to many. In reality, the index closed February 9 at 2,620, just 54 points (2%) below its 2017 year-end close.

Why the sudden increase in volatility and correction in equity prices? Barron's summed up the consensus in their February 10 cover story, "Seat Belts Fastened: Volatility Ahead:"

> A fast and vertiginous drop in February points to a material change in investor psychology, to cautious from enthusiastic. Where previously rising interest rates were acceptable because of strong global growth, now investors are focused on the potential inflationary threat from such growth.

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[1] https://www.barrons.com/articles/seat-belts-fastened-volatility-ahead-1518237935?

> The underlying concern is that rising prices could cause the Federal Reserve to tighten monetary policy faster than the market is anticipating. There is also a new unknown factor: Fed chair Jerome Powell, who was sworn in Feb. 5.[2]

Layer on concerns about risk-parity, machine trading, and all of the short-volatility funds that have developed over the past few years and a satisfying narrative emerges. Humans hate uncertainty and are thus excellent at developing explanations. Yet, even though the narrative seems credible, recall Mark Twain's notice – do not try too hard to find a motive, moral, or plot. Rather than concocting a story that explains recent market action, it is better to look at the setting (prices and fundamentals) where our story unfolds.

Remember, as we have pointed out numerous times in past letters, this is one of the most expensive stock markets in recorded history. As of December 31, 2017 (with the S&P 500 within a few percent of its current price), GMO forecast -4.7% annual real return for large capitalization US stocks for the next seven years.[3] Unfortunately, there are few places to hide. From a valuation perspective, only emerging market equities and debt offer the likelihood of (modest) positive real returns. At the end of the day, THAT (valuation) will be the primary driver of any meaningful correction. Like the Mississippi river for Twain's Huck Finn, valuations are carved deep into the environmental backdrop for today's investors.

**The Grey Owl Strategy (Revisted[4])**

If you believe the analysis that nearly every global asset class is set up for the worst prospective returns in history, the natural question is how can one earn any positive absolute return in the short-term without putting principal at risk long-term? Here is our approach:

1. **Don't be binary (yet).** While we are keenly aware of asset class valuations, we recognize that the current cycle could continue for some time. (Jeremy Grantham of GMO makes a plausible argument for a significant, blow-off rally.[5]) Valuation matters in the long-run, but sentiment matters far more in the short-run. Thus, we are not fully invested, but we are not fully in cash either. This also means recognizing investment factors other than valuation (e.g. momentum) have relevance. We are actively working on how and when to incorporate "momentum" into our process, so that a value focus does not leave a portfolio out of phase for too long. Still, should credit spreads widen, breadth

[2] Ibid.
[3] https://www.gmo.com/docs/default-source/research-and-commentary/strategies/asset-class-forecasts/gmo-7-year-asset-class-forecast-(4q2017).pdf?
[4] Borrowed heavily from our second quarter 2017 commentary.
[5] https://www.gmo.com/docs/default-source/research-and-commentary/strategies/asset-allocation/viewpoints---bracing-yourself-for-a-possible-near-term-melt-up.pdf?sfvrsn=4

significantly narrow, and indices break below ten-month moving averages we will move to become meaningfully more defensive.

2. **All Weather.** Building on point one, the "all weather" philosophy seeks to own assets that do well in distinct environments. We want to have some exposure to risky assets that do well in growth environments (equities), recessions (Treasury bonds), stagflation (gold), and inflation (commodities and emerging market equities). And, while all (or most) asset classes may be expensive, the all weather approach can add value when some assets "zig" and other assets "zag." For example, historically equity corrections have typically been accompanied by Treasury bond rallies. In the case where inflation and rising yields are the cause of rising rates AND an equity correction (what investors seem to fear most now), inflation hedges such as gold and commodities should act as portfolio ballasts.

3. **Individual security selection.** We do not have to own the index, and so we don't. We have built a portfolio of securities that we believe offers reasonable to excellent prospective returns. We also recognize that in the current environment where almost every security is elevated in price there is a far higher risk that cheap securities are more likely value traps than value. Despite the want (need) to be invested, extra caution is necessary. And, we recognize that in market corrections cheap securities go down too. (See points two and four for risk mitigation on that front). Finally, it is worth noting that if we do have a "blow-off" rally as Mr. Grantham suspects, the market will likely get more narrow and the "hot" stocks will do best – a challenge to our process for sure (and something that momentum could help balance).

4. **Watch investor sentiment.** Valuation matters in the long-run, investor sentiment matters far more in the short-run. Today, market breadth and credit spreads (two gauges of investor sentiment) still signal investors' willingness to take risk (even after the February correction and increase in volatility). This keeps us more invested than we otherwise would be if only considering valuation. Over the past year or so, we have become far more sensitive to this factor and continue to work on both the degree and timing of further incorporating it into our process and portfolio construction.

Big picture items like economics, asset class valuations, and investor sentiment really do matter. The economic and market landscape is probably as relevant today as it ever has been. We do not know the plot the story will take, but we do know the setting and it is potentially dangerous.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

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Sincerely,

*Grey Owl Capital Management*

Grey Owl Capital Management, LLC

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