



Is the Fed Your Friend, or Foe ?

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One principle of economics is that what works well for the individual isn't necessarily what works for the group, and vice versa.

Here's an example.

The 'Paradox of Thrift'. If a family finds their monthly expenses exceed their income, one smart way to respond is to reduce spending. But if many or all families do this their country's economy will suffer, perhaps collapse.

Expand this to today's United States. The financial status of the average American family is far from sound. Net worth's are down from 2007, income hasn't grown much for decades, credit card debt is near 2008's high, 62 % of households have less than \$ 1,000 in the bank and, ready for this, 30 % have no savings at all !

As a frugal person who has counseled finances for 31 years, my first advice to these folks would be to stop spending and start saving. Let's stop for a moment, I don't want to sound like Marie Antoinette. My wife and I are fortunate and in pretty good financial shape. But there was a time a few decades ago, I can recall it vividly, when we too had little to nothing saved (and three

minor children). So I don't mean to lecture those families who are struggling mightily just to 'get by'. But one thing we did was follow a time-tested strategy, we lived within our means.

The point here is not about the financial discipline of the average American, it is about the Federal Reserve Bank's strategy: Because they believe it will increase GDP, the Fed is encouraging families to borrow and spend, and don't seem to care that it may be contrary to those families' financial future.

A couple of points. I believe the Paradox of Thrift is accurate in the short - term. If the majority of American's stop buying new homes, new cars, etc. our economy will suffer and un-employment will increase. This sort of decline can be deflationary and spiral into a depression. While I am no fan of the group-thinking economists at the Fed, I believe they are smart enough to see this possibility. Better than their tepid public comments, it explains their willingness to take the extraordinary steps they have.

In the long-term, however, I believe the Paradox of Thrift is wrong. It is not possible, it seems to me, for the majority of citizens in a country to

over-in-debt themselves to support the whole without materially weakening that whole.

The U.S. and the world are awash in debt, the highest ever in both absolute and relative terms. Yet the highly-educated economists who control Central Banks believe the solution is to borrow even more.

A suggestion. Do not let the Fed dictate what you do with your money. The best path towards a secure financial future for your family is to save, not spend. Live within your means. Do not buy things just because interest rates are low.

Likewise, investors should be wary. The Fed wants asset prices to rise (inflation). That occurs when people, frustrated by earning little in the bank, take money out and buy assets they believe have better prospects. After years of low interest rates it is likely most investments are fully priced, with more downside than up.

I know they mean well, but I don't think the Fed is my friend, or yours...

Brexit and Broken Promises

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The 2nd quarter ended with dramatic worldwide capital market volatility in response to the UK referendum vote in favor of leaving the EU, aka Brexit. Concerns over numerous Eurozone problems were greatly heightened by the Brits' decision to reject Brussels' directives re. trade and immigration policies. This may well mark the beginning of the end for the post-WWII European project to integrate the continent as a single economic & currency zone. After 17 years of the euro, to have the economies of France, Spain, Italy and Greece (which adopted the currency in 2001) in long-term stagnation is a devastating failure. Youth unemployment in Spain is running around 45 percent, in Italy around 37 percent. About Greece the less said the better. Monetary union without fiscal union & uniform cross-border banking systems doesn't work. Was the United States of Europe ever going to happen? Probably not, even before the Syrian refugee crisis and ISIS attacks put a fork in it.

We'll likely see more referendums & elections in France, the Netherlands and elsewhere where nationalists push to take back control of their domestic economies & borders. Faith in supranational entities such as the EU, ECB & IMF to ensure stability and growth is clearly on the decline.

The U.S. version of Brexit is epitomized in different ways by both Sanders' & Trump's political success with very different constituencies. "Financialization" of the economy – the replacement of equity & capital investment with debt – is the result of years of M&A and stock buybacks funded by ever larger amounts of ever cheaper credit. Without more productivity, wages stagnate and it's easy to blame greedy companies (and their Wall St. accomplices) for exporting jobs to cheap foreign labor, or immigrants (legal or otherwise) coming here to work for less. When did we begin to think of our homes as investments & retirement assets instead of residences? After we built an economic &

political system that encourages & subsidizes debt, while penalizing income & savings. Central banks have greatly contributed to income & wealth inequality that is causing populist uprisings across Europe & in the USA. Claims that globalization and trade would create broad prosperity for all have proven false to many. Politicians of all parties produce little legislation to foster positive structural reform with all of this cheap money, while working overtime to demonize opponents. The possibility of failure to deliver promised health care & retirement benefits to broad swaths of the public is a real and growing risk.

Gold and silver are again doing very well this year for the first time since all-time highs were reached in 2011; miners of precious metals even better. An increasing portion of global sovereign debt outside of the U.S. trades at negative int. rates as the ECB, BoJ and other central banks continue their misguided QE policies with no end in sight. Brexit added another reason for our Fed to delay any further rate hikes for the foreseeable future, which reduces the allure of US\$ investments to frightened foreign investors. This makes gold glitter all the more relative to other options tied to fiat currencies. Fiat = govt. decree that something has value. We promise.

Usually We Don't like Gold... BUT

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We have said it for many years; we are not gold-bugs, and don't generally find much investment value in the metal. Gold has little industrial purpose and doesn't pay dividends or interest. Its main attraction is its rarity, sturdiness, and how it looks on our fingers, wrists and necks when displayed during an evening out with friends. For these reasons, long before countries created their own currencies, gold was a much used medium of exchange for purchasing power across the world.

You may be confused and assume we do not hold gold inside our clients' accounts. You would be wrong. In 'normal' times we find little value in owning gold as an investment, but these times are not normal. History teaches that investors worldwide use gold as an insurance policy against out of control currencies, like today's global economic environment where countries fight to make their money worth less than others (seems backwards, but that's a whole other conversation).

As more investors realize the need to protect their purchasing power, gold has come out of the shadows as a traditional way to do this. Since the end of 2015 gold performed very well, up some 25 %. Many gold mining company stock prices more than doubled. If Central Banks continue their unprecedented stimulus (as we suspect) we believe more large investment institutions will embrace gold for the large client accounts they are hired to protect. Gold is rare and expensive to extract. If demand increases substantially miners will be unable to keep pace. In those conditions the price may soar.

If you have thought about using gold to insure the value of your holdings, or have questions about what percentage is prudent, etc. please feel free to give me a call, there are lots of options. Today's investment environment is anything but normal. Gold can protect in times of uncertainty, and today things are 'certainly uncertain'.

Timely Comments from Successful Investors

Bill Gross. Bond Manager.

" The U.S. Government has outstanding debt of approximately \$ 16 Trillion, or close to 100 % of GDP. The present value, however, of Medicaid (\$35T), Medicare (\$23T), and Social Security (\$8T) promised under existing programs totals \$ 66 Trillion or another 400 % of GDP. "

Lacy Hunt. Economist.

" By definition, government spending adds to GDP, no matter how ridiculous the expenditure. If the government paid people to spit at the moon, it would add to GDP. But the long term consequences of such ridiculousness should be obvious. Japan is proof enough. The country has nothing but massive amounts of debt and slow growth to show for decades of building bridges to nowhere. "

James Gipson. From his 1984 book, " Winning The Investment Game ".

" Moderate government spending was a blessing for the economy, but moderation was not a virtue shared by Keynesians and liberal politicians. Only when the economy was careening out of control did economists note that the Keynesian's drivers' manual pointed only to the accelerator, not the brake. That fatal lack of symmetry plunged the economy into the inflationary 1970's. "

Bob Rodriguez

“80 Year Tsunami”

William Mason CFA

On June 5, I met with Bob Rodriguez. Bob is the President of First Pacific Advisors (FPA).

I have known Bob Rodriguez personally since 1985. In recent years Bob has been very pessimistic. That is not Bob's nature. He is usually very optimistic and usually has been a buyer of stocks – the cheap, bargain type.

During the 25 years he managed FPA Capital it was the best performing stock mutual fund. There were none better.

Prior to working at FPA, Bob managed investment portfolios for a couple of major insurance companies. While at Transamerica, Bob took the company's portfolio deeply into financial services stocks in 1974 after the major stock market decline of 1973-1974. They owned 17% of E.F. Hutton and a host of other financials such as Dean Witter and Merrill Lynch. In 1981, while at Sun America he argued for and got the go ahead to invest a larger portion of the portfolio in common stocks. He took the portfolio from 5% stock to 30% stock. 1981 was essentially the mirror opposite of today. Interests were high and stock valuations were very low. In addition, economic growth for the prior decade had been very good instead of pathetic like now. Insurance companies typically invest their portfolios in bonds. As interest rates rose during the 1970's the portfolios of many of these insurance companies were suffering because bond prices go down as interest rates increase. At the time, Moody's called Bob a “capricious risk taker.” Within two years the Sun America portfolio was made whole again.

So you know, price/sales is now at an all-time high and price/earnings is the second highest in history - while corporate earnings are going down.

Comments

If you like bargain stocks – this is not your market. The

following are some key comments Bob made to me.

“I own zero stocks directly, that is the first time since 1971.” (He does have some money in the FPA funds.)

“20% of my net worth is in numismatic coins.” (Bob has been a collector since he was a kid and apparently his coins will be displayed at the Smithsonian. Bob's father made jewelry.)

“I don't write anything anymore for the company (FPA) because I'm too negative.” (The curse of a value investor in an overpriced bubble market.)

“We are on the verge of an 80 year tsunami. If you loved 07-09 you're going to love the sequel.” (By 80 year tsunami he meant a once in every 80 year event.)

In regard to the financial markets they are “totally out of control.”

If this goes... “Not if, it will.”

“I absolutely hate the equity and fixed income market. I have never been more negative of the capital markets.”

Bob has always had a valuation screen that he uses. It classifies stocks based on items such as P/E ratio, Price/Sales ratio and EBITDA multiples. In 2007 it got to a low of 40. In March 2009 it was about 450.

“This is now a new all-time low for the valuation model.

“Productivity growth is near non-existent. Productivity growth is the seed corn for economic growth.

“Consumption is going up primarily due to healthcare. Healthcare accounts for over 50% of the growth in consumption.

“There is a transfer of wealth from the responsible to the irresponsible.

“The prevailing attitude now is close your eyes and keep the blinders on.

“I said 2016 would be a very challenging year. The \$64,000 question is what happens in the second half? The second half will be weaker than expected going into 2017. You will hear ‘Fiscal Policy.’ Deficits and spending will rise.”

Jokingly he said with an aristocratic voice: “We're a Plantain Republic not a Banana Republic.

“We are destroying all elements of financial discipline.”

Bob is one of a list of remarkable investors warning about the current market environment. The list includes Jim Rogers, Stanley Druckenmiller, Bill Gross, Fred Hickey, Bill Fleckenstein, Jeff Gundlach, Carl Icahn and Sam Zell.

Beware.

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