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JUNE 2018 INVESTMENT COMMENTARY

TWITTER SPATS, PUFFERY AND BLUSTER CAPTURE OUR ATTENTION
THIS DRAMA DISTRACTS FROM VERY REAL RISKS THAT INVESTORS IGNORE AT THEIR PERIL

I am going to begin this month's commentary by providing a short summarization of what I feel about both the economy and capital markets.

> *Following the financial crisis of 2008-09, the U.S. economy exhibited a recovery that was slower than most hoped. This slow and steady recovery process occurred concurrently with a strong bull market in stocks which resulted in the broad U.S. stock market indexes rising well over 100%. This remarkable bull market in stocks was very unloved, and many market participants conflated slower than "normal" economic growth with higher than "normal" risk. The Federal Reserve signaled the end of the recovery period with the first increase in the Fed Funds Rate in December 2015. Over the last two and half years the Federal Reserve has been on a path to "normalizing" interest rates. This process of "normalization" is not yet complete. However, the economy appears to have substantially recovered from the shock of the financial crisis. As a result of the late 2017 tax cut legislation, the economy has begun to show signs that this substantial fiscal stimulus is paying modest dividends regarding increased economic growth. The expectation of higher economic growth, after almost a decade of below-trend growth, has boosted investor sentiment regarding prospects for the economy and equity markets. Just as market participants incorrectly conflated a slow recovery in the economy with higher risk, I believe that market participants today are incorrectly conflating today's higher economic growth with a lower risk environment*.

The American Association of Individual Investors (AAII) tracks individual investor sentiment. AAII reported on June 8, 2018, its latest reading of individual investor sentiment that "bullish sentiment rose to its highest level since February, and is above its historical average for just the second time in fifteen months.

The month of May turned out to be a relatively good month for the broad U.S. equity market as represented by the S & P 500 Index. The S & P 500 index advanced 2.41% for the month. May's strong performance brought the year-to-date total return for the S & P 500 Index to just 2.02%. After a very strong one month start to the year in January and a ten percent correction in early February, the broad U.S. equity markets had been trading sideways in a very narrow range through the end of April.

Of course, the debate now turns to whether or not May is the beginning of a new uptrend for the broad markets or simply an up month within the sideways trend that has been in place since March. As I indicated above, I see reason to be cautious, and I have begun to prepare for less hospitable markets in the near to intermediate future.

Over the last 18 months, the U.S. equity markets have

been attempting to process unprecedented economic policy inconsistency emanating from the White House. This inconsistency has made it impossible for market participants to forecast factors such as U.S. Dollar strength, the future of foundational trading relationships, and intermediate to long-term economic growth. In spite of this, the 2017 tax cut legislation appears to be having a modest positive impact on U.S. economic growth in spite of a weak first quarter to start 2018. Second quarter forecasts for annualized Real U.S. GDP growth are currently in a range between mid-3% and low 4%. If second-quarter GDP comes in, after revisions, at or above 4%, this will mean that the first half of 2018 annualized Real GDP growth will exceed 3%. If that growth can be sustained for the second half of 2018, this would mark the first calendar year of 3% or better GDP growth since the mid-2000's.

I remain skeptical that both global and U.S. economic growth will accelerate much from the current 2.50% to 3.0% range for the following reasons:

- Continued trade disputes and uncertainty surrounding NAFTA.
- The sharp increase in deficit spending caused by the tax cut legislation, which will not stimulate sustainable economic growth without a corresponding increase in "Thin Air Credit.", which is credit created through Federal Reserve chartered banks. (without an increase in "Thin Air Credit," the increased issuance of U.S. government debt, which must be purchased by individual and institutional investors, will actually reduce investment in risk assets or productivity enhancing investment)
- Higher interest rates and the elimination of quantitative easing by the Federal Reserve has created a monetary policy headwind for economic growth.
- U.S. economic productivity continues to grow at a very anemic pace.
- The U.S. labor pool was already tight before the tax cut legislation was passed and this large fiscal stimulus only makes those labor shortage more acute.
- Trump era immigration policy is not only reducing illegal immigration, but the perception created by the harsh rhetoric and new stringent policies are reducing legal immigration and tourism.

I concede that it is possible that I will be wrong and economic growth will shift from a 2-3% range that has been the trend over the last eight year s to a 2.5-3.5% range. There is a good argument that the U.S. economy could grow in excess of 3.0% temporarily as a result of the effects of the tax cut legislation that became law in 2018. It seems likely that a 14% cut in the corporate tax rate and the strong incentives for increased capital investments that were written into this legislation will temporarily boost economic activity by pulling future economic activity forward. In manufacturing, this would be called "stuffing the channel." In layman's terms, it means that tax savings end up burning a hole in the pocket of consumers and corporate managers, which motivates spending today that otherwise would have occurred in the future.

Former Fed Chairman Ben Bernanke spoke about this risk recently. In a CNNMoney article titled Ben Bernanke warns this is a Wile E. Coyote economy, published on June 10th, former Chairman Bernanke was quoted from his recent remarks at an American Enterprise Institute. The article stated that the former Federal Reserve chief "questions the wisdom of Congress for waiting until the economy looked healthy and then hitting the gas with massive corporate tax cuts and a burst of spending. Bernanke himself stated "what you're getting is stimulus at the very wrong moment," The article went on to quote Bernanke regarding what he fears could happen as a result. Bernanke said, "It's going to hit the economy in a big way this year and next and then in 2020, Wile E. Coyote is going to go off the cliff and look down." This forecast from the Fed Chairman who engineered a remarkable recovery from an "almost Depression" in 2008-09 and then a smooth landing after massive monetary stimulus under his watch cannot be ignored. However, we must take all forecasts, no matter who formulates them, with a grain of salt, particularly relating to exact timing and duration.

The big unknown is how much of the tax cut's fiscal stimulus will be offset by the aforementioned policy uncertainty, more restrictive monetary policy, and anti-economic growth effects of hostile immigration rhetoric and more restrictive visa and legal immigration policies will offset what should be a temporary boost to economic growth. A Bloomberg article published April 3, 2018, titled Foreign Visa's Plunge Under Trump looked at various immigration and visa issuance trends which show a noteworthy drop off in people visiting the U.S. since President Trump took office. The article stated "evidence plainly indicates that Trump's desire to restrict foreigners' access to the U.S. has become a reality. Critics say that, by imposing new procedural and security hurdles, Trump and his aides are building a figurative wall to keep people out of America, even those who just want to come for a brief visit. The critics fear the drop in visas could damage industries, ranging from tourism to higher education." Tourism, education, and work visas are an important factor in our country's ongoing economic vibrancy. The Bloomberg article showed that "for fiscal year (2016), the U.S. granted an average of 865,124 visas worldwide per month. But, from March 2017 to February 2018, the U.S. granted 754,479 visitor visas worldwide per month — a 13 percent drop." This drop in visa issuance encompasses work, tourism, and student visas. A reduction in work visas has a direct impact on the ability of businesses to fill needed positions during a time of increasing economic growth and a very tight domestic job market.

A drop in the number of international students seeking higher education opportunities in the U.S. both hurts the finances of domestic universities, as these students are full tuition cash payers, and the inability to attract the best and brightest from around the world will have consequences in the future. Many of our most successful information age U.S. companies were founded either by children of immigrants or non-citizens who studied here on student visas and later decided to stay and apply for citizenship. Lastly, a drop in tourist visas has an adverse impact on both economic growth and employment. The aforementioned Bloomberg article wrote about the drop in tourism subsequent to President Trump's election, saying "tourism spending in the United States has also fallen under Trump, according to Commerce Department data analyzed by the U.S. Travel Association. Travelers spent 3.3 percent less from January 2017 to the end of November 2017 compared with the same period a year earlier, which the travel association equated to a loss of $4.6 billion and 40,000 jobs." This occurred during a period of improved economic growth here and around the world.

It is not unusual that a Seven Summits Capital actively managed client equity portfolio deviates from the broad market over short and intermediate time horizons. This normal deviation occurs because our investment time horizon is long-term and fundamentally driven compared to a market that has become dominated by short-termism and momentum strategies. Furthermore, the metrics of market composition does not inform our security selection. Instead, we are driven by value considerations, special situations, and a contrarian bent. As previously mentioned, May turned out to be a good month for the broad U.S. equity markets. For Seven Summits Capital client accounts, May and year-to-date performance has generally compared quite well to the relatively flat broad U.S. equity market. Several widely held equity positions have performed very well, particularly during May and, thus, year-to-date. Some noteworthy performers were Under Armor (up 26.98% May, 28.27% YTD), Macy's (up 14.06% May, 32.69% YTD), Moelis (up 11.12% May, 20.80% YTD), Square (up 26.69% May, 42.49% YTD) , Athersys (up 22.0% May, 26..42% YTD), and Tandem Diabetes (up 186.59% May, 309.04% YTD). Some of these equity investments, such as Under Armor and Macy's were added to accounts last year when they were very attractive out-of-favor value opportunities created by too much pessimism surrounding the retail sector. Others, such as Moelis and Square were fast-growing companies in their respective sectors, but their growth was not being fully recognized relative to other much larger and more recognizable peers. Lastly, Athersys and Tandem Diabetes represented smaller allocations to longer held speculative growth companies

in which I had maintained a high long-term conviction. These types of companies fly under the radar of most investors. These types of more speculative investments require a deep understanding of the companies; their strategies, and competitive position. Most importantly, to be best positioned to reap the potential substantial rewards of owning such investments, a high conviction level and a lot of patience is required. As a former equity analyst who worked for a highly regarded small-cap growth mutual fund manager, I have found that a small allocation to these types of companies within an otherwise moderate risk equity portfolio can pay off over the long-term. The challenge for most investors is to maintain a high conviction level in the face of what can be very volatile and confusing stocks at times.

I have had the opportunity over the last couple weeks of talking with quite a few clients, and prospective clients regarding the advantages of an actively managed individual security portfolio process. I mentioned in the commentaries earlier in the year that I felt that the period of being able to blindly throw money at the broad equities markets and be rewarded has passed for this cycle. I was beginning to see the unusually high equity correlations and macro driven sector rotations that characterized the broad U.S. equity markets over the last several years begin to break down. I could see that investment capital was beginning to discriminate within the markets and reward fundamental metrics such as valuation, organic growth, and strong returns of investment capital.

I am certainly open to the idea that these more fundamentally driven markets will continue and that we may see stronger economic growth as the year progresses. However, I am actively looking for opportunities to selectively take profits and allocate some or all of those proceeds to less equity market investments as we move through the end of the year and into early 2019.

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