Financial Markets Investor Road Map

Patrick Adams CFA

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Abstract

The purpose of this paper is to provide investors and financial advisors a review of the current investment environment, an analysis of where the markets may be headed by comparing to other similar economic periods, accessing the risks and rewards, and formulating a clear path for investors. We examine the previous 10 years and how the next 5 to 10 years will likely look completely different. The expected returns of all traditional asset classes look uninspiring. We propose a conservative but non-traditional asset allocation that still maintains attractive return potential, yet provides low risk even given the high valuations of the equity markets and low yields in the bond market.

Patrick Adams CFA

PVG Asset Management Corp

6898 S. University Blvd

Centennial, CO

80122

info@pvgasset.com

www.pvgassetmanagement.com

Roadmap

Introduction

What should an investor be doing now after a 10-year bull market. The road map for the market over the next 10 years or even 5 years will very likely look completely different than the previous. Investors should take a lower risk path to maximize returns. First, in this paper we want to discuss the current fundamentals and valuations of the market and assess the risks to the economy and financial markets. Second, we give some suggestions for investors to consider in how to allocate assets given the obvious risks, to take advantage of the opportunities in the market, and to implement certain strategies that perform uniquely well in this current environment.

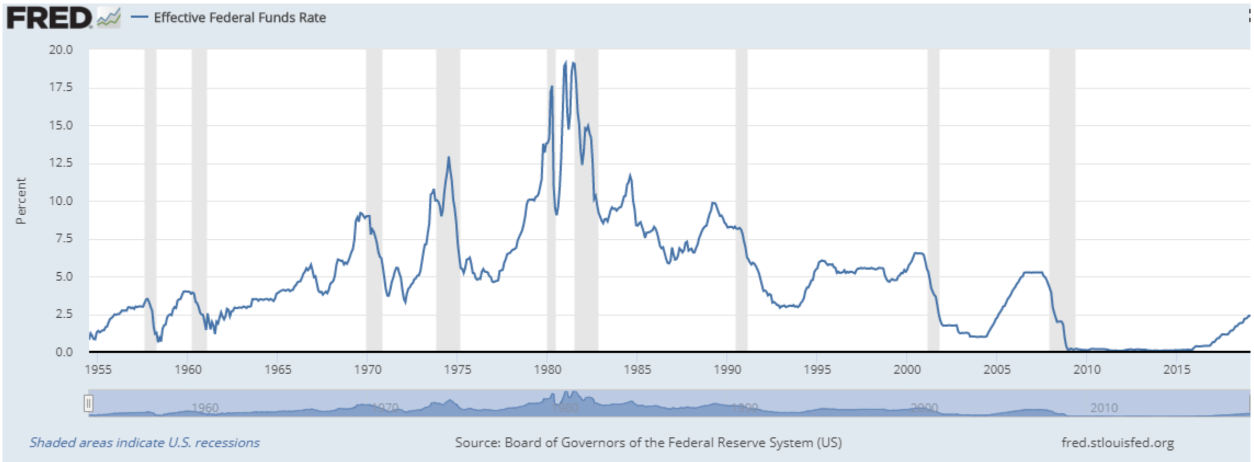
Economic Outlook and Financial Market Assessment

The Federal Reserve and other global central banks put the pedal to the metal in the most aggressive easing cycle in terms of magnitude and duration in history. We estimate around $14 trillion in total from the start of 2008 has been put into the financial markets from the Federal Reserve, European Central Bank, Bank of Japan, and the Peoples Bank of China. It has been a truly remarkable event globally, which has caused $13 trillion of bonds to have negative yields. What rational person would invest in negative yielding bonds? In the stock market there is a new category which is called "growth at any cost". Much like the ultra-paranoia of the bond market there are growth investors that will pay any valuation for certain "predictable" growth companies. These stocks are as richly valued as the stocks during the technology bubble of the 1990's. Again, why would you pay over 20 times revenues, not earnings, for a stock when perhaps the normal valuation for the predictable growth stocks of the software sector are historically only around 5 times revenues? Money must find a home. Money managers and investors are only human and do what they believe "feels" right. There is no question that there are clear excesses in both the stock and bond market.

The 10-Year U.S. Treasury Note is currently around 2% which is lower than yields during the Great Depress and not much higher than the recent lows. Inflation expectations are low, with 1.5% inflation, leaving little real return for bond investors. The price to earnings ratio for the S&P 500 on 2019 earnings expectations is around 18 times, if you adjust for the lower tax rates the multiple is about 20 times earnings (top 95 percentile). The stock market valuation is not at an all-time high, but it is clearly for pre-recessionary periods way at the upper end of the range, except for only the year 2000. The big difference between now and the 1990s, earnings growth was very strong in the 90s, this cycle has been on the disappointing side in terms of the rate of economic growth. S&P 500 earnings growth is currently tracking about flat for 2019. An investor will have a hard time getting a decent return in the bond market unless perhaps you stretch in terms of the credit quality where the risks are much higher. The stock market is loaded with risk. It is interesting that the stock market is very richly valued, "growth" stocks are very richly valued but the "value" is very attractively valued.

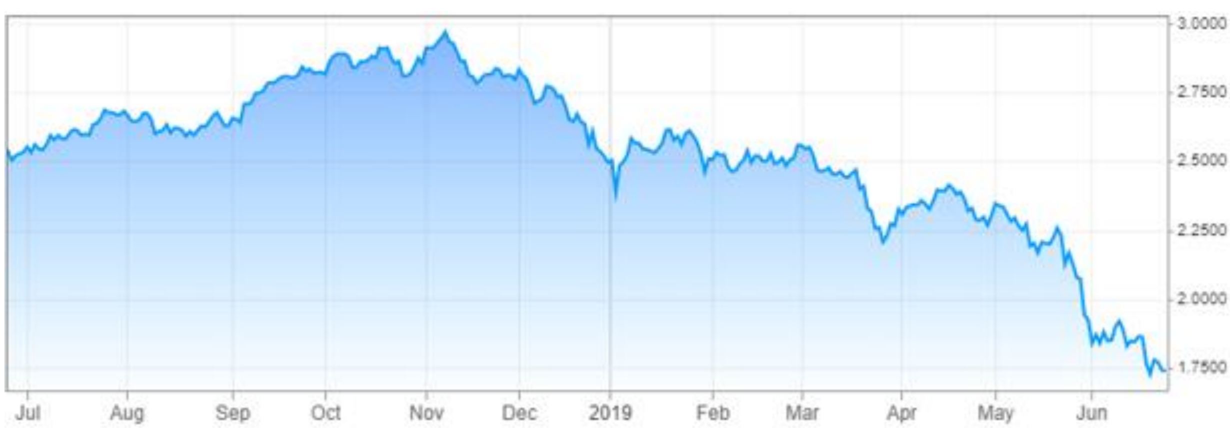
The market has been very concerned about the Federal Reserve raising interest rates 9 times from the bottom. Markets and the economy adjust to a level of interest rates which occurs during all economic cycles when the Fed opens the liquidity spickets. The economy can only withstand so many rate increases. You can see from the chart of the Fed Funds rate below that the rate stayed at around 0% for 7 years, never this low for this long.

Federal Funds Rate and Recessions Since 1955



There has been a dramatic shift in sentiment in the bond markets regarding economic growth and inflation. Clearly the Federal Reserve went too far in raising interest rates. In November 2018, the 2-Year U.S. Treasury Note was close to 3% and now well below 2%. The yield curve is inverted with the very short-end maturities, the overnight rate is much higher than longer-term maturities. An inverted yield curve has generally been an indicator with 100% reliability in predicting a recession, and consequently, a bear market. We shall see if the Federal Reserve cuts rates fast enough to relieve the inversion, and reinvigorate the economy.

2 Year Treasury Note



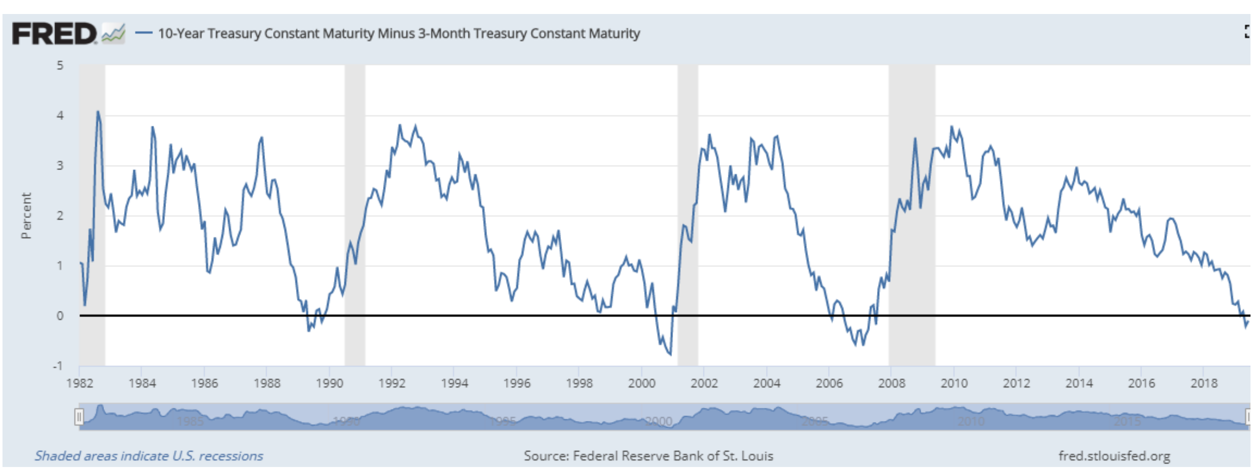
The last two bear markets have declined from high to low by over -50%, both had an inverted yield curve followed by recessions. We have had two major corrects during this past 10-year bull market in 2011 and 2018 that were very close to down -20%, thus close to the definition of a bear market. In both periods the market bounced back quickly and did not resemble a bear, where the market sentiment changes from euphoria to despondency for a significant period of time. We have observed a lot of complacency in the market, investors do not want to be bothered with changing their portfolios. Generally, the market will fix this issue and make investors react. Since 1926, the average bull market has lasted about 6.5 years. The average bear market lasts about 1.3 years and declines about -38%. We have no reason to believe the next bear market will not resemble some version of the last two bear markets, given the magnitude of the current bull. With the amount of liquidity, the global central banks have put into the system, it is understandable that this bull is lasting longer, as well as the business cycle.

Perhaps this bull will last longer if the Fed quickly cuts interest rates meaningfully this year, regardless there is a looming bear market out there, which could culminate from a multitude of reasons. Below is a proprietary PVG Asset Management chart showing the start of the 1990's bull market and bear market and this current bull market, which shows the cumulative returns from the start until the bottom of the bear for the 1990's bull and this current cycle. Cycles are never exactly the same, but our point is the market is on borrowed time. You can see that the current cycle is in a topping pattern. Perhaps it breaks out and keeps going, but we would be surprised to see that occur without some time passing and earnings reaccelerating. If this should occur, we believe the "value" sectors of the market would have to lead the advance. What is surprising is that this cycle has been stronger and lasted longer than the market cycle of the 1990's, which was never likely to occur again. In December 1999, the technology sector was about 30% of the S&P 500, which is about the same weighting as now if you put the "technology" type of communication stocks and Amazon into the technology sector. This is historically a very volatile sector and generally averages around 15% of the market, not a whopping 30%.

We are not intending to put a negative spin on the present conditions and realize the potential upside of the market may not be done yet, but investors need to be aware of the very significant risks. By investing in traditional strategies an investor needs to be willing to wait a significant period of time before getting their portfolio back to even should a bear market occur. What most investors cannot handle is seeing their assets evaporate during a bear market causing them to panic and sell at the bottom. If you are a retiree, or pre-retiree, sequence of returns is critical in your investment decisions. A 50% drop in value for a conservative investor would be devastating if they are pulling money from their investments for their support, or they intend to at a later date. Below is the PVG Loss Averse Equity Income strategy as an example of a conservative strategy that was up approximately 60% from Spetember of 2007 5 years later, while the overall market was flat over that 5 year period. If an investor was pulling 5% out per year the investor in the PVG strategy would have still significantly more than what he started with but much less for the investor that owned a more aggressive investment.

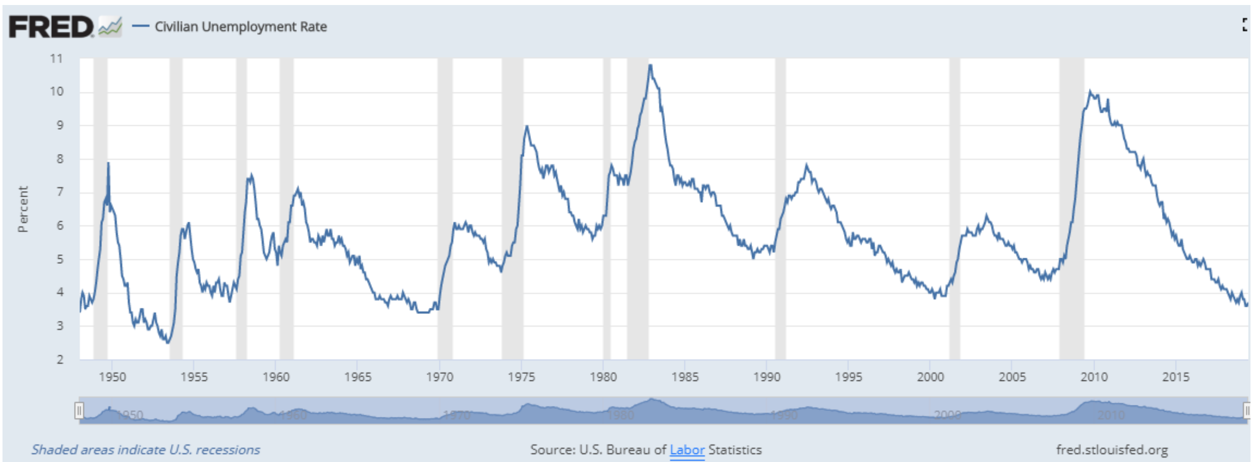
We believe strongly that the next 10 years will look nothing like the previous 10 years. The next 5 years could look like the 2000-2005 or 2007-2012, or something similar with a lot more volatility then what we have seen recently. The major fundamental issue is the inverted yield curve late in an economic cycle, which as you can see below is very similar to previous recessions/bear markets.

The Yield Curve—10-Year Treasury Yield Minus 3-Month T-Bill



Using fundamental analysis, based on similar periods in history, we will try to put some numbers around the path forward for the financial markets. The odds of a recession are perhaps high given that this is the longest economic cycle in history, the pent-up demand for goods and services has been largely satisfied over the past 10 years, the yield curve is inverted, many parts of the global economy are weak or in a recession, and lastly the trade issues both with China and then perhaps Europe will put increased stress on global growth. Low Unemployment is good, but it tends to not go down much from the current low levels, and consequently, then it tends to go back up rather quickly.

Unemployment Rate



A bear market, a recession, or both during the next 12 months or 2 years seems highly likely. From the high of the market to the low during September through December 2018 the S&P 500 was down just under -20%. With the remarkable pivot by the Fed the market turned back up. When the yield curve inverted in 2007 and the stock market topped it took 5 years for the S&P 500 to get back to even.

With the returns on bonds being very unattractive in the 2% range for the 10-Year U.S. Treasury makes no sense as an investment. If interest rates were to move up 1%, which could easily happen, it would cause a paper loss of over -30%. Otherwise, if an investor holds the bond and allows it to mature the return is a dismal 2%.

Asset Allocation

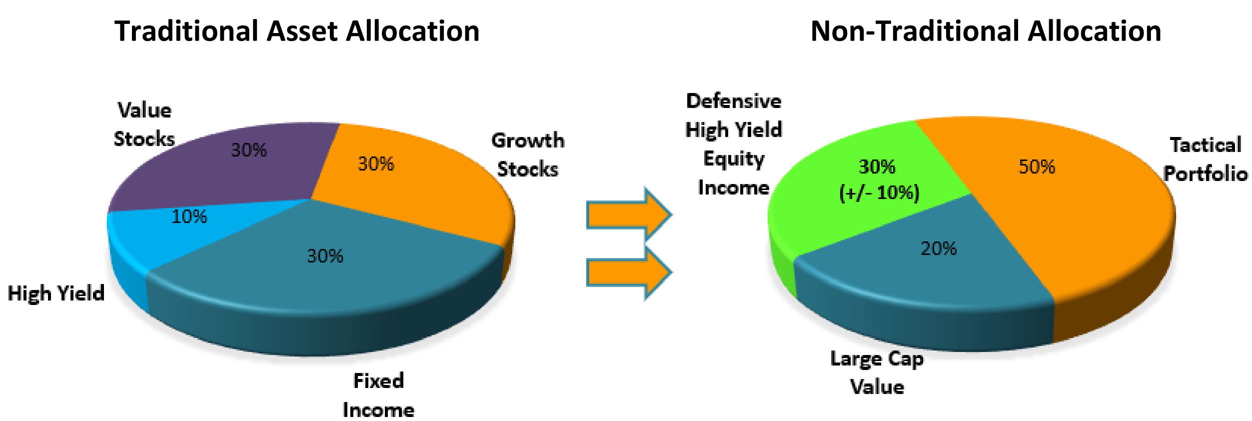
The big question, how to be positioned given the current fundamentals for both for the long-term, but also tactically, perhaps most importantly, for the next several years. It is difficult to argue that the stock market doesn't have considerable risk and the bond market has very limited return potential. It is most important now to diligently consider the downside risk for equities.

We have two compelling investment ideas for equities. First, tactical strategies that are only driven by technicals, and second, true value strategies. Tactical strategies, that do not focus on fundamentals, stay invested until the bear starts to occur, and once the market does start to roll-over then then these strategies become defensive. This way the tactical strategy stays invested as long as the bull continues. Tactical should be the core of a portfolio.

Second, value strategies have underperformed growth for about 12 years, which is the longest on record. Generally, growth or value will outperform one or the other for about a 6-year cycle. Value is set up to have significant out performance for multiple years when it occurs. We would expect during the next bear, or perhaps if there is another leg up for this bull, value should exhibit strong relative performance. Lastly, instead of using bonds in a portfolio it makes great sense to use a truly loss averse higher dividend paying, value oriented, equity income strategy.

From the chart on page 4 there is considerable risk in the markets, so investor need a plan, for both a continuation of the bull and its eventual end. Please see page 10 of the Appendix should the Fed cut rates enough to reinvigorate the economy.

Investors and advisors need to think outside the traditional stock/ bond portfolios given where we are in the financial cycle as the traditional asset classes are uninspiring on the surface. A traditional 60%/40% may not return positive returns under very reasonable assumptions during the next 3-5 years. As an example, if the stock market fell 40% a traditional balanced account would likely fall by over 20%. By reducing risk an investor maybe significantly increasing returns. A portfolio of lower risk strategies, based on their ability to protect in periods of falling markets, and investing in great long-term strategies opportunistically, should increase the expected return. Below, please see a traditional portfolio versus a non-traditional allocation, which is more suited for the current environment, but also for the long-term, for a moderately conservative and conservative investor. We expect the returns in a bear market would be far superior using the Non-Traditional Allocation.

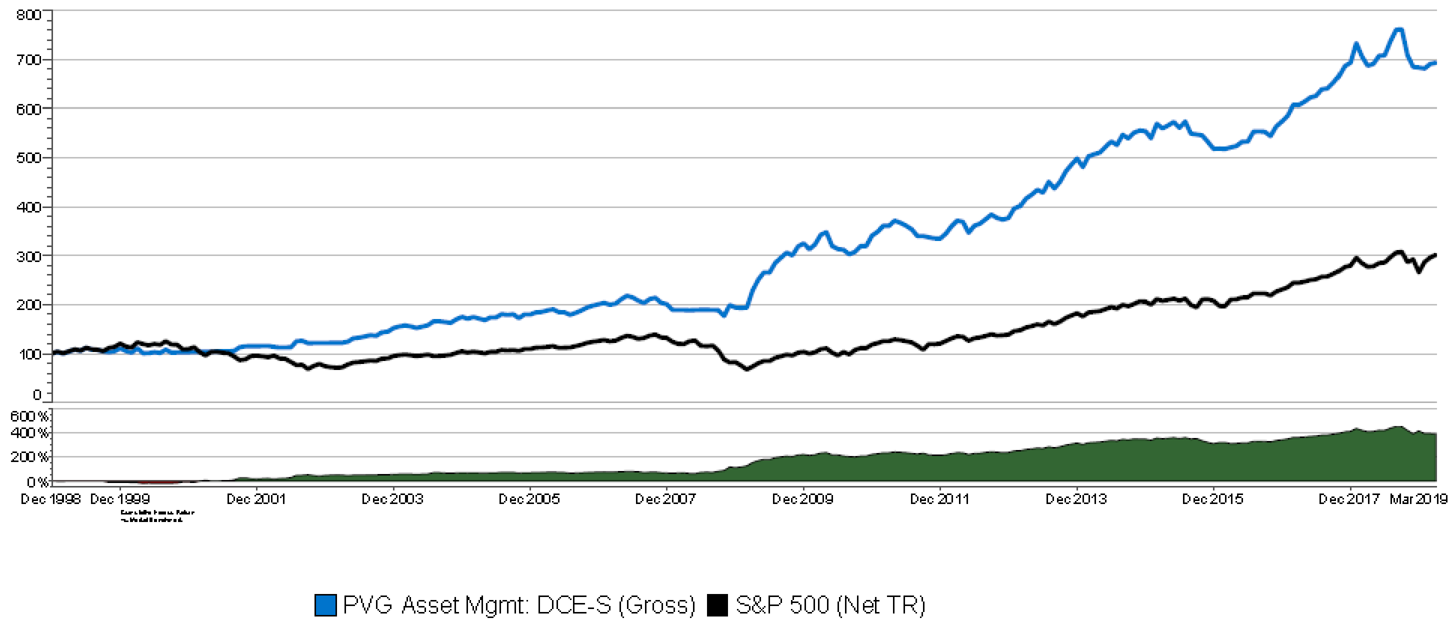


APPENDIX

Tactical Strategy

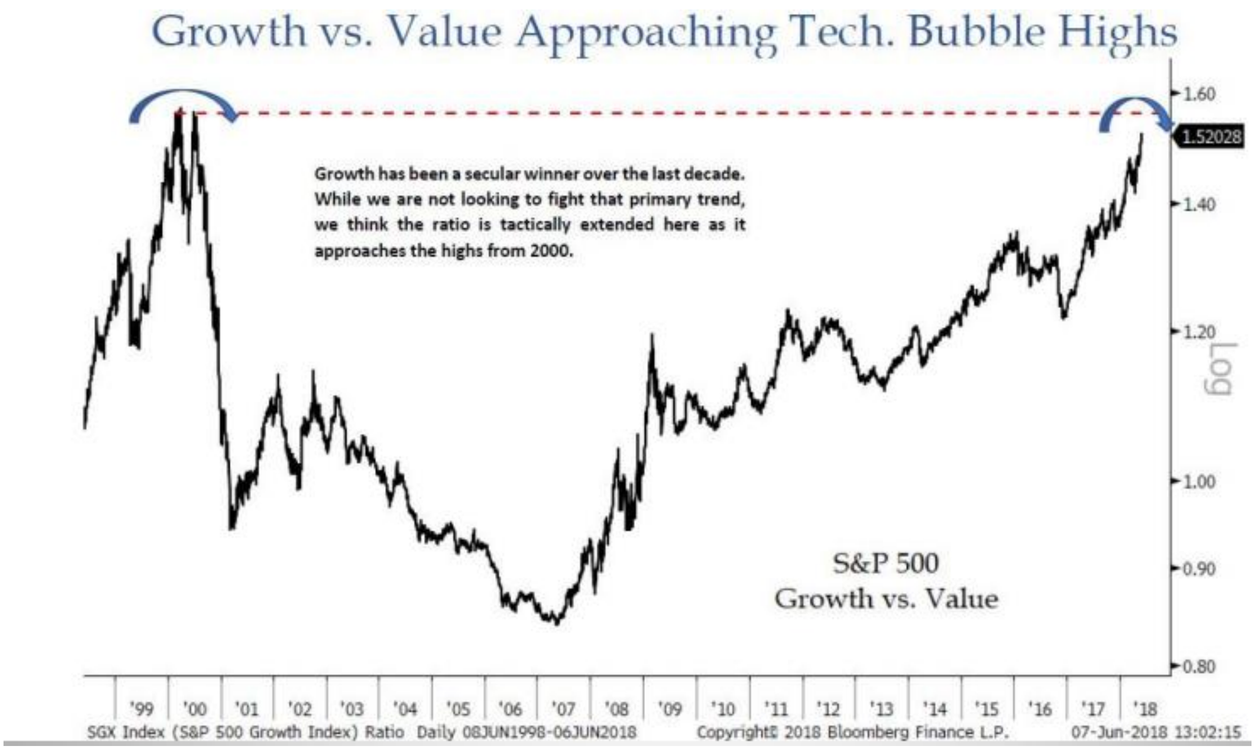
PVG Dynamic Core vs. S&P 500

Performance



	Portfolio Performance			vs. S&P 500 (Net TR)	
	Annualized Return (%)	Cumulative Return (%)	Std Dev (%)	Annualized Excess Return (%)	Cumulative Excess Return (%)
PVG Asset Mgmt: DCE-S (Gross)	10.03	593.13	11.22	4.43	391.33

Created with Zephyr StyleADVISOR. Manager returns supplied by: Informa Investment Solutions, Inc.(PSN)



- During the last year, value stocks have dramatically underperformed growth stocks.

- Value stocks are generally much more dependent on the economy, and this underperformance disparity tends to happen at the end of a bull market.

- Many value stocks also tend to be nice income producers as well.

Life Cyle of Different Sectors or Asset Classes

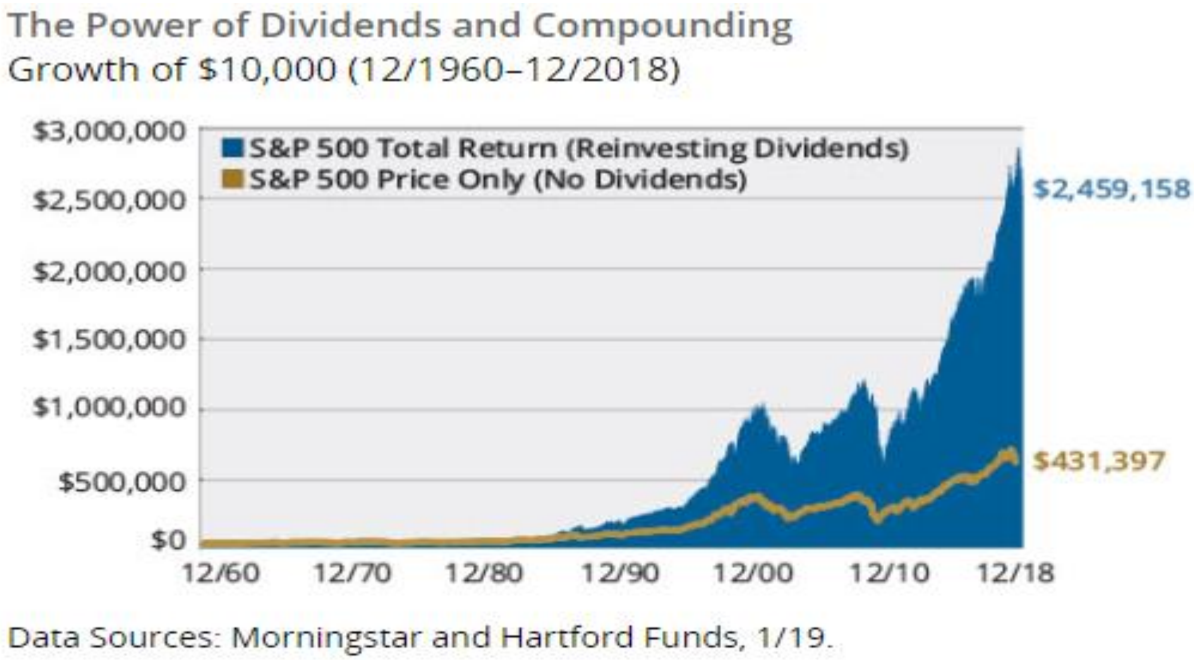
Below is an investment clock of the stock market, at 6 o'clock it is the bottom of the recession where smaller cap stocks, early cycle and value stocks begin to perform strongly, and at the end of an economic cyle, when the economy slows, from 12-3 o'clock is when defensive stocks, and predicatble growth outperform. This is where the market has been stuck for a number of years, creating excessiveness.

- Late in an economic cycle defensive sectors and growth outperform. Since 2013 when the Federal Reserve started to lay the groundwork to tighten monetary policy these sectors have seen significant outperformance, this is from 12-4 on the clock, but the market itself has been uncharacteristically strong.

- If the Federal Reserve cuts interest rates enough, the rate sensitive, value, early cycle, and small cap stocks will recharge and should outperform, 4-9 on the clock, and likely avoid a major decline in the stock market.

- If the Fed is unsuccussful in cutting rates enough to reinvigorate the economy then the economy will drift into a recession and investors will want to be very cautious in owning equities that do not have downside protection. A bear market should occur if rates don't come down enough.

Dividend Paying Stocks Should be Strong Performers



Higher dividend paying stocks are undervalued relative to the stock and bond market, thus could potentially go up in a bear market and the dividends cushion any decline. Owning dividend paying stocks is always a great long- term investment theme, and currently perhaps a very timely tactical idea.