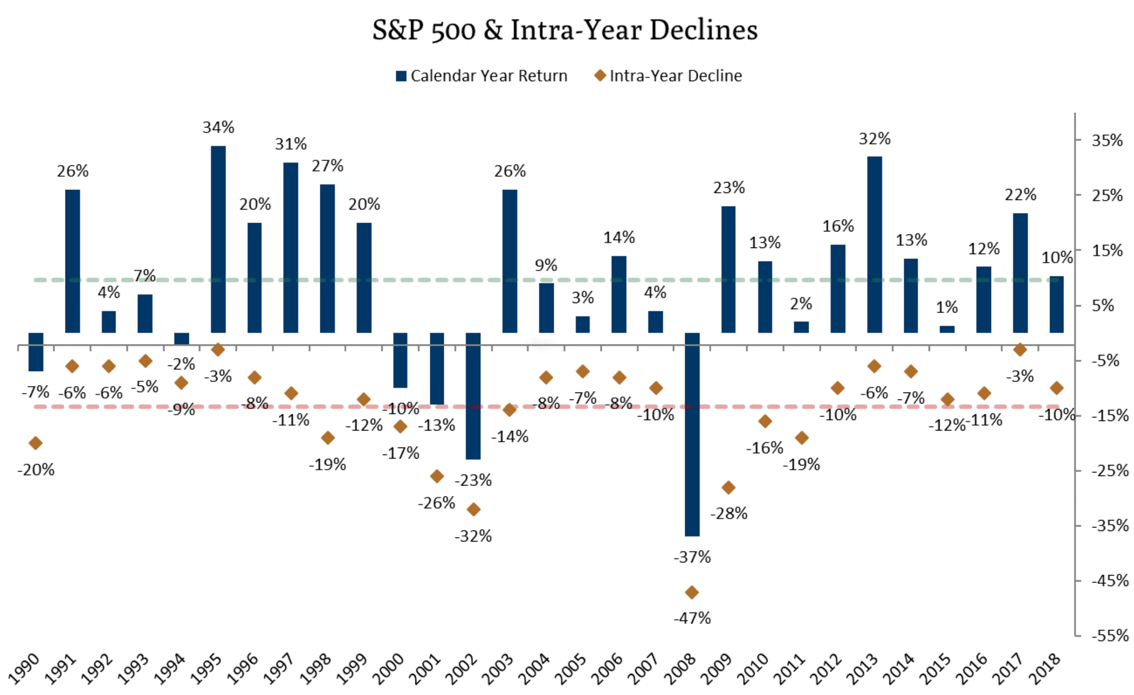
Storm Clouds

"The Federal Reserve's Gone Crazy" ***– Donald Trump***

As we write this letter (late October), we have the benefit of knowing that the 3rd quarter was the calm before the storm. The S&P 500 was up 7.7% for the quarter, and there wasn't a lot of volatility as the market continued upwards. The economic and financial landscape painted a pretty rosy picture, which included accomodative interest rates, the benefits of enormous tax cuts, record corporate earnings and a stock market only slightly over-valued. Fast forward a few weeks and the market has dropped 9% (most of that in 2 days) giving all the quarter's gains away. Looking for something to blame, the news pundits now claim that rates have moved too far too fast, the tax cuts were too good, corporate earnings are too optimistic and the market is greatly overvalued. Really? Has the world changed that much in a few weeks? Maybe it was the trade war with China, the never-ending tweets from Trump, the worry that Democrats will take the house and Washington will be gridlocked once again. But none of this is new, the world doesn't change overnight! No one really knows why the market pulled back so quickly, but what we do know is that in an average year, the market normally has 3 drops of over 5%. This is the 2nd drop this year after zero in 2017. In other words the market generally goes up over time, but can take a step or two back at any moment. That said, markets tend to move in cycles and we must be cognizant of where we are because, as cycles get longer, pull backs tend to become more frequent and more severe.



This is one of our favorite charts, which puts the ups and downs in perspective. The blue line is the total return for the S&P 500 going back to 1990. The diamond represents the largest pull back during each year. As you can see, the average drop, tends to be just under 14%, while the average total return is just under 10%. In other words, to achieve higher returns over time, we are going to experience some volatility.

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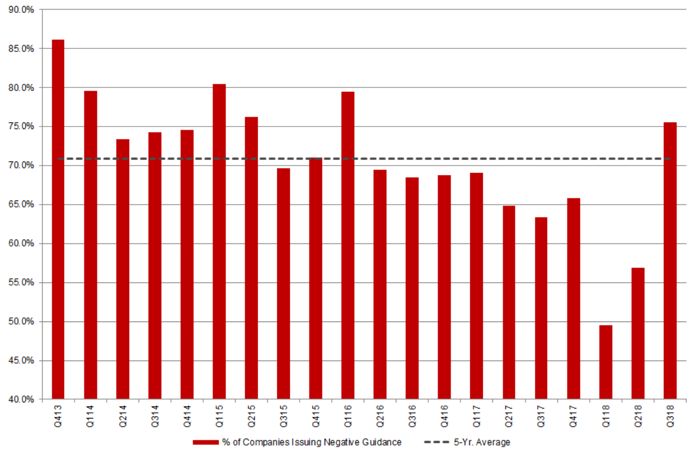
Market Cycles (Where Are We?)

We are firm believers in cycles of all sorts. There are economic cycles, markets cycles, real estate cycles. Individual stocks and sectors can have cycles as well, and we have probably just seen the end of the longest interest rate cycle in history. The question is where are we in all of those various cycles? It is nearly impossible to consistently call tops and bottoms, but history tends to give us a good indication of where we are. While not exact, we use those probabilities to help in our decision making and manage the most important thing in investing, RISK (thank you Howard Marks). Below we discuss some of the current cycles:

- *Interest Rates* – Rising interest rates are bad for new debt and mortgages of all types. They are not so bad for existing debt holders, if the rates are fixed. Rising rates are a blessing for savers and baby boomers as returns are starting to get better on certain safe assets. We are in a rising rate environment that should continue as long as the economy remains strong. Historically, rising rates have not been bad for stocks if they are gradual, which is the Federal Reserve's current intention, but once they get to a certain level, they can become problematic as safer assets offer competitive returns and liquidity becomes expensive.
- *Economic Cycle* – The economy is clearly a complicated machine. Today unemployment is near all time lows. As competition increases for workers, wages must increase, which hurts the bottom line and increases inflation. Combine wages with rising rates (which makes debt more costly) and you can see that a really hot economy runs the risk of overheating.
- *Stock Market* – We have discussed the current stock market cycle many times. It is our continued belief that we are in the later innings, but the problem is that a baseball game doesn't have to end after 9, the game can continue well into extra innings. Perhaps the biggest challenge faced by stocks will be the trajectory of earnings growth. 2018 earnings growth is projected to be around 20%. For 2019, earnings are projected to grow by 10%. While this is still a great number, the market often does not like declining growth rates. The earnings cycle has a very large impact on the stock market cycle. The 2nd challenge faced by stocks will be declining profit margins. As mentioned above, higher wages and higher debt costs, two of the largest expenses for most companies, will certainly eat into today's record profit margins.

S&P 500: % of Companies Issuing Negative Earnings Guidance (Factset)



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Strategies for Long Term Wealth

It's easy for all of us to get caught up in the fluctuations of the market and headlines. At the end of the day we have to concentrate on the things that we can control and try to eliminate the noise of those things we cannot. There is a commonality among those that are able to build and maintain wealth. Below are some of the most important things that we can control:

- *Game Planning* – None of us know where we are going until we write it down. We are big advocates of financial planning which helps to determine one's investment strategy. The key to success is making and sticking with a strategy through good times and bad. Financial planning can help build confidence in that strategy and avoid acting irrationally when times get tough.
- *Compound Interest* – Compound interest is said to be the most powerful force in the universe. Saving and investing for the long term are the biggest determinants of wealth. Although it is nice to think we are able to pick the next Amazon, that is more of an example of luck than hard work.
- *Tax Management* – For nearly all Americans the biggest single expense is taxes. Although the tax code was updated at the end of the year, it is still highly complex. Complexity should not be avoided; it can often lead to opportunity. Like compound interest, one might not get rich overnight, but consistently reducing taxes will have a major impact long term.
- *Diversification* – "Diversification is the only free lunch." One of the most often used quotes in investing and some of the best advice. Over time, diversification wins out, but recently, that free lunch has felt pretty expensive. This year (as of the writing of this letter), the US Stock market, as measured by the S&P 500, is the only major asset class in positive territory. Bonds, International Developed Stocks, Emerging Market Stocks and REITs are all down for the year. Having a diversified portfolio has hurt you, but, as with all good investment strategies, persistence pays. It's not going to work every year and some years will feel much worse than others, but as history has shown us, over time, diversification works.
- *Alternative Investing* – Non-traditional asset classes are some of the largest weightings of the Super-Endowments (Yale, Harvard, etc.). Super-Endowments are large pools of money dedicated to building permanent wealth for their institutions. Alternative asset classes have become a major tool for them because of the added diversification benefits they provide over the long term. Once an asset class that was tough for individual investors to gain access to has now seen a flurry of products become available. While the access to the investments is good, the democratization of this asset class has put a lot of investments out there that are not. Proper diligence takes time, money, patience and expertise.
- *Income Investing* – Putting a focus on investments that provide predictable income is important. Asset prices go up and down, but income is far more certain. Over time (since 1929) 40% of the returns from stocks have come from dividends. Additionally, bonds, direct lending and real estate can also be great sources of consistent income. Predictable income helps manage cash flows without having to sell assets. It also helps to build liquidity which can provide the "dry" powder needed to purchase assets when prices are depressed.

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Thanks for reading and as always, please don't hesitate to contact us with any changes to your personal situation.

Sincerely,

Canal Capital Management

DISCLOSURE: Past performance is no guarantee of future results. Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than original value. These investments may not be suitable for all investors, and there is no guarantee that any investment objective will be obtained.

All indices are unmanaged and investors cannot invest directly in an index. Unlike investments, indices do not incur management fees, charges or expenses.

Investing in alternative investments may not be suitable for all investors and involves special risks, such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potential illiquidity. The purchase of bonds is subject to availability and market conditions. There is an inverse relationship between the price of bonds and the yield: when price goes up, yield goes down, and vice versa. Market risk is a consideration if sold or redeemed prior to maturity. Some bonds have call features that may affect income. Treasury bonds are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, they offer a fixed rate of return and fixed principal value. U.S. Treasury bonds do not eliminate market risk.

The precious metals, rare coin and rare currency markets are speculative, unregulated and volatile and prices for these items may rise or fall over time. The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

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