

INVESTMENT LETTER

Recent declines in stock prices have me thinking a lot about the Dark Ages. When I was young, the period after the fall of the Roman Empire (in the fifth century) and before the Renaissance (during the 15th century) was referred to as the Dark Ages. This name was not so much a reference to the quality of life experienced by Europeans during this period as it was a phrase meant to highlight the lack of written records available to historians who wanted to chronical the history of the period. Over time, as historians slowly recovered the historical records made during that time, the Dark Ages eventually became known as the Middle Ages.

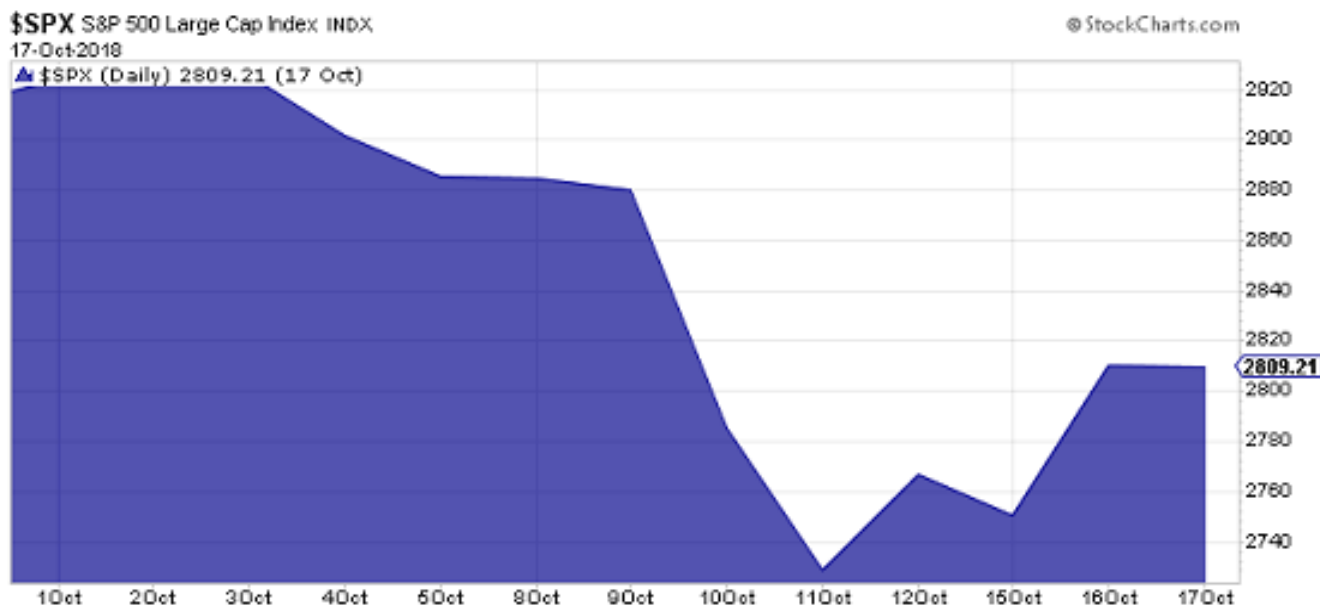
With apologies to the many great historians who have documented this period of human history, I would like to make the argument that there are still good reasons to refer to this period as dark. While the discovery of historical documents has allowed us to better know what was happening during this period, it turns out the Middle Ages are most noteworthy for what was lost. The technical knowledge needed to build the Roman Colosseum and much of the advanced math that made such feats of engineering possible was lost after the Roman Empire collapsed. While many of the cultural touchstones of Western Civilization lived on in the Catholic Church and in the Byzantine Empire to the east, a good deal of the collective knowledge of Europe

was lost for centuries. Some of this knowledge, like how to make stained glass windows, can be viewed as unfortunate, but the loss of, for instance, the recipe for concrete and advanced architectural methods, not to mention astronomy, medicine and mathematics came at a very high cost for mankind.

Today, we have a term for this collected knowledge: Institutional Memory. Institutional memory is the entire body of knowledge accumulated by an organization or a society that provides historical context and guidance for decision makers. Historians discovered that it could take as little as two generations for institutional memory to disappear during the Dark Ages. That is probably due to the fact that knowledge was handed down from father to son or from master to apprentice. When plagues killed 25 million Europeans (one-third of the population) during the 14th century, the bond between the generations was broken, often making the passing of vital knowledge impossible.

Recently, it seems to me that Wall Street has managed to speed up the process of losing institutional memory. What once took two generations appears to have been achieved in just two weeks.

I give you as exhibit A, the recent report issued by



the Organization for Economic Cooperation and Development. The OECD warns that “The expansion may have peaked... global growth is projected to settle at 3.7% in 2018 and 2019, marginally below pre-crisis norms, with downside risks intensifying.” I don’t want you to conclude that I am singling out the OECD. The truth is, nearly every economist and market analysts has embraced this notion of “peak growth”.

The reasons are not hard to understand. It seems the Fed’s determination to keep increasing short-term interest rates, despite calls from both the White House and Wall Street to cease and desist, has everybody preparing for a new recession. There is also the very real possibility that the temporary spike in annual growth witnessed here in the United States will begin to wane as we move farther and farther away from the stimulative effect of last year’s tax cuts. From there you can add... well, take your pick: looming trade wars, possible oil embargos, rising inflation, rising wages, weak retail and home sales, as well as political uncertainty stemming from a possible Democratic takeover of Congress in November.

It seems there is no end to the calamities that can befall this stock market. The rising panic and the selloff that followed are almost enough to make you think that we have never experienced so much potential trouble... ever.

Of course, you know where I am going with this. Nothing, and I mean nothing, I have just listed justifies the level of hysteria exhibited by so many investors

over the past few days. I have been involved in the investment advisory business for close to four decades now and I don’t believe I have ever seen investors so quick to believe that the market is headed for an epic crash. The irony is that history teaches us that, when it comes to the stock market, the time to be concerned about prices is when nearly everybody is convinced that stocks can never go down. Stop and consider the history of the last monster market crash. Back in 2007, you had to look awfully hard to find anyone on Wall Street who was warning of a coming financial collapse. Yes, there was the usual collection of gloom and doom types who were predicting we would soon experience the collapse of the financial system and perhaps even the end of Western Civilization, but these people don’t count. They are always warning investors of a coming crash, even right after the stock market corrects by 50%.

I recently wrote in the *Money Forecast Letter* that I agree with those who say a recession and a bear market are coming. However, I made it clear that I disagreed vehemently with the notion that they were coming any time soon.

Yes, the Fed has finally begun the long overdue process of raising rates back to levels that could be defined as “neutral.” But there is little evidence to suggest that the mere initiation of a plan to move towards a neutral position will produce an instant recession and an instant bear market. Prior to the Financial Panic of 2008, the Fed raised the fed funds rate from 1.0% to 5.25% from the middle of 2004 to the middle of 2006. They then left



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rates unchanged for the next 12 months, before signs of an economic slowdown forced them to begin dropping short term rates in a rapid fashion. Stocks climbed 40% during this period of Fed “tightening.”

Today, market pundits seem incapable of calling on the all-important institutional memory that is so easily accessed from their computers. They have seemingly lost the ability to apply the lessons of the past to their current situation. I am suggesting that you must not blindly follow them into this intellectual dead-end.

Let us start by examining the notion that we have reached “peak earnings.” As you can see from the chart on page two, earnings have been growing smartly for the past ten quarters. Since the start of the year, that trend has only accelerated. Obviously, the massive reduction in the corporate tax rate has played a central role in this recent earnings boom. But central is not synonymous with singular. While it is always difficult to separate out the contribution the tax cuts have made to higher earnings, the best guess is that they are responsible for somewhere between one-third and one-half of the increase. Given that annual corporate earnings grew by 25% in the first half of the year and are expected to do roughly the same during the second half, it is hard to suggest that the strong economy has not also played an important role in the rise of profits. Because the tax cut bump is a one-off deal, we should not be surprised that estimates for 2019 earnings are well below 2018 results. Currently, S&P forecasts that 2019 earnings will rise by 12.2%. That number is actually 2% higher than the estimates made six months ago. It is hard for me to find anything even remotely scary about this expected profit growth. We are, after all, in the ninth year of an economic recovery. The fact that we are still expecting double-digit growth in annual profits is a testament to

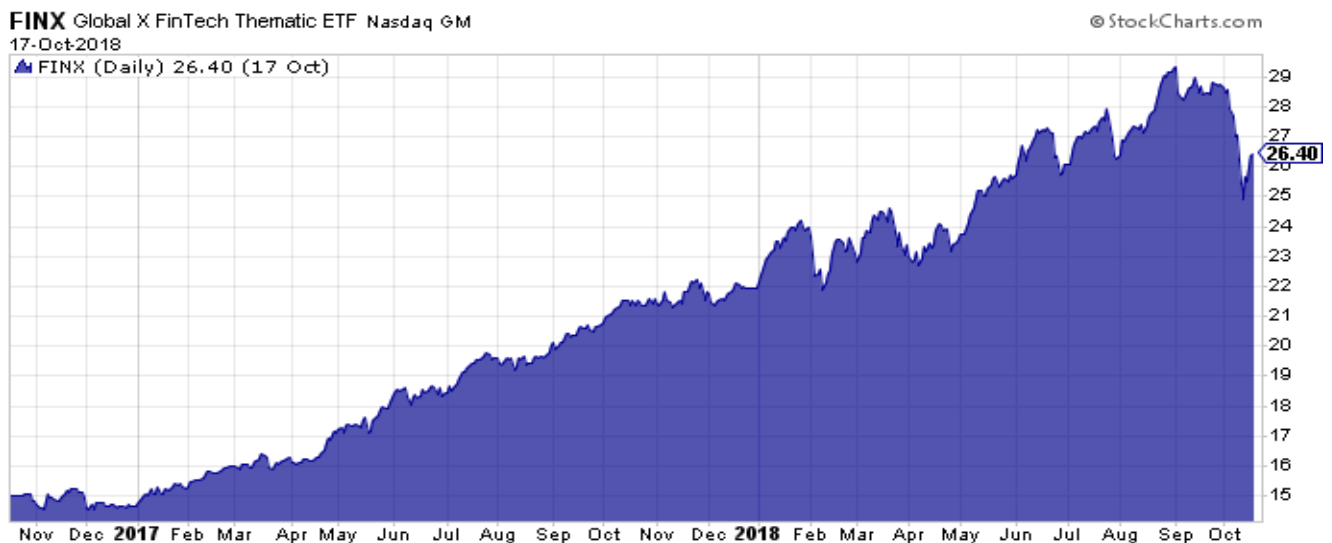
the solid foundation this economy has built since the end of the last recession.

As for interest rates, why would we assume that a 3.25% yield on the 10-year U.S. Treasury bond is enough to suck money out of the stock market? The stock market has an average annual return of around 7.5%. Price appreciation accounts for about two-thirds of that total and annual dividend payments contribute the rest. The current yield on the 10-year bond, once adjusted for inflation, is still below 1%. I fail to see how those two numbers can suggest that investors are anxious to sell their equities and rush to the bond market.

Did I mention that the Fed insists that it is far from done when it comes to rate increases? How can those who appear on your television or computer screen every day be so sure investors are ready to stampede out of stocks and into bonds, especially when the Fed is all but promising to make the price of those bonds decline? It seems to me that a quick check in the institutional memory file would show that investors do not usually rush out of the stock market under such circumstances.

Yes, there will always be short-term interruptions to market trends; the stock market does put in a 10% correction every eighteen months on average after all. But for anyone focused on the long-term, the occasional 10% correction is hardly worth thinking about. I note for the record that this market, despite all the scary headlines, is down just 6% from its recent all-time high. I would also ask you to keep in mind that it is still 42% higher than it was on January 1, 2016. In short, investors are still playing with house money when it comes to the stock market.

For quite some time now, I have been highlighting



the historically high price/earnings ratio for the S&P 500 Index. I have argued that the massive jump in 2018 earnings gave us a unique opportunity to shrink the market's multiple without the need for a large market correction. Right this moment, thanks to the combination of higher earnings and a 6% drop in stock prices, the market multiple based on trailing twelve-month earnings has fallen from 20.9 one year ago to just 19.6 today. That's still high, but it's getting closer to the 15.5 mark that has been the historic average. Better still, the market multiple based on forward-looking earnings has declined even more. Last year at this time, the forward-looking P/E was 17.2. Today it stands at just 14.7. These numbers suggest to me that the market decline experienced of late has already succeeded in eliminating the over-priced nature of this stock market. That is one more reason that those predicting more blood on the floor at the New York Stock Exchange seem a bit "over their skis" right now.

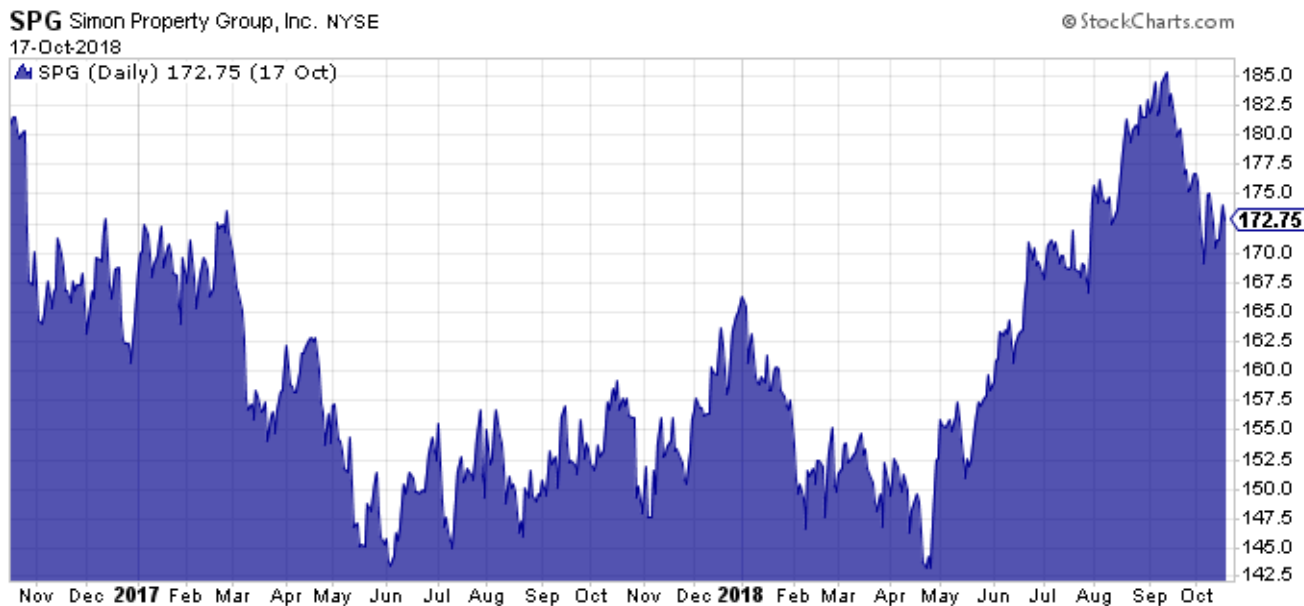
My advice is to take predictions of collapsing corporate earnings with a grain of salt. Earnings were always going to be significantly lower in 2019 than in 2018. To pretend this fact has caught investors by surprise recently is straight out fraud on the part of market pundits. Combine that with the overwrought hand-wringing about the possibility that a 3.25% fed funds rate will derail the recovery and you get the makings for a market bottom. I can't tell you exactly where that bottom is... no one can. But I do believe we are a lot closer to it than most people know.

In a perfect world, that bottom would come once stocks hit the 10% correction mark. Using that institutional memory bank again, I note that investor sentiment

often turns bullish once stocks correct by 10% and then steady. Sometimes, the bounce off the 10% correction mark is so swift investors find themselves getting caught flat footed. As the market quickly rebounds, they find themselves out of stock at a time when they really should be in. By the time they come to believe in the move higher, they often find they have missed a sizable chunk of the rebound. This is why I do not recommend that long-term investors try to time the markets: the likely result is selling low and buying high.

I would recommend that any investor sitting on cash and waiting for a good time to put some or all of it back to work, might consider doing that right now. Once investors climb off the ledge they currently inhabit, I suspect that the story for this stock market will be one of steady gains starting soon and lasting at least through the middle of next year. I don't expect, nor do I hope to see, a rush back to new highs before the end of the year. Any such move would suggest that, once again, investors have not learned any lessons about market multiples and rising interest rates. Rising rates should dictate that market multiples decline. Any rapid rise that wipes out the recent and necessary drop in that multiple will only mean greater pain for investors, when the economy does finally slow and earnings growth turns into earnings declines.

For those waiting for the market to decline by that magic 10% figure that marks an official correction, I remind you that more than half the stocks have already experienced at least a 10% decline in price. This "rolling correction" has masked the sheer number of stocks that now trade at very attractive prices. Right now, it appears to me that investors are already pouring



money back into the market to take advantage of these suddenly cheap stocks. Delaying reentry until the market as a whole shows a 10% decline might mean missing out on the stocks best positioned to bounce back after this mini market meltdown.

With the macro picture out of the way, I would like to use the rest of this letter to focus on two new buys and one sell for the model portfolio.

On the sell side, I am going to drop Blackrock (BLK; \$407.21 – NYSE). Blackrock's stock price has been declining all year and this trend has only accelerated of late. The main problem seems to be doubt about the company's ability to provide growth in the face of so many international uncertainties. While I have more faith than the average investor in Blackrock's ability to provide profits from their investment activities, most investors do not share this confidence. Because I have a second investment company in the portfolio (Carlyle Group), it feels like this sector is currently over-weighted. I will sell Blackrock and put the money to work somewhere else.

The first "somewhere else" I found was an ETF specializing in the rapidly evolving sector known as financial technology (Fin Tech). In the old days (meaning about 20 years ago) fintech was a term applied to backroom operations at banks and investment houses. It involved the nuts and bolts activities necessary to track and efficiently execute the movement of money. Today, thanks to the explosion in online retailing, Fin Tech is defined as more of a consumer service industry. Whether you know it or not, you are probably relying on the services of Fin Tech companies several times a day. The reason you might not, is that Fin Tech is all about making financial transactions seamless. When you buy something from a small vendor at the county fair, you probably notice that you no longer need to bring cash to the table. Most small vendors now have a little box attached to their smart phone that allows them to process the payment using your credit card. Because we live in an age where technology is taken for granted, we never stop to appreciate just how complicated this act really is. Companies like Square and PayPal have experienced rapid expansion thanks to this growing need to facilitate commercial transactions in the digital age. Other companies, like First Data and Intuit are applying similar technologies to help both large and small businesses seamlessly handle online payments. Other companies in the industry are working with the hottest technology on the planet – blockchain.

Blockchain is the technological backbone of encrypted online transactions and the cryptocurrency business and – once all the kinks are worked out – should help revolutionize the level of security involved in all electronic transactions.

All of these companies and many more make up the holdings for an ETF known as Global X Fin Tech (FINX; \$26.35 – NasdaqGM). The ETF has been active for less than two years, but has racked up some impressive numbers. And like so many other stocks and ETFs, it has taken a price hit during this recent market correction. I look at this as an ideal time to get in at what should prove to be an excellent buying point.

The second addition to the portfolio is a play on the currently out of favor retail sector. For years, it has been taken for granted that the American mall was the financial equivalent of a dead man walking. As one of the largest and most visible owners of these malls, Simon Property Group (SPG; \$173.66 – NYSE) has seen its stock price lose ground and greatly underperform the market as a whole. However, a funny thing happened on the way to bankruptcy court, mall traffic suddenly began to pick up last year. Simon, who concentrates much of its energy on managing upscale malls, has seen a reversal of fortune as high-end consumers are once again flooding into the malls to make purchases. Net income was up 37% during the first six months of this year compared to 2017. This is a vast improvement over the 6% growth experienced for all of 2017 vs 2016. For all of 2018, per share profit is expected to grow by 17% to 20%. I think the recent 7% drop in the stock price gives us a chance to buy into this company at an attractive price point.

I leave you with this final reminder. While it is natural to have doubts about the stability of the stock market when so many big name market watchers are advising caution, I urge you to remember that most of these high-priced pundits have a spotty record when it comes to market timing. If there has been one constant on Wall Street it has been the tendency to be too bullish at market tops and too bearish at market bottoms. In between, most market watchers exhibit constant fear about how long the good times can last. There is a reason why one of the most accurate sayings on Wall Street is that bull markets climb a wall of worry. The fact that so many people are worried today should give us the courage to remain invested.

— *David C. Jennett*

INVESTMENT ASSET ALLOCATION

U.S. STOCKS	79%	INT'L STOCKS	6%
BONDS	2%	REITs & REAL ESTATE.....	5%
GOLD	2%	CASH	6%

\$100,000 INVESTMENT PORTFOLIO

Symbol	Name	Shrs	Paid	ORIGINAL VALUE	10/17/18 PRICE	10/17/18 VALUE	\$ Change	% Change	BUY DATE
T	AT&T	133	\$35.52	\$4,724.16	\$32.57	\$4,331.81	-\$392.35	-8.3%	2/22/2013
BKNG	BOOKING HOLDINGS	3	\$1,146.59	\$3,439.77	\$1,850.51	\$5,551.53	\$2,111.76	61.4%	10/31/2014
CG	CARLYLE GROUP	325	\$17.00	\$5,525.00	\$21.13	\$6,867.25	\$1,342.25	24.3%	1/22/2017
CFR	CULLEN/FROST BANKERS	63	\$88.18	\$5,555.34	\$100.47	\$6,329.61	\$774.27	13.9%	1/22/2017
DFS	DISCOVER FINANCIAL SERVICES	90	\$78.27	\$7,044.30	\$75.89	\$6,830.10	-\$214.20	-3.0%	8/24/2018
FB	FACEBOOK	31	\$56.75	\$1,759.25	\$159.42	\$4,942.02	\$3,182.77	180.9%	12/27/2013
FDM	FIRST TRUST DJ SEL MICROCAP ETF	240	\$52.11	\$12,506.40	\$48.52	\$11,644.80	-\$861.60	-6.9%	6/18/2018
GD	GENERAL DYNAMICS	23	\$188.94	\$4,345.62	\$193.84	\$4,458.32	\$112.70	2.6%	4/23/2017
FINX	GLOBAL X FIN TECH	375	\$26.40	\$9,900.00	\$26.40	\$9,900.00	\$0.00	0.0%	10/17/2018
HPT	HOSPITALITY PROPERTIES TRUST	178	\$26.38	\$4,695.64	\$26.73	\$4,757.94	\$62.30	1.3%	2/11/2011
IBM	INTERNATIONAL BUSINESS MACH	32	\$147.91	\$4,733.12	\$134.05	\$4,289.60	-\$443.52	-9.4%	10/23/2015
WPS	ISHARES INT'L DEV PROPERTY ETF	175	\$37.74	\$6,604.50	\$35.62	\$6,233.50	-\$371.00	-5.6%	7/24/2017
ENZL	ISHARES NEW ZEALAND CAP ETF	130	\$42.27	\$5,495.10	\$46.05	\$5,986.50	\$491.40	8.9%	1/22/2017
IWM	ISHARES RUSSELL 2000 ETF	75	\$168.60	\$12,645.00	\$157.96	\$11,847.00	-\$798.00	-6.3%	6/18/2018
JPM	JPMORGAN CHASE	66	\$59.40	\$3,920.40	\$109.83	\$7,248.78	\$3,328.38	84.9%	3/28/2016
MCHP	MICROCHIP TECHNOLOGY	80	\$86.98	\$6,958.40	\$69.05	\$5,524.00	-\$1,434.40	-20.6%	8/24/2018
MKSI	MKS INSTRUMENTS	25	\$101.90	\$2,547.50	\$78.04	\$1,951.00	-\$596.50	-23.4%	10/23/2017
NVDA	NVIDIA	26	\$272.22	\$7,077.72	\$243.06	\$6,319.56	-\$758.16	-10.7%	8/24/2018
PJP	POWERSHARES DYNAMIC PHARMA ETF	100	\$64.54	\$6,454.00	\$70.74	\$7,074.00	\$620.00	9.6%	7/24/2017
RRC	RANGE RESOURCES	200	\$33.13	\$6,626.00	\$17.25	\$3,450.00	-\$3,176.00	-47.9%	1/22/2017
RTN	RAYTHEON	28	\$154.04	\$4,313.12	\$193.12	\$5,407.36	\$1,094.24	25.4%	4/23/2017
RHT	RED HAT	20	\$122.13	\$2,442.60	\$124.84	\$2,496.80	\$54.20	2.2%	10/23/2017
SPG	SIMON PROPERTY GROUP	60	\$172.75	\$10,365.00	\$172.75	\$10,365.00	\$0.00	0.0%	10/17/2018
JNK	SPDR BARCLAYS HIGH YIELD BOND	172	\$37.16	\$6,391.52	\$35.53	\$6,111.16	-\$280.36	-4.4%	8/10/2009
KBE	SPDR KBW BANK	144	\$40.29	\$5,801.76	\$44.76	\$6,445.44	\$643.68	11.1%	1/22/2018
GLD	SPDR GOLD TRUST ETF	42	\$115.05	\$4,832.10	\$115.79	\$4,863.18	\$31.08	0.6%	1/22/2017
TTWO	TAKE-TWO INTERACTIVE SOFTWARE	65	\$35.40	\$2,301.00	\$132.06	\$8,583.90	\$6,282.90	273.1%	3/28/2016
UNP	UNION PACIFIC	51	\$63.78	\$3,252.78	\$149.89	\$7,644.39	\$4,391.61	135.0%	9/16/2010
VNQ	VANGUARD REIT INDEX ETF	66	\$72.32	\$4,773.12	\$77.60	\$5,121.60	\$348.48	7.3%	7/26/2013
VZ	VERIZON COMMUNICATIONS	105	\$52.72	\$5,535.60	\$53.96	\$5,665.80	\$130.20	2.4%	1/22/2017
DES	WISDOM TREE SMALLCAP DIV ETF	204	\$27.10	\$5,528.40	\$28.32	\$5,777.28	\$248.88	4.5%	1/22/2017
WDAY	WORKDAY	63	\$103.65	\$6,529.95	\$137.25	\$8,646.75	\$2,116.80	32.4%	7/24/2017
	CASH					\$13,992.78			
	TOTAL					\$216,658.76			

Value December 31,2017: \$222,955.60 2017 Change: +15.5% S&P 500 Total Return Index 2017 Change: +21.8%

Value October 17, 2018: \$216,658.76 2018 Change: -2.8% S&P 500 Total Return Index 2018 Change: +6.7%

Dividends & Interest 9/24/2018 thru 10/17/2018: \$515.86 (Assumes dividends not reinvested and cash earning money-market rates)