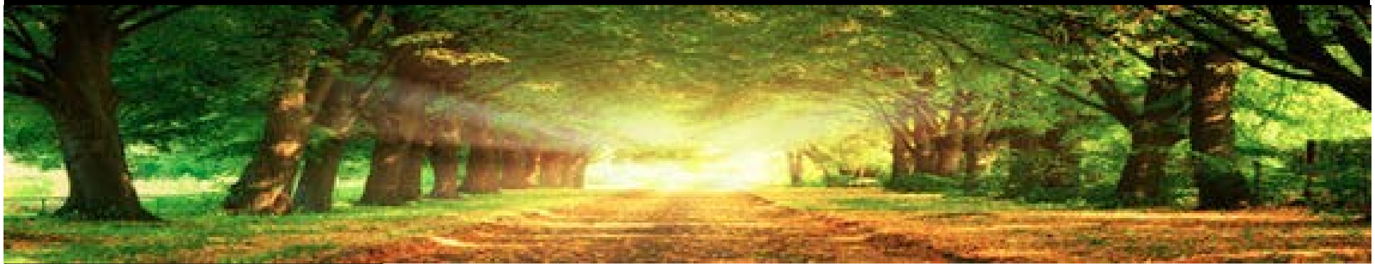

Celestial
WEALTH MANAGEMENT

IN THIS ISSUE

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Summary

- At the September Federal Reserve Meeting, the Fed decided to leave short term interest rates unchanged. Not a big surprise. However, longer term bond yields have started rising not only in the U.S. but also in Japan. Is this a short term phenomena or has the low in rates been seen?
- Volatility has increased in various asset classes as we approach the Presidential election.
- I am becoming increasingly worried there may be a severe overvaluation in so-called "safe stocks". In my opinion there is no such thing as a "safe stock".
- US equity markets continue to be rangebound within 5% of all-time highs
- U.S. Dollar is strengthening slightly but still within its 18 month trading range
- Crude Oil rallied up towards $50 pulling energy stocks along with it. OPEC released a statement stating they will cut production in November by up to 750,000 barrels per day. Interestingly, Saudi Arabia has a seasonal drop in production of around 500,000 bpd after summer demand ends. This is essentially the same amount as the "production cut" they announced.
- Gold is in the midst of its first significant correction of the massive rally since January. Bullish trends are still in tact and the correction may provide more opportunity than peril.
- Emerging Market equities and bonds have continued to rally
- The Trump campaign continues to narrow the gap between them and the Clinton campaign which brings more uncertainty and skittishness in the financial markets.
- More and more discussion has emerged surrounding potential fiscal stimulus targeted at infrastructure upgrades in the U.S. I first mentioned this potential investment theme back in my June 2016 newsletter.

Is there a bubble in "safe stocks?"

Many times in the investment world an idea is created, researched, explained, expanded upon, marketed and written about to the point that a good idea morphs into something entirely different and becomes potentially dangerous. In the zero percent yielding environment that central bankers have created, **I believe** that dividend paying equities (and specifically large, U.S. dividend paying companies) have become one of the most dangerous places that individuals are placing their hard earned savings. Just Google "safe stocks" for fun and see all the articles on the first page of results. They are **ALL** from May 2016 on.

I recently heard a "financial advisor" on a financial network say, "You should buy stocks for income and bonds for capital appreciation." I stopped what I was doing and looked up. What in the world did I just hear? The crux of the statement is that because the 10 Year Treasury bond is roughly 1.70% the only way an investor is going to make anything significant on their bonds is by rates heading even lower and thus providing appreciation. In addition, if one looks for high quality U.S. stocks that pay a dividend higher than 1.70% you can get income that could potentially rise if dividends increase. On the surface this doesn't sound like a bad argument. However, the statement is what made the hair on the back of my neck stand up. Central bankers have now pushed interest rates so low that investors are turning long term investments on their heads. The only way one would buy a 1.70% yielding 10 year bond is if they believe other options will pay them even less or they believe they can sell that bond to a greater fool in the near future. I don't like that idea at all.

There have been numerous investments created and marketed in the past two years toward the investing public to profit from this idea. The amount of money that has flowed into these dividend paying strategies has been just staggering and has driven prices up to what I believe to be unsustainable levels. Valuations of these "safe stocks" as they have been affectionately called have reached levels rarely ever seen. The stocks are primarily found in four areas; utilities, telecommunications, consumer staples and large pharmaceutical companies. While the companies in these sectors are generally high quality companies that make products that are almost always in demand, that doesn't mean the stocks should be bought at any price. Like ANY OTHER asset, these companies can be undervalued, fairly valued and overvalued. I sincerely wonder how many investors have placed the lions share of their life savings in these companies unaware that these stocks can go down in value and in the past have gone down in value by north of 30% in significant market corrections. A 3% yielding dividend paying stock can lose 5 years worth of dividends in a run of the mill 15% correction. **I wonder aloud how many investors understand this and whether the next market correction will be worse than expected because investors are holdings investments they don't truly understand.**

While I love investments that pay cash flow to investors there is a limit to their value and a point when you can overpay for reliable cash flow. That may be the point we recently reached. There is a saying that ***"What the wise man does in the beginning, the fool does in the end."***

Fed Interest Rates…Do they set or follow markets?

Every day that I come to work it seems I am listening or reading about when the Federal Reserve is going to raise interest rates. Why they should raise, why they shouldn't raise and why they can't raise. For the past three years, each Fed meeting has been looked at as "extremely important" for the direction of interest rates. However, I pose to you something entirely different. "What if the Federal Reserve doesn't actually control interest rates? What If the Federal Reserve just follows the direction of market based interest rates? Well that would sure turn traditional thinking on its head. Is it possible to determine what the Fed and for that matter what Central Banks will do by monitoring market interest rates?

For more than two decades research has been tracking the relationship between market interest rates and the interest rates set by the U.S. Federal Reserve, the European Central Bank, the Bank of England and the Bank of Australia. The research has concluded that the market moves rates first and THEN the Central Banks follow. If you want to determine what the Federal Reserve is likely to do, watch the Treasury Bill market for moves first. This pattern has occurred all the way back to the double digit interest rates of the 1970 and early 80s. Treasury Bill rates peaked four times in 1980-1982. Each of those tops occurred a month or more before reactive peaks in the Fed Funds Rate. The Fed also has lagged when you are at extremely low rates. The same pattern has occurred with interest rates in the European Union and the U.K. ECB interest rate settings have lagged the market rates in Europe at all seven major turning points in rates since 1999. The average lag is 5.3 months. The same pattern also holds true with research on Australia.

In my opinion, those assuming that Central Bank policy can control interest rates and to a lesser extent financial markets are mistaken. However, conventional analysis allows for one to assume Central Bank decisions control markets rather than looking at actual data. For most investors, the idea that the financial markets lead the action of central bankers is counterintuitive. However all one must do is think about interest rate policy this year for evidence that the financial markets "tell" central bankers what they should do. At each Fed meeting in which they have failed to raise rates this year, they have an explanation for not doing so related to volatile markets in certain areas of the globe. To me, this is anecdotal evidence that the Fed is watching financial markets for clues on how to act, not the other way around.

If one comes to accept that the markets control interest rates and that market movements can give you clues about what central bankers can do, it makes these Fed meetings less uncertain. One must simply watch the T-Bill market to determine what the Fed will do in the near future. If that is the case, here is a chart of T-Bill Rates to give you a clue. As you can see, the T-Bill rate moved higher starting in mid 2015 which gave you a clue that rates would rise at the end of 2015. Since that point, T-Bill rates have stayed relatively flat. In my opinion you would need a rise to north of 0.50% in the T-Bill rate before the Fed would hike rates.

Here is a shorter term Treasury Bill chart that shows the current T-Bill rate is LESS than it was in February of this year.

Deutsche Bank, Credit Suisse, Credit Agricole

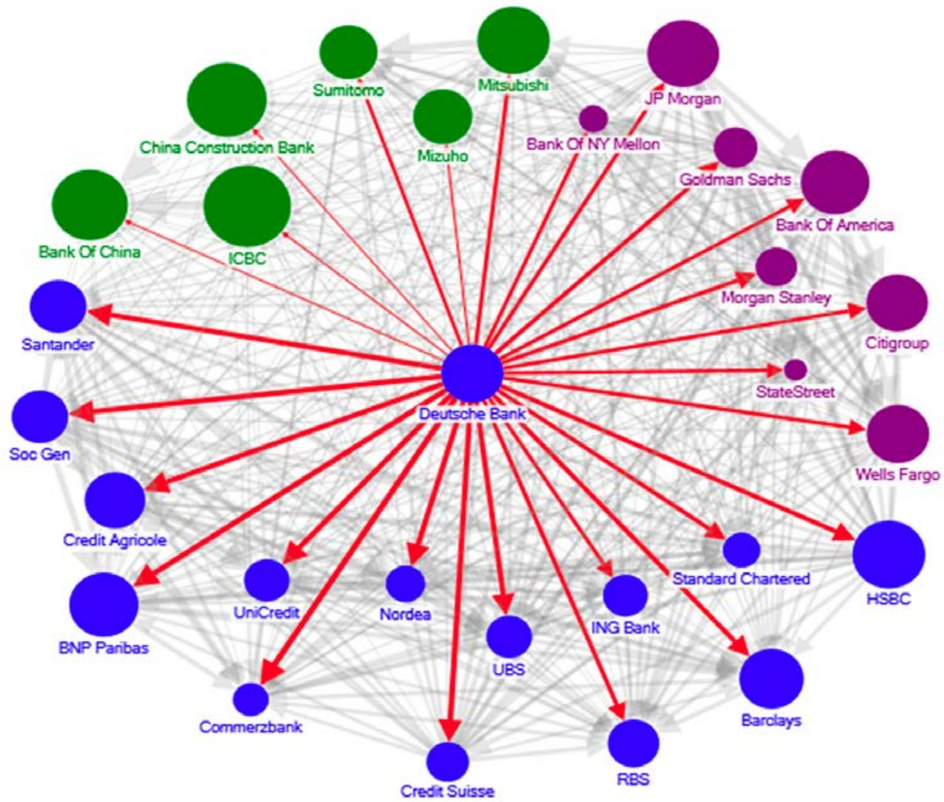
I have been watching these three European banks since late last year and specifically, Deutsche Bank. The stock and bonds of these three companies has steadily marched lower over the past year as worries mount at these banks. The high degree of leverage at these institutions has been a risk ever since the financial crisis. I do not dismiss brewing trouble at the world's largest bank. In my opinion they are severely undercapitalized and may eventually need a bailout by the German government.

My worry is that the financial system is a complicated web of interconnected banks and no one really knows who owes what to whom. These large institutions have many moving parts and unbelievable amounts of leverage. Let me explain. According to CMG Research, JP Morgan (widely thought of as very well run) has equity capital of $250 billion. Their balance sheet of assets is $2.5 trillion. The balance sheet is all the loans they have made. The capital is the money set aside to support the business. U.S. Banks are currently leveraged roughly 10 to 1. Let's pretend you are a bank. You have $1 million in capital and you loan out as much as $10 million. If a few of the businesses you loaned money to go out of business you might not get paid back. If 10% of the loans you made default you have wiped out your equity and are effectively bankrupt. You need to be very selective about how you make loans.

Deutsche Bank's equity capital is $15 billion. Their balance sheet is $2.5 trillion! That puts them leveraged at over 100 to 1. It is massively larger than J.P. Morgan. That means less than 0.25% of your loans can default without running out of capital. With a government backstop to help it is possible to stay afloat if that happened. However, Chancellor Angela Merkel has publicly stated she would not bail out another bank. Well she just might have to. At the height of Bear and Lehman's problems in 2008 they were levered at 30 to 1. This bank is 100 to 1.

Deutsche Bank's CEO has publicly been making statements that the "balance sheet is safer than at any point in the last two decades." This is eerily similar to statements made by the CEOs of Bear Stearns and Lehman Brothers to try and calm the market before they went bust.

To me, the risk is not that Germany will not bail out Deutsche Bank if it gets in trouble. The risk is how this could affect the world financial system. Here is a chart from the International Monetary Fund (IMF) that shows how these banks are connected.



source: International Monetary Fund, Germany – Financial System Stability Assessment, IMF Country Report No. 16/189 (June 2016).

Banks rely and operate on trust. Zero interest rate policy may be eroding that trust. This is something that should be top of mind, not swept under the rug.

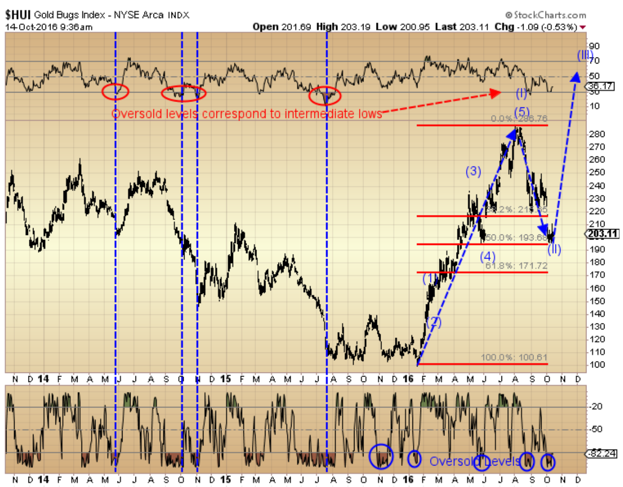
Gold Technical Update

Gold, silver and the mining stocks have been in the midst of their first real correction since a huge advance from January. Interestingly, a point that I have brought up numerous times has been hammered home recently. Gold and for that matter many assets don't trade on fundamentals in the short term; they trade on sentiment. How investors are "feeling" about the market in question and how greedy or fearful in general are those investors can determine short term direction. In my opinion, by following moves in sentiment from pessimistic to optimistic and back one can put the odds in their favor of being on the right side of market moves.

Leading up to the September Federal Reserve meeting the widely accepted narrative was that if the Fed hiked rates that would be bad for gold and if the Fed left rates unchanged that would be good for gold. Well, the Fed left rates unchanged and on the day of the Fed meeting gold rallied. However, ever since that day, gold has trended lower, punctuated with the largest sell-off in 3 years on Tuesday, October 4. Gold has certainly not acted on the fundamentals of Fed rate moves.

A less widely held opinion is that the massive move in gold, silver and the mining companies in 2016 was overdue for a meaningful correction and this is indeed that correction. In my opinion this is not the end of the gold and silver rally in 2016 but only the beginning of a multi-year bull market move. Markets don’t move in a straight line and this is just a correction in one of the most volatile sectors of the financial markets. Investing in this sector is not for the faint of heart and position sizes should reflect your risk tolerance and time horizon.

All that being said, it looks like we may be 90% of the way through this correction. For those that missed the first rally or for those who have been waiting for a point to add to their positions, this may be an opportune time to take action. Feel free to give me a call or shoot me an email if you would like to discuss further. In my opinion, substantial gains can potentially be made by buying the dips in a multi-year rally. It feels terrible to see asset values reduced temporarily in a correction, but these corrections are NECESSARY to shake out those who jumped on the bandwagon late in the game. Here are short and long term charts of gold and the miners with my opinions on where we may go from here.



All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

The first chart is a three-year chart of the HUI Gold Miners index. The second chart is a one-year chart. You can see from the circled sentiment indicators, each time they become oversold that has marked an intermediate low and a solid time to add additional capital. Elliott Wave Analysis has been used since the 1920s and is an excellent tool to help investors decide with a higher degree of confidence where they may reside in a move. Typically, primary waves consist of 5 sub waves. I have labeled these waves on the charts. You can see in the longer term chart, that if my labels are correct, we have a completed 5 wave advance that ended in July. Those five waves were part of a larger degree first wave.

We are now in the midst of a second wave correction, which typically retraces roughly 1/3 to ½ of the previous advance. We are very close to retracing half of the previous advance. That is why I think that we may be near the end of this correction, before starting another 5 wave move higher which should be part of a larger 3rd degree wave advance. For anyone looking to learn more about Elliott Wave Analysis there are many books and online resources that can help you learn the nuances of wave theory. In essence, it is another tool to use in helping one invest. The goal of sentiment analysis is to analyze it and interpret it not be a participant in it.

Investment Ideas

- **Rather than trying to "beat the market", focus on beating inflation and the rate on cash. Plan for safety and liquidity while seeking positive returns.**
- Equity valuations are very rich but masked due to the distortion of the Treasury curve. Volatility is returning to the markets and I think long/short managers are best positioned to capture this volatility by owning companies with strong businesses, barriers to entry, and good valuations and selling short weaker companies with high debt loads that have risen sharply with the broad market rally. I think this strategy of <u>hedged equity may have the potential to produce attractive risk-adjusted returns</u> if and when investors begin to question the valuations of companies. Stock investing involves risk including loss of principal. No strategy ensures success or protects against a loss. Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

- Monsoon country investments. Attempting to take advantage of demographic, educational and investment possibilities in the countries surrounding the old spice routes of the Indian Ocean. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

- In 2013, the Affordable Care Act began implementation. There will be many winners and losers in the healthcare industry as a result of the biggest change in the healthcare industry's history. With the largest portion of the U.S. population entering their golden years, healthcare needs will become even more important. Long/short Healthcare seems to be a very attractive way to invest in a sector with lots of potential and lots of potential pitfalls. Investing in a specific sector involves additional risk and will be subject to greater volatility than investing more broadly.

- A potential U.S. infrastructure upgrade cycle may be around the corner. Moving from our current grade of D+ to B would require an investment of $3.6 trillion by 2020.

- Supply problems remain high across the energy asset class. While there isn't a current shortage of energy on the planet, it is taking more and more energy and capital to discover, drill, transport and refine it. Long term Demand should continue to grow globally, particularly in China, India, and other developing countries.

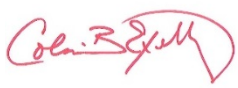
- Potential food shortages due to inclement weather and higher demand from the emerging Asian middle class could result in a boon to agricultural land and potash fertilizer companies. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

- The rise of E-Commerce has coincided with an increased desire for efficient warehouse distribution real estate. As e-commerce moves toward even faster delivery, positioning of distribution becomes even more important.

- Precious metals mining companies have been extremely beaten down over the past four years. Mining is an industry that spans hundreds of years. Companies that mine for commodities are often highly cyclical, meaning they have sustained moves both up and down. When investing in the mining space it is important to be a contrarian. Ideally, you would want to accumulate miners when sentiment is poor around them and sell them when sentiment is positive. Historically this has been a good strategy.

  No strategy ensures success or protects against a loss.

Regards,



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