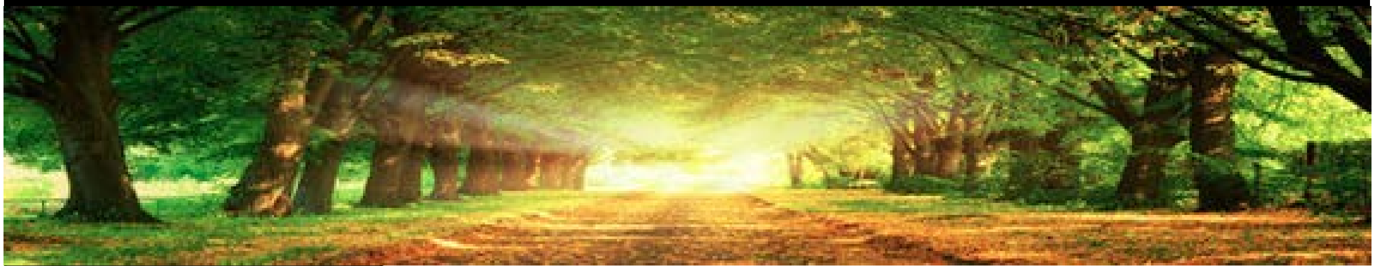
JANUARY 20, 2017



Celestial
WEALTH MANAGEMENT

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Has FOMO taken over?

The euphoria is rampant. Fear of loss in early 2016 has been replaced with FOMO, the fear of missing out. When it comes to investing good news is about the last thing you should spend your energy on. I believe one of the secrets to being a good long-term investor is to focus on risk management. As shown in my newsletter last month, U.S. equities are very expensive irrespective of what valuation metric one chooses to use.

Over the past 24 months, markets have become more volatile but investors seem to ignore business fundamentals and instead focused on the liquidity provided by the Federal Reserve. According to FactSet, in 2015, S&P 500 earnings declined. In 2016, the estimated EARNINGS growth for S&P 500 companies was 0.1% (4^{th} quarter reporting is ongoing). In total, over the past 24 months S&P 500 earnings have been negative….yet the market moved higher. Investors were willing to pay more and more for each dollar of earnings.

U.S. industrial production has declined YOY for 15 consecutive months and new capital goods orders have been falling since 2012. Industrial utilization is at 75% currently. According to Fred Hickey of the High-Tech Strategist, historically, the Fed doesn't raise interest rates unless capacity utilization is above 80%. The Fed is forecasting three more interest rate hikes in 2017, many pundits are forecasting two. It is possible that both are disappointed. **While I do believe that five years from now chance are that interest rates are higher than they are today, I think it will be a very slow process….especially if the U.S. borrows even more money to fund infrastructure and military spending.** The facts show that the U.S. just can't afford much higher interest payments on its debt without compromising its fiscal budget. It is for that reason that I believe rates are not set to skyrocket anytime soon. However, the days of negative interest rates are hopefully behind us.

The prevailing sentiment has shifted dramatically from June 2016. At that point, in my Koffee Talk Interview on our website, Schuyler interviewed me about Brexit, interest rates and the U.S. dollar among other things. At that point, most pundits were calling for rates to stay low and the dollar to remain unattractive. The exact opposite happened. Interest rates have risen significantly and the dollar broke out to a 14 year high. Now, pundits are extremely bullish the dollar and the talk is the rates are going to keep rising. I would temper my enthusiasm. The herd has moved.

Behavioral Analysis

Last week, I had a client meeting and we discussed behavioral biases amongst other things.. I just posted an article about how investor behavior works on LinkedIn. Check it out if you are on LinkedIn as well. My client said to me that he has learned over the last few years that is gut is always wrong. (I have heard this more than once from clients) He said he believed that in order to "win" at investing you need to do the opposite of the masses. I said, I mostly agreed.

The crowd is generally right in the middle of a trending market so it is generally a good idea to follow the herd in the middle of a move. However, when a move gets to extreme sentiment in one direction or the other, it may be beneficial to run to the other side of the boat. When investors begin to believe that a trend will continue in perpetuity it is often best to take the other side. When investors get too fearful or too greedy it is often best to increase or decrease your position and wait for the trend to reverse. Being a contrarian can potentially be very lucrative, but it can also be very lonely!

The Math Suggests Lower Returns Ahead

Today, the 10 Year U.S. Treasury Yield is roughly 2.50%. That is about 1% higher than a year ago. It is mathematically certain that if you invest in that bond today, 10 years from now you will have made 2.50% annually before inflation.
If you have a portfolio with 40-60% or more of your assets in Treasury bonds it is a mathematical certainty of what you will earn. So, if you want to earn a 7% rate of return before inflation on your portfolio, what must you earn on your other assets? Well, if you have 50% of your money in 10 year Treasuries, you must earn 11.50% each and every year for the next decade in order to achieve a 7% gross return. I would argue that with today's roughly 2% dividend yield and high valuations based on almost any metric you look at, that the potential for 11.50% average annualized U.S. stock returns is highly unlikely.

It appears, CALPERS, the California Public Employee Retirement Pension fund agrees with me. CALPERS at $306 billion in assets is the largest pension manager in the U.S. In an article last year from the L.A. Times, it said they are reducing their average annual return assumption from 7.50% in 2012 down to 7.25% today. As of this month, Bloomberg reported they are lowering it again to 7%. This is the fourth time they have lowered their return expectations since 2012. It seems they are finally coming around to something I have been talking about for almost four years. This follows their 2016 fiscal year returns of 0.61%. That followed a return of 2.40% in fiscal year 2015. They announced a plan to lower forward expectations to 6.5% over time. The problem for CALPERS is that each time they lower return expectations, they must either increase funding into the plan from other areas, or cut benefits. That is a tough choice and is part of a bigger pension issue in the U.S. Many pension plans promised more than they are able to deliver. It becomes, in essence a default. In my opinion, the state of the United States pension system will come under more pressure in the next five years. There is the potential that many promises could be broken.

What does that mean for you?

Each quarter, Grantham Mayo and Van Otterloo (GMO) releases a quarterly report. For value based investors, I consider it a must read. The piece was well done and is a summary of their esteemed opinion of how markets over the next 7-10 years may perform based on current interest rates and valuation. Needless to say it isn't pretty. Here is a summary.

GMO and I believe that either valuations will revert back to long term averages as they always have in history and near term returns will be poor (2-4 years), OR valuations will remain high relative to history due primarily to the low interest rate structure we currently enjoy. If valuations remain elevated indefinitely, near-term returns could be less bad but insufficient for many investors to achieve their financial goals. From a financial and investment planning perspective it would obviously be helpful to know which scenario will play out. GMO believes that since you cannot determine which scenario will play out over the next decade it would be prudent to plan for both. Investors saving for college educations or retirement should in my opinion plan for the possibility that returns over the next decade would be even lower than the returns where from the last decade, which were lower than that of the decade before that and so on.

I feel that today's investment landscape is truly unprecedented. GMO's historical investment assumptions have been between 5.50% and 6% stock returns ABOVE inflation. 2.5%-3% in bond returns ABOVE inflation and cash 1-1.5% ABOVE inflation. If we do not move from current interest rates and valuations to more normal levels (and thus suffer a severe correction to both bonds and stocks), GMO believes long term returns will be about 1.25% less than in the past. That basically means, that cash earns next to nothing, bonds earn slightly more than nothing but about half its normal returns and stocks average between 4.25% and 4.75%. What becomes clear to me is that in this more rosy scenario, the 5% return after inflation or the 7% nominal return that CALPERS says it needs would be impossible to achieve being that no single asset has an expected return above that level. Remember, that doesn't mean that an asset can't return more than that in a single year, GMO is talking about the next decade, which is how investors and financial planners should think about portfolios. IF we are in this new paradigm of higher valuation levels and lower interest rates then the basic assumptions of many investors fail due to a slow bleed of missing targets via lower than expected returns.

However, if we do mean revert, as we always have in history, we are due a nasty decline in the markets to justify earnings that haven't budged in two years and rising interest rates. The point here is that I believe the status quo is in trouble. Those that have built a "traditional" portfolio of U.S. stocks and bonds may be in serious trouble over the next decade. The longer your time horizon, the better the mean reversion of valuations is a positive. If you are 30 or 40 and have another 35 years until retirement you would hope for mean reversion so that you can put more of your capital to work at higher interest rates and lower valuations. They key is preserving what you have while the market adjusts. However, if you are 50 or 60 and closing in on retirement, that scenario is not what you want to hear.

Secular Change Ahead?

Where do we go from here? Ironically, I think some of it will come from politics. It is possible that President-Elect Trump becomes a historical President. While some think he could be historically good and some historically bad, I think his election was quite outside the box.

In 2000, when George W Bush took over the White House he was supposedly the most pro-business President ever. Armed with an MBA, and business experience it was assumed he would take what Clinton built and usher in a golden era. Instead the opposite happened. He was in charge during two of the worst recessions in U.S. history, constant wars and the unexpected events of 9/11. So the most pro business President presided over a time of increasing public debt, job losses, economic stagnation and two massive stock market sell-offs.

Fast forward to the eight year term of Barack Obama. He was widely viewed as an agent of change when he took office. He was going to increase regulation and expand government intervention into a variety of areas. He was generally observed to be anti-corporate as well. He presided over a period again with massive debt expansion but a tripling of the U.S. stock market, and remarkable gains out of the bond market through 2015.

I actually wonder if what President-Elect Trump is inheriting may be setting him up for a fall. The people have spoken and are looking for change. The President-Elect promises to bring change. (Isn't that what President Obama said as well?). My fear is that the optimists are way too optimistic. Odd as it may sound, I think many of Trump's economic policies may work. The rise of nationalism and ability to negotiate deals may help our economy grow significantly. HOWEVER, that is not necessarily good for financial assets. His policies are generally inflationary. Putting more people to work and relocating plants from foreign countries to the U.S. is great for the working man (which is what he campaigned on). However, with that comes higher wages and potentially higher import prices. That is bad for companies. Higher inflation puts pressure on stock valuations and it becomes impossible for bonds to generate returns to keep up. **I actually think a Trump administration may be even better for the U.S. economy than expected but much worse for the U.S. stock and bond markets.** I know it is counterintuitive but it makes sense when I think deeper about it.

I think the key to managing your financial plan and your assets over the next five years is the following.

- Reduce your return expectations, which means you will have to save more or spend less
- Diversify your investments around the globe to potentially take advantage of cheaper markets than the U.S.
- Expect and welcome more volatility….which creates opportunity

Depending upon your individual investment objectives and other suitability factors, look into:

- Income producing assets with the ability to raise that income (dividends, rents, distributions, etc.)
- Raw materials and natural resources that generally benefit from inflation
- High quality companies with differentiated products with increasing revenue and attractive valuations
- Emerging Market debt and equity that generally performs well wither higher inflation
- Alternative strategies such as market neutral, merger arbitrage and floating rate debt
- Investment managers with high conviction ideas and strategies
- Nimble strategies with the potential to profit as volatility increases such as alternative investments

I believe investors should be wary of the following:

- Fixed Rate investments such as bonds
- Low quality companies with commoditized products
- Companies with high debt levels
- Securities tied to Market Cap weighted Indexes that may not perform well in the changing environment

Labor may be rewarded more than capital over the next four years

    - Meaning starting a business and the tax advantages that come with it may be a great opportunity
    - Working longer hours could be rewarded with higher wages and lower tax rates resulting in higher take home pay

These are just some thoughts on how to plan for the future and potentially position your portfolio. I believe traditional allocation is in for a rough ride and many of the index based strategies could be leading investors in the wrong direction. Feel free to contact me if you would like to discuss your strategy.

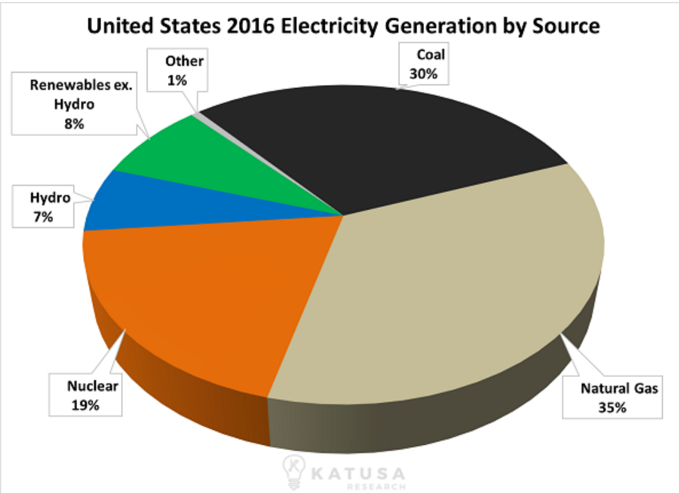
Thematic Update- Nuclear Power

On March 11, 2011 one of the largest earthquakes ever recorded struck the east coast of Japan causing a Tsunami of water killing more than 15,000 people and causing over $200 billion in damage. Structural damage was caused to a very old nuclear power plant that was unfortunately built on a fault line. The damage to the plant caused the cooling systems to malfunction. There was a reactor meltdown that released radioactivity into the air. Now, Fukushima is said in the same breadth at Chernobyl and Three Mile Island.

Interestingly, as pointed out by Katusa Research, Fukushima was not the closes nuclear power plan to the epicenter. That was Onagawa. The town of Onagawa was virtually destroyed but the nuclear facilities withstood the onslaught without incident. A 46 foot seawall was strong enough to prevent flooding and solid enough to withstand high levels of ground shaking. In fact, instead of evacuation, like Fukushima, area residents took cover at the power station. It was the safest place in the area. I have studied and read a lot about Fukushima but this was the first I had heard of that. Most news articles and the media focus on what sells. The panic and fallout from Fukushima gets more eyeballs than how well Onagawa performed. The headline could have been, **In 2011, a well-built nuclear power plant took a direct hit from one of the largest earthquakes in recorded history, without incident.** When nuclear power is used the right way, it can be very safe and provide a much needed form of clean energy.

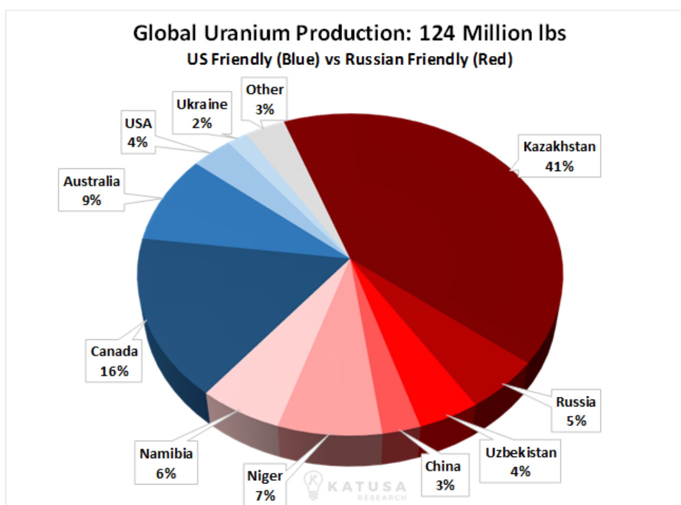
Following that meltdown, Japan shut down all its nuclear reactors. Germany and Italy enacted rushed plans to close down is nuclear power industry due to fear. Before the earthquake, uranium prices traded north of $70 per pound. As Japan dumped excess supplies on the market and demand fell due to their shutdown, oversupply has taken prices down 69% to a low of just under $20 per pound. Prices are so low now that ALL U.S. uranium mines are losing money. An industry executive told Reuters, "There has never been a worse time" than now. Statements like these are what contrarian investors live for. In the natural resources industry, more than any other, the cure for low prices is low prices. Since, suppliers generally can't make money at these low prices they have shut down supplies. If and when demand slowly returns, supplies become insufficient and prices rise. It has happened time after time.

I don't believe risk to be volatility, I believe risk to be making hasty or emotional decisions in reaction to that volatility. In my opinion, one of the best ways to reduce this risk is to invest in cheap assets and have more patience by extending your time horizon. As I have said for over a year, I believe we are at such a point.



The reality is that nuclear power can be a safe way of providing clean energy for decades. It is much cleaner and safer than coal for example. According to the World Nuclear Association, one out of every five U.S. homes is powered by Nuclear. We know that the U.S. wants to reduce dependence upon "dirty" coal and accelerate advancement of clean energy. Most people in the world generally agree. Currently, according to Katusa Research, nuclear energy is responsible for about 10% of global electricity. The main benefit in my opinion is that is provides base load power. The wind may not blow, the sun may not shine and water may be calm. That is why those sources may not be a permanent and only source of future energy. Nuclear power could continue to be a main source of base load power for decades to come. As Japan restarts reactors demand returns and that could be the cure for low prices. Interestingly, in the last sixty days, the uranium sector has come to life. Numerous smaller companies have increased 75% or more.

There are three reasons for the sentiment change in my opinion. First and most important, the industry was just too hated for how essential it is to modern living. Second, President-Elect Trump is viewed as more favorable to nuclear power than President Obama was. Even if he does rebuild our nuclear weaponry, that demand is insignificant compared to nuclear power demand. Third and more significant in my opinion was the recent announcement from Kazakhstan. If you didn't already know, Kazakhstan is the #1 uranium producer in the world Here is a pie chart of total uranium production. They are currently responsible for 41% of global mining production followed by Canada and Australia. (most producers are considered Russian friendly as opposed to U.S. friendly). Kazakhstan just announced in January that they will be reducing production by 10%. That is significant. The world's largest supplier just cut production by 10%. While they are arguably the world's lowest cost producer even they are giving away their uranium at these prices.



As I have mentioned before, uranium demand is expected to increase to 190 million pounds by 2020. In addition to the planned Japanese reactor restarts, currently China has 29 new reactors under construction, Russia has nine, India has six and the U.S. has four. Resource investors know that one of the potential indicators of a market bottom is when the lowest cost of production is above the current market price. That means they lose money by selling at current prices. **That is NOT sustainable unless the lights are turned out on nuclear**

power. So far, the world has always chosen to keep cars running and the lights on. The average cost of production in North America is roughly $60 per pound. The highest grade project in the world is the McArthur River project in Canada, jointly owned by Cameco and Denison Mines. It needs $30-$35 uranium to break even. Sometimes, all that is needed for a turn is for things to be less bad. The three positives I mentioned earlier seem to be the move toward less bad and could be the birth of a new bull market. Just 12 years ago Uranium climbed from $12 per pound to $137 per pound. The market flourished because supply was constrained and demand was increasing. We may be on our way to that same scenario today.

Finally, while writing this letter last night, I was flipping through channels on the TV and came across PBS/Nova. They were airing a hour long documentary titled, "The Nuclear Option". Click on the link for a 10 minute intro. or click on the picture for the entire video. It was just too coincidental not to mention. The amount of investment into new ways of using and making nuclear power safe is astounding. The awareness of global warming and the millennials desire to change the way we consume energy is leading to an incredible focus on alternative energy. It seems over the next ten years there will be continued improvements to the way we consume energy and emit it into our atmosphere.

Nuclear power has the potential to be a great solution. If you would like to learn more about how to add nuclear power to your portfolio send us a message or give us a call.

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 hedged equity may have the potential to produce attractive risk-adjusted returns 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.

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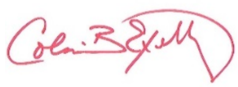
Regards,



Colin B. Exelby

President

Celestial Wealth Management

29 W. Susquehanna Ave.

Suite 710

Towson, MD 21204

www.celestialwealthmanagement.com

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