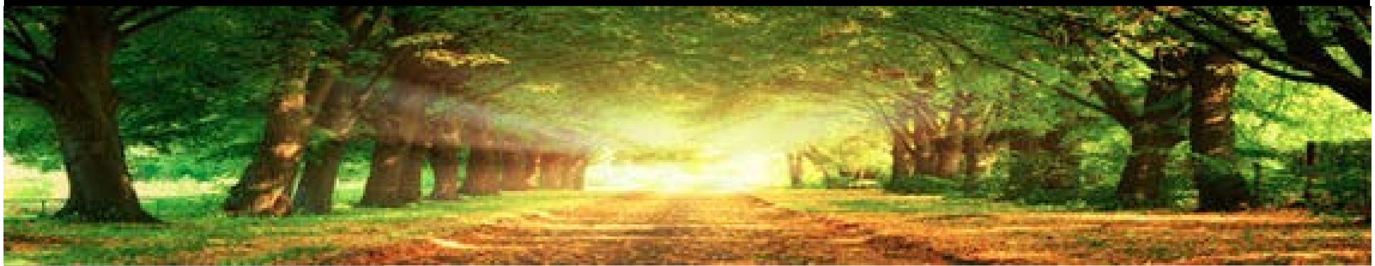
JANUARY 17, 2018



Celestial Wealth Management

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A big, fat ugly bubble?

Who would have thought heading into 2017, risk assets overall would have such a stellar year? Even cash equivalents managed to have a positive return as the Federal Reserve began to raise interest rates.

Interestingly, when President Trump was President-Elect Trump and the Dow Jones was at about 18,000 he was calling it a "big, fat, ugly bubble". Now, 8,000 points higher and there is no talk of a bubble in stocks. Maybe a bubble in bonds or cryptocurrencies, but there isn't any more talk of a stock market bubble.

You have to search far and wide, to find anyone with something negative to say about the stock market….and after the run since election-day, who is to argue?

One of the consequences of a "Centrally Managed" economy is that many investors have come to forget that the stock market is inherently volatile. I fear that the Federal Reserve, the European Central Bank and the Bank of Japan, through their constant interventions have managed to convince millions of people to become overconfident speculators.

- **There wasn't a single 3% U.S. stock market correction(S&P 500) in all of 2017!**
  - **That has never happened before.**
- **As of January 9th we have gone 387 trading days without a 5% correction.**
  - **That record is 401 days ending in 1996. Only 13 days away as I write.**
- **The last time there was a 2% decline in a day was September 2016…**
  - **Typically, according to market researcher John K. Harris, those happen roughly 10 times a year!**

To say the markets are sanguine may be an understatement. Many market commentators note that we just are not seeing the speculative fervor in the markets to warrant caution. Small account options trading is nascent. According to Robert Prechter, OTC bulletin board stock volumes are 60% of what they were at the Tech Bubble Peak. In March 2000, $24.8 billion flooded into OTC penny stocks. In November, the number was $15.7 million. Speculative fervor doesn't seem to be in the stock market but it is present if you are willing to look…

For instance, in November, a painting called Salvator Mundi sold for $450.3 million! It smashed the previous record of Pablo Picasso's The Women of Algiers which sold for a paltry $179.4 million in 2015. In fact, according to Sotheby's the Salvator Mundi painting sold for $80 million just 4 years ago. In the past five years, I have been increasingly concerned with global monetary policy. Interventions that made sense to me in the midst of the worst crisis since the Great Depression have been largely maintained. There is no telling how distorted things actually are.

It's just my opinion, but saying there isn't a speculative fervor in the stock market may be true, it may not, but there seems to be a serious speculative fervor that exists in global asset markets.

New Tax Bill

It is amazing, but Congress was actually able to pass a tax bill at year-end. I know, I know, everyone has heard about how they missed their chance to have "real" reform. How it's a benefit to the ultra-rich. How corporations make out like bandits and the little guy doesn't. **But, in my opinion, there are ways for 90% of Americans to benefit with a little planning.** We can all debate on what is good for the country and whether this is it, but my job is to provide you with the facts of the bill and then work to maximize your personal situation.

This plan should be a positive for those with investments in the stock market. What I do not know is how much juice this will provide and how much was already priced in. The market prices in what is already know. The majority of the details of the bill and the expectation of it passing may have been priced in during the rally that started this fall. 100% deductibility right away for capital spending over the next five years. Logically, that should induce further capital spending and thus potentially increase productivity.

According to CPA, Mark Kohler, over 80% of Americans will see a tax reduction. What I try to do is take all media reports with a grain of salt and actually talk to accountants, tax attorneys and read independent analyses of the code.

While there obviously could have been a better and more substantial bill put forth, there are some key points of this bill for individuals and small business owners to consider. To see how it affects you, one of the best calculators out there is via The New York Times at [http://snip.ly/yb71a.](http://snip.ly/yb71a)

I summarized the latest podcast from CPA, Mark Kohler and small business attorney, Mat Sorensen. I think they provided a concise analysis in a 40-minute podcast. If you would like to listen, we can email you the link.

Most importantly though is that most of these expire in 5 years, so we will be doing this all over again!

Individual Summary

- The number of brackets stays the same but most brackets will drop 2-3%.
- The Standard deduction is being doubled..$24k for married and $12k for single filers
- The increase in the standard deduction is designed to have fewer people itemize.
    - Most Americans who itemize have household incomes north of $100k. That is 27.7% of Americans according to Statista.
- State and local tax deductions now limited to $10k. Affects those in high tax states more than others. (Florida residents couldn't care less)
- **According to Kohler, this could result in roughly 30 million Americans no longer itemizing!**
- There is a doubling of the Child Tax credit (not deduction) to $2k per child.
    - In addition, the phase-out was raised even higher so that the overwhelming majority of people with kids will receive this credit.
- The Estate tax limit is now so high ($11 million individual or $22 million) that very few people are affected.
- Obamacare penalty for not buying insurance has been repealed in 2019, **not 2018**.
- Mortgage Interest Deduction is alive and well for those with under a $750k loan.
    - Any HELOC loan is only deductible if it was done for improvement. No more deducting that HELOC interest for a trip to the Bahamas….or a new boat.
- Moving expense deduction is gone unless in military
- Electric vehicle deduction is gone
- 529 Plan assets can now be used for k-12 expenses up to $10k per year. This is a clear benefit for Americans who prefer their children attend private schools.

Small Business Summary

This section is for S corp, LLC, Sole Proprietors, etc.

- The most important part is the 20% deduction on pass-through business income to help small businesses in a similar fashion to the C Corp tax rate reduction. This was added because often in small businesses with multiple owners, they often have different income levels.
    - Take a look at your payroll matrix for potential savings on FICA taxes and getting the new 20% deduction
    - For a personal service business (realtor, financial advisor, actor, athlete, CPA, etc.)- this deduction phases out at $315k married filing jointly and $157,500 if you are single.

- **90% of small biz owners are going to see this benefit.** (*Look for guidance from IRS on categorizing income if you are personal service)
- IRS should be more aggressive on payroll allocations going forward….be taxed as an S corp and make sure to take payroll. In general, according to Kohler, don't be an LLC or sole proprietorship.
- **Businesses that have $1m plus businesses that have good payroll and are not personal services are going to be the biggest winners.**

- Entertainment business deduction is gone. No write-offs on golf, spa, show, skybox, a play, baseball game, etc. anymore.
    - However, a "gift" of entertainment, such as tickets to a play, game, etc. has been shown in the past to qualify because the "gifter" is not receiving the benefit.
- Much more valuable depreciation schedules now. This is to incentivize companies to spend money on productivity-enhancing technology.
- Providing food at the workplace, bagels, donuts, coffee, cafeteria services is now 50% write-off, not 100%. Stock up now.
- A C corp is taxed at 21% but still distributes profits to the owner at their personal rate. You are double taxed in this scenario. Most often remaining taxed as an S corp makes the most sense.

As you know, I am not a tax advisor. It is important that you discuss these changes with your CPA or tax professional. None of these statements are meant to be personal advice or recommendations.

Market Outlook

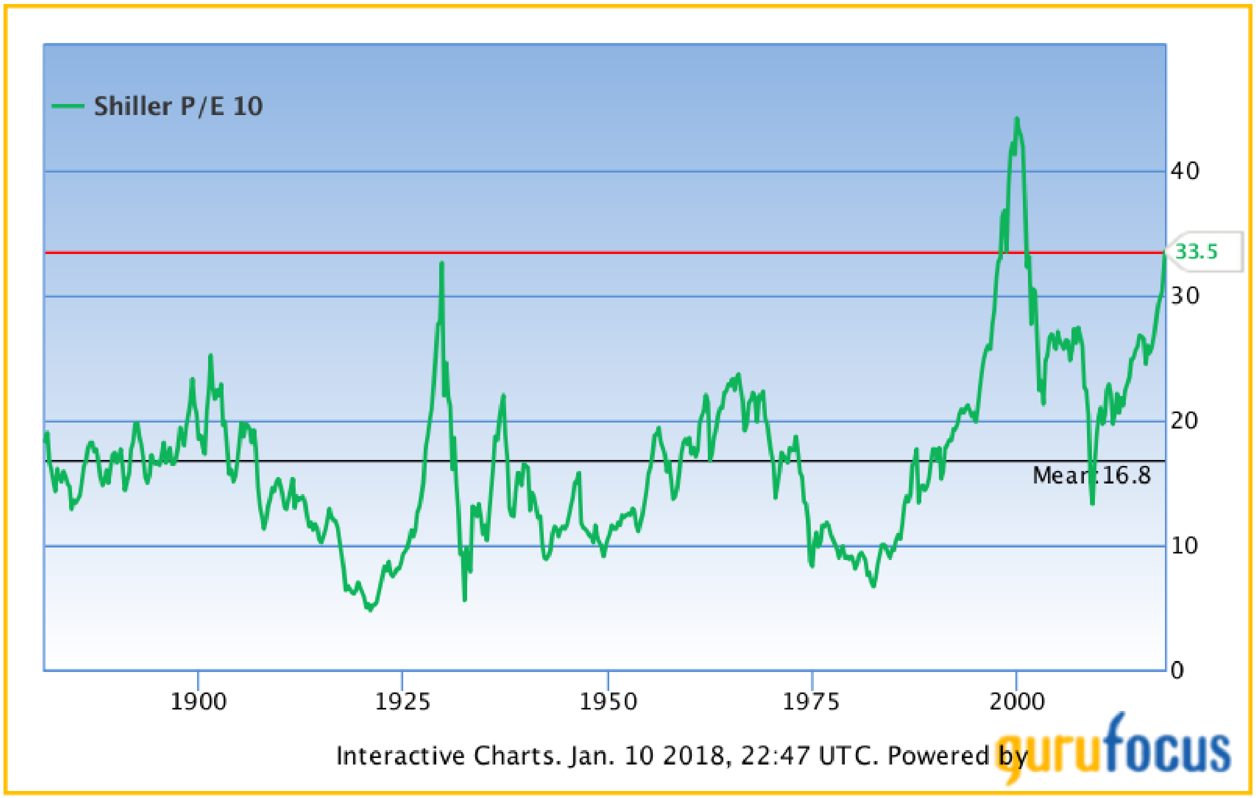
This is typically the part of most investment newsletters where I should pontificate on why I think this or that asset will do well and which will do poorly over the coming 12 months. Hopefully, if you read my piece in 2016 on Evidence-based investing, I dispelled the notion that we should be "guessing" about what may or may not occur in the coming 12 months.

Esteemed investor John W. Henry, also owner of the Boston Red Sox once said,

"I don't believe that I am the only person who cannot predict future prices. Despite this, investors hope or believe that they can predict the future, or someone else can. A lot of them look to you to predict what the next macroeconomic cycle will be. We rely on the fact that other investors are convinced that they can predict the future, and I believe that's where our profits come from."

While I don't believe one can predict the future with any accuracy, what I do believe is that there are times to be aggressive and times to be conservative. **There are times when markets are overvalued and offer more risk than is being accounted for and times when markets are undervalued and are actually less risky than they appear.** Thus, one can adjust their strategy to overweight undervalued markets or underweight overvalued markets and wait for reversion to the mean. Historically this has been a strategy that can bear fruit. Some may call it, "buy low, sell high".

With that as a backdrop, here is the U.S. stock market valuation using the popular Shiller P/E ratio.
Named after the Nobel Prize Award Winner, Robert Shiller, this valuation metric aims to smooth out corporate earnings over rolling 10 year periods to reduce the cyclicality of those earnings.



As you can see from the above, when going back to the late 1800s, the current valuation metric of 33.5 is now the second highest on record above 1929! Now, ONLY the dot-com era bubble is a higher valuation. What is the point of monitoring this chart? When valuations are high, returns over the coming 7-10 years are often subpar. When valuations are low, the returns are often above normal. **Using average market returns for the last 80 or 100 years to do your retirement planning for the next 20 years may be dangerous.** Portfolio returns over a 10-20 year period depend immensely on the valuations and level of interest rates at your starting point.

The explanation often used for why this high valuation is acceptable is that interest rates are low and thus other assets can support higher valuations. At a high level, I generally agree with this premise, but that does NOT mean that if interest rates are 0% that investors should be willing to pay ANY valuation. That is just ludicrous. Further, the Fed's first interest rate hike of this cycle was way back in December 2015. We are now starting year 3 of this slow tightening cycle, so that reasoning for why valuations can be sustained so high is beginning to dissipate.

In fact, the 2 year U.S. Treasury Bond, generally described as almost risk-free is currently yielding 1.96% as of 1/9/2018, 7 years ago it yielded 0.15%. I would venture to say that the lows in interest rates have been made. A 2% 2 year bond is now attractive enough to start competing for investment dollars. I might even go so far as to say that the return on the 2 year bond might even beat the return out of the U.S. stock market over the coming 24 months.

It seems to me that with extremely high valuations, rising interest rates, and potentially rising inflation it is a sign to be cautious. If you haven't rebalanced your portfolio recently, you may want to consider it. Locking in some gains and investing in more conservative strategies may look brilliant 24 months from now.

Foreign stock markets look much more attractive to me than the U.S. market when looking solely at valuations. **This helped me turn bullish on the emerging markets and specifically the "Monsoon Region" in 2016.** The significant rally over the past 24 months in the emerging markets and other foreign markets has reduced the undervaluation to a point where it is now fairly valued. Just look at the rally! **From the low in January 2016 to now, the MSCI Emerging Markets Index is up 73.4%.**

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

That rally just got the emerging markets back to a fair valuation. It is still roughly half that of the United States. This is also despite a two year period where the U.S. dollar was generally rangebound. **Considering the U.S. stock market is trading at the second highest valuation on record, foreign markets may offer a nice alternative.**

Late Cycle?

I believe markets, like life move in cycles. If the current upcycle began in early 2009 with interest rates of 0%, a high economic growth rate coming out of the recession and fair to undervalued U.S. stock market valuations, then I sincerely doubt we are still early or even middle. As you move into the late innings of an economic cycle or even extra innings, you most often have the following:

- High stock market valuations moving higher
- Interest Rates moving higher
- Inflation moving higher
- Rising Wages
- Booming economy
- High consumer confidence
- Greater than normal amount of corporate mergers
- Rising raw materials prices
- Potential for an investment mania
- Excessive Risk-taking

It seems to me that almost all of these are currently present. Does that mean you should run for the hills? Of course not. Who knows how high markets could go? Does that mean you should be increasing risk? Probably not. Back in the 1980s people thought the Japanese stock market was expensive when it was at the same valuation as today's U.S. valuations. What happened? The Nikkei Index valuation exploded three times higher to 100X before eventually collapsing under its own weight.

There are some who believe the U.S. stock market is valued higher than the rest of the world because of the higher index weightings to healthcare and technology generally more expensive industries. This has only happened because of the run in those sectors compared to other cheaper areas like basic materials, utilities, and energy. It's the same excuse used in 2007 when mortgage lenders and financials were roughly 50% of the index and back in 1999 when technology was 50% of the index. But, GMO Asset Management ran an analysis putting the MSCI EAFE international index at the same sector weighting as the U.S. What they found is that the S&P 500 was still north of a 25% premium to the international stock index.

The presence of so many who constantly need to find ways to justify the high valuation of U.S. stocks in order to convince investors to pile in their hard earned money tells me this is most likely late cycle thinking. Additionally, indexes based on a market capitalization weighting, think S&P 500, DOW, Russell Index, are heavily weighted in the sectors that have performed the BEST already over the past 8 years. New money added is being funneled into the most expensive areas of the market. By structure, when investing in the Dow and S&P 500 you are owning more of the most overvalued stocks and are forced into the most overvalued sectors at market tops. The exact worst time to be doing that. Eventually…..that should be a poor strategy. Index investing, in my opinion, works about 75% of the time. **But, it's the other 25% of the time that really, really hurts investors and creates poor decisions.**

What I do want to point out is that late cycle, often commodities start to outperform. It seems this has begun happening since early 2016 as well. Take a look at these two charts. One is of the broad commodities index and one is of gold. Broad commodities began to rally in early 2016 and are up 23.89% from the low as I write. Gold just notched its second calendar year gain in a row and is up 26.2% cumulatively. Additionally, the trend is now positive, above both the 50 day and the 200 day moving average. (key trend signals)

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When an economy reaches late cycle, there is often an expansion in capital expenditures. (Exactly what this tax bill is designed to do). With the increased construction and cap ex, raw materials prices usually rise due to increased demand. This pushes through to the inflation number. If history is any guide, there may be some room to run in diversified commodities and the companies that look for and produce them.

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It's possible that gold is set up to have a substantial rally in 2018. In the long run, gold has risen but in my opinion, that is only because fiat (paper) currencies are constantly debased by politicians. As they promise more and more, currencies fall against gold, which cannot be debased. Gold rose in almost all currencies globally in 2017. Only the Euro rose more. **In fact, according to Mark O'Byrne at GoldCore, gold is now priced at all-time highs in emerging market currencies.**

Additionally, in my opinion, there is a fallacy perpetuated by the media that gold declines during a Fed tightening cycle. In order to discredit that media statement simply look at the 2003-2007 period. **The Fed hiked rates 17 times from 1% to 5% during that time period and gold rose by 52%!** This is the most recent example, but many times in history this has been the case.

What is needed for a substantial move, in my opinion, is a break of the 2016 and 2017 highs of $1,377 and $1,362. A breakout above those levels could set the stage for a move much higher as the public takes notice. It's possible that breakout occurs coincidentally to a piece of news such as N. Korea tensions, a Saudia Arabian oil crisis, Brexit discord, Cryptocurrency values plummeting….or nothing at all.

It's hard to believe that gold bottomed over two years ago and there is still such apathy toward it as an investment in the U.S. As part of a diversified portfolio, I think gold reserves a place, and when it is unloved it may deserve a larger than normal place in a portfolio. Since 2000, Gold has still outperformed the U.S. stock market. Gold returned 421% as of this writing. According to Money Chimp, the S&P 500 with dividends has compounded 256% over the same time period.

I hope this newsletter gets you up to speed on where we are in the market cycle. If you have questions, would like to review your portfolio, your financial situation or your retirement plan please reach out to schedule a consultation. Further, if you have a friend or colleague who may be interested in this outlook please share it via the buttons at the beginning of the letter.

Good luck in 2018!

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.

- 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 and commodity mining companies are still extremely beaten down but many have rallied over the past 24 months. 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.

JANUARY 17, 2018

Regards,

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President
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