While "Interesting" was the word used to describe the first quarter of 2017, "return of volatility" could be the phrase I'd use to describe Q2 of 2017. In this note I'll again provide a brief synopsis of our Solution Equity Model's performance, followed by a more in depth overview of my views given the current investing environment.

So – how has our Equity model fared vs. broader market through - 2Q2017?

2017 performance through Q2 for the S&P

9.34% Total Return
8.24% Performance Return

2017 performance for Q2 for the DJIA

9.35% Total Return
8.03% Performance Return

2017 performance through Q2 for our Equity Solutions Model

10.52%** Total Return
9.74%** Performance Return

We maintained our hedge in gold stocks, as well as a cash position of roughly 17-19%, creating a volatility lower than that of the both the S&P & DJIA. adding a few new names to the model in an effort to further reduce the overall risk of the portfolio.

Observation:

Cracks in the dam are getting bigger… We've got it covered… What makes our economy function? Will you have a chair when the music stops? Have you been paying attention? Oil and Agriculture…

Cracks in the dam are getting bigger…

Per Reuters: Monday, June 26th, 2017: **GM lowers outlook for U.S. 2017 new vehicle sales**

> *"The market is definitely slowing ... it's something we are going to monitor month to month," Chief Financial Officer Chuck Stevens told analysts on a conference call. "Pricing is more challenging."*

GM's latest sales revisions take the company's production levels back to those not seen since… 2015; yet, the company still remains positive…

> *GM had previously announced it expected 2017 new vehicle sales in the "mid-17 million" unit range. Stevens told analysts that sales could fall by 200,000 to 300,000 units this year but that the automaker had "somewhat insulated" itself from a downturn by reducing fleet sales, which lower vehicles' residual values.*

However, GM's CFO, Chuck Stevens, admits the company has a supply of 110 days sitting on dealer lots right now compared with the historical averages of all major U.S Automakers of a typical 65 day supply dating back to 1960.

If you happen to be curious, for comparison purposes, 17 million new vehicle sales happens to be where new vehicle sales peaked out in 2005, just prior to falling off a cliff to the 10 million range during the "great recession" of 2008/09.

If you've read any note of mine over the last year and a half, I've talked ad nauseam on the explosion of sub-prime debt over the past 6-8 years, including that of sub-prime auto loans which fueled new vehicle auto sales over that time, pushing those markets to a record high 17.55 million units in 2016, with a little help from abnormally high dealer incentives.

The past 6-8 months have begun to tell a different story, with auto loan defaults steadily increasing along with car repo's, lending standards are just beginning to tighten; and the markets don't like it. As money becomes more difficult to borrow, both sales and revenues have been rollover starting with the lenders, followed by the rental car companies (largest U.S Auto fleet buyers who rely on both used car sales and a constant stream of credit to fund operations with razor thin margins), then flowing faster to Auto manufacturers themselves, followed by weakness in the part suppliers, and ultimately, US manufacturing as a whole (with Auto being such a large part of the US manufacturing sector).

The trickle down effect began back in mid-2105 documented here, with one of the largest sub-prime auto lenders, Santander Consumer finance (SC), as their book of business reported significant deterioration year over year. This foreshadowed what was more than likely to occur to the rental car companies, which is exactly what has happened with both Hertz and Avis over the past 6-8 months. The next domino to fall would more than likely be the Auto's, and while they both have remained relatively strong, as we can see from GM's CFO Stevens, their revenues have begun to fall; dealer incentives have dried up, while dealer inventories have blossomed to startling levels.

These issues are not isolated solely to General Motors as Ford's first quarter, while beating "industry experts" expectations, were 36% lower than 2016Q1 numbers. As Reuters reported here:

> *The company reported a first-quarter net profit of $1.6 billion, or 40 cents a share, down 36 percent from $2.5 billion, or 61 cents per share, a year earlier.*
>
> *"(CFO Bob) Shanks said Ford's own used-car values at its finance arm were down 7 percent compared to the same quarter in 2016, but said customers' credit scores remained high and we "feel really good about where credit is.""*
>
> *"Clearly we're moving to a different stage of the cycle, **but we think based on what we know that we've got it covered**," he said.*

We've got it covered! Hmm… Where have we heard that before???

A calm stream can turn into class 5 rapids fairly quickly; for those who have been white water rafting, you know full well, if you're not paying attention tremendously strong currents can capsize you in a split second (and turn your pants into a parachute rapped around your ankles making it nearly impossible to swim to safety, but that's a story for a different time).

While it feels like a century ago, in 2005, Federal Reserve Chairman, Ben Bernanke said...

> *"We've never had a decline in house prices on a nationwide basis. So, what I think what is more likely is that house prices will slow, maybe stabilize, might slow consumption spending a bit...*
>
> *House prices have risen by nearly 25% over the past two years. Although speculative activity has increased in some areas, at a national level these price increases largely reflect strong economic fundamentals."*

Fast forward to 2007, it was Ben Bernanke who constantly assured the public that the problems in subprime mortgages were "contained"...

> *"Despite the ongoing adjustments in the housing sector, overall economic prospects for households remain good. Household finances appear generally solid, and delinquency rates on most types of consumer loans and residential mortgages remain low...*
>
> *The effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."*

Again, in 2008, mere days before the collapse in subprime debt, demolished wall street icons like Lehman Brothers and Bear Sterns, while forcing J.P. Morgan to throw Merrill Lynch a lifeline as we watched mortgage giants Fannie Mae (FNMA) and Freddie Mac (FMCC) collapse, Bernanke swore the following before Congress:

> *"Fannie and Freddie are adequately capitalized. They are in **NO** danger of failing." (Emphasis mine)*

While I am in no way, shape or form advocating for any specific politician or political party – Senator Sanders (VT-D) has an entire page documenting countless Bernanke's "We've got it covered" – here; Which is much simpler and more efficient than adding 15 different hyperlinks from countless .gov sites or news sources.

So… what makes our economy function?

People of all walks of life read these thoughts; Bankers, entrepreneurs, business owners, c-level execs, professional athletes, doctors, dentists, CPAs, attorneys, the list go on. I decided to take an informal poll and asked roughly 100 friends and colleagues, the same question:

What is the primary fuel, which makes our economy function - the single, key item or "driving force" necessary for the U.S. economy to function?

The answers were as diverse as those who read this; Consumer spending topped the list with jobs, i.e. "employment" closely behind. Other suggestions were small business, free enterprise, self-preservation, heck - I even got the answers "freedom" and "faith". While all great answers, my personal belief is none of the aforementioned to be the ***primary*** force, which drives our economy. I believe it's much more obvious, yet hidden in plain sight. It's something that is so etched into our cultural fabric that we don't think twice about it and often take it for granted…

A stable workforce is imperative for economy to function, so clearly we need people working; without small business, we lose many of these jobs and wages, which is arguably the "Bedrock" of our economy. Though, while small business is clearly *a* driving force of the economy, it's not the primary fuel. Free enterprise, in theory, allows companies to compete against one another with limited governmental control (cough), and then there's consumer spending… Wages made are typically wages spent; depending on where we fall on the wages scale, we purchase everything from airplanes and fancy cars, to furniture, food, clothing, books, toys and well, junk… Our culture consumes, we buy, buy, buy and spend, spend, spend; for the most part, we save very little…

We could argue that a slowdown in consumer spending creates a compounding downward snowball effect; less spending generates a glut of inventory, which creates a slowdown in manufacturing or building, generating an inventory glut down the supply chain, forcing layoffs as the snowball continues down hill getting bigger the whole way. Without spending we don't function… BUT!

People gave consumer spending as an answer to your question and you said, *"I don't believe any one of the aforementioned to be the **primary** force, which drives our economy."* I stick to these words… While I completely agree that Consumer spending is pivotal, there is something that's much more important which allows us to spend as much as we do.

I'm speaking about the dynamic between CREDIT and DEBT! The Credit/Debt dynamic is without question, THE PRIMARY driving force behind our economy; without credit, the vast majority of American consumers wouldn't be able to spend a majority of what they spend. The instant an item is purchased on credit, an immediate debt is created. We could argue the semantics as to whether or not we're discussing two separate items, but it's nothing more than a chicken or the egg scenario; without being approved to assume the debt, the credit isn't extended, once an item is purchased with credit, the debt is immediately created. This dynamic is the lighter fluid on the U.S economy's campfire.

Banks offer consumers "credit" to buy their home; the consumer assumes "debt" in the form of a mortgage. Without this dynamic, the housing markets freeze, as we witnessed in 2008/09. While outstanding mortgages dwarf other segments of "consumer credit" markets, i.e. Auto loans, Student loans and Credit Cards, these markets are what allows the vast majority of our country to spend any discretionary money. Most individuals in the United States do not have the ability to outright purchase any large ticket items without first, being approved to assume a significant DEBT before the "credit" is extended to them.

Without this dynamic, small businesses can't get their feet off the ground, while larger businesses don't have the ability to grow as quickly. For example, Amazon just purchased Whole foods for $13.7 billion dollars. And while I am not advocating for or against, Amazon's lifetime "earnings" are roughly $5 billion dollars. Sure they have some staggering revenues, though, when you spend more than you make, investors extending credit and the assumption of **debt** is necessary to bridge the gap or fuel expansion, regardless of how much "infrastructure" or cloud service is being built out.

Without the credit/debt dynamic, discretionary spending grinds to a halt as individuals focus more of their attention to buying necessities; food, heat, electricity and a roof over their heads and less on more expensive cars, vacations, casual dining, clothing, etc. We witnessed the entire housing market seize as mortgages dried up in 2008/2009.

Understanding this dynamic is so, tremendously important; for as the credit/debt dynamic goes, so goes our ability to spend, which fuels our consumption, and in turn, growth.

Will you have a chair when the music stops???

Debt, in and of itself, isn't necessarily a bad thing, we just talked about how it allows people to consume as well as provides leverage for companies to grow. However, too much debt extended to too many people who have an inability to repay it, backed by little to virtually no collateral, has the ability to create a disaster. For example, too much sub-prime auto debt extended to those without an ability to repay given the specified terms of the loan that can't be met (absurdly high interest rates with too lengthy a term) leads to, a glut of upside down, repossessed cars along with early returned leases – adversely affecting new sales, leading to idle production, and what once was a trickle which US manufacturing markets could handle, now becomes a nasty class 5 rapid that few have the ability to navigate.

What amplifies the debt problem we are currently dealing with isn't necessarily its size, but the amount of sub-prime loans that are packaged up and sold off as AAA rated "safe debt" and subsequently sold to a bank, insurance company or pension fund near you drives its magnitude…

Per the Federal Reserve, there is over $10 Trillion dollars of 1-4 family mortgage debt outstanding, as of June 1, 2017. Auto loans have eclipsed $1.004 Trillion dollars; credit card debt is over $1 trillion as are Student loans ($1.4 Trillion). During the housing crisis of 2008/09 there were roughly $8.4 Trillion, 1-4 family mortgages outstanding – with roughly $1 Trillion dollars' worth of mortgage related products defaulting. As with subprime mortgages being packed up and sold off as AA or AAA debt obligations (never having defaulted pre-2008), Sub-prime Auto debts have been packaged and sold in the very same way in the form of CDO's (Collateralized Debt Obligations). The collateral on a mortgage is typically the land and home that mortgage is written on. As mentioned above, the collateral on an Auto loan is a vehicle, which typically depreciates with ever mile put on the car and every day that passes; every accident, bump or blemish. What do you think the recovery on these sub-prime auto loans will be as the used car markets are flooded with these repossessed vehicles?

While "experts" like to point out that the entire Auto loan market adds up to a fraction of what the mortgage market looked like back in 2008/09 (which is "technically" true; in 2008/09 nearly $1 trillion worth of mortgage related product failed vs. $8.4 trillion dollars of outstanding mortgages in the US) what they fail to mention is what really matters in terms of the stability of the banking industry is how many of these loan were securitized, along with what credits were; as was the case with securitized mortgages, the securitization model creates complexity – which consists of bundling these loans together and selling them to investors worldwide.. Nearly 80% of all sub-prime auto loans were securitized and sold off as a high quality security, there is over $250 billion of this product circulating in markets and no one knows who owns it. When these loans are securitized, no one knows how deep these problems are.

> *"Along with innovation came complexity – and complexity is the enemy of transparency… and complexity is NOT a good thing in finance!" Treasury Secretary Henry "Hank" Paulson 2013 Documentary HANK: Five Years from the Brink*

This represents one quarter of "what went bad" during the mortgage meltdown may soon be coming to a bank or pension fund near you (remember, these products were sold as AA and AAA, safe investments). Couple this with a significant amount of delinquencies and defaults piling up in the $1.4 trillion dollar student loan market added to the spike in delinquencies in the trillion dollar consumer "credit card" markets, and roughly $1.5 trillion dollars of junk bonds which will need to roll over in the next 4 ½ years, we could be staring down that class 5 rapid very quickly?!

I mentioned "consumer credit card" market.

Capital One is the 3rd largest Credit Card issuer in the United States, with the fastest growth in outstanding card balances since 2010. Buried in their Q1 numbers Page 13 Table 8 management felt the need to increase their loan loss reserves by $1.7 billion or 30%. For those unfamiliar with balance sheets, you don't increase loan loss reserves by 30% unless you anticipate or there is a high likelihood of something relatively bad looming…

Every segment of the “consumer credit” markets have begun to show stress and as I refer to it above, the cracks in the dam are now visible and leaking. The “Auto” lenders like Santander Consumer finance (SC) and others… provided too many auto loans to those unable to repay based upon the terms of the loans. Rental car companies and largest “new car fleet buyers” like Hertz (HTZ) and Avis (CAR) are having trouble unloading their used cars as the used car markets weaken by the day. As noted above by GM’s CFO, Chuck Stevens, Fleet sales are weaker and dealer inventories are 70% higher than history average dating back to the 1960’s. As lenders tighten their credit standards, the slowdown will continue and more than likely “snowball” into the manufacturing sectors, not only the US supply chain, but globally as well…

So, where will you be when the music once again, stops? What is your protection strategy? What are you doing differently today then you were in 2006/07; the years leading up to 2008/09? We are being handed an opportunity to install hurricane shutters before any hurricane hits… and if it doesn’t hit, you’re still in excellent position to take advantage of the flood of money that central banks have been putting to work in equity markets around the globe. (see Q1 note)

Have you been paying attention?

Warning signs have been flashing in certain sectors of the markets for some time; the flashing yellows are getting a touch brighter, however, my belief is they are suggesting we proceed with caution. They aren’t saying stay out, pack your bags and run for the hills... Not just yet anyway.

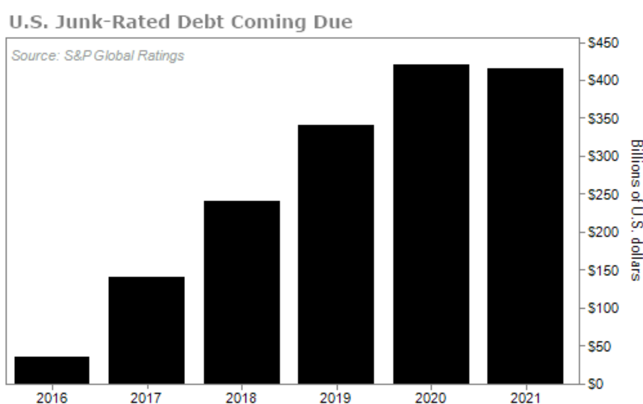
History suggests the late stages of most bull markets are where the greatest of gains are typically made. Euphoric buying pushes stocks up to unrealistic valuations and levels and in our current environment, central banks will more than likely attempt to “defend” their positions should markets attempt to take them lower. It’s either defend your position or deal with a currency issue because of the value of your equity positions?!

Anyone who’s taken a moment to read just one of my notes over the past year and a half has more than likely read about this looming debt crisis in sub-prime auto loans, student loans and the high yield debt market (which I’ve written on for nearly 2 years now).

In January I wrote:

> *More than 9.5 Trillion dollars’ worth of Global Corporate Debt will be coming due over the next 5 years. Let’s let that sink in for just a minute...*

- **Roughly 2.3 Trillion of this is considered “High Yield” - “Junk Bonds”**



- **Roughly 1.5 Trillion of this debt is that of the United States**

In that January note, I also spoke of the dangers of Bank Investment grade bonds, i.e. the bonds we’re led to believe are the safest! (For those with a short memory – the AAA rated Collateralized Mortgage Obligations was the 800-pound gorilla that nearly collapsed the economy – not junk bonds). I continued…

> ***Corporate bond analysts at Morgan Stanley anticipate the default rate among junk companies to reach 25% within 5 years.*** *The lowest "rung" of high quality bonds or BBB Rated bonds used to comprise roughly 17% of the market now represents nearly 30% of all bond issuance. When adjusted for the amount of corporate debt issued, US equity markets are trading at record highs with outlandish valuations - though corporate earnings have fallen for five straight quarters.*
> *What does this mean? It means BBB credits may not be investment grade credits anymore?! In a recent report from Bloomberg found here - both Moody's and S&P have been "cutting companies slack on mergers and acquisitions, an analysis of credit-ratings by Bloomberg News found."*
>
> ***"Over the past year and a half, both have bumped up their ratings by two, three or even six levels on a majority of the biggest deals, the analysis found."*** *(Emphasis mine)*
>
> *It also means that if you own the Equity or Stock of a company whose debt goes into default - the equity value will more than likely be wiped out as bond or debt holders take precedence over that of Equity holders.*

I've also attached the Q1 note should you like to revisit the "optimism vs. caution" piece as it still holds true.

The experts…

I referenced and provided quotes from Former Federal Reserve Chairman Ben Bernanke above. I don't know him personally, I'm sure he's a brilliant man; clearly not always right, in fact, often very publically wrong – said differently, he's simply not infallible.

Tuesday, June 27th, 2017, during a Q&A discussion in London, Fed Chair Janet Yellen was asked about the likelihood of another financial crisis. Do you want to take a guess at what she said?

As reported by CNBC:

> *"Speaking during an exchange in London with British Academy President Lord Nicholas Stern, the central bank chief said the Fed has learned lessons from the financial crisis and has brought stability to the banking system..."*

Yellen also made a prediction:

> *"That another financial crisis the likes of the one that exploded in 2008 was not likely "in our lifetime".*

She added: *"I think the system is much safer and much sounder."*

> *"The crisis, which erupted in September 2008 with the implosion of Lehman Brothers but had been stewing for years, would have been "worse than the Great Depression" without the Fed's intervention, Yellen said.*

If you happen to have NETFLIX, assuming you haven't already watched it, I suggest you watch a documentary.

"HANK: Five Years from the Brink"

Released in 2013, it highlights the 2008/09 crises from the eyes and perspective of former U.S. Treasury Secretary Henry "HANK" Paulson and Wendy Paulson. It's directed by Joe Berlinger.

Hank Paulson also said some things in the thick of what could have led to a national disaster that weren't exactly accurate. However, without the spotlight on him; having the time to reflect and think about things, he has, what I would think, to be some very poignant thoughts…

> *"I get asked all the time, what's the likelihood of another financial crisis? And I begin by saying it's a certainty; as long as we have markets, as long as we have banks, no matter what the regulatory system is, there will be flawed government policies – those policies will create bubbles. They will manifest themselves in the financial system no matter how it's structured and how it's regulated."*

When I came to Washington, the largest 10 banks held over 50% of the assets held in the banking system, 10 years early that would have been 10%. Today the problem is worse because obviously to get through the night, we needed to encourage consolidation. Too big to fail is a phenomenon that is definitely NOT acceptable.

While Paulson does go on to say that he believes the banks are stronger, better capitalized and more prepared for a crises due to more regulation. He concludes with this message:

"More still needs to be done with the shadow banking markets, the money market funds, the wholesale lending markets – the so called repo market. When I came to Washington Fannie or Freddie guaranteed or insured roughly ½ the new mortgages in America, today, well over 90% are insured by the government. So today it's worse."

"I tend to look forward. The whole reason I am doing this is not because I want to look back, but because I have an increasingly come to the view that it's important that there be a historical record for those that come after me. So we don't replay this movie all over again…."

I don't know if being too close to a situation influences an individual's behavior or not? In feeling like the weight of the world is on your shoulders, maybe we say things we want to believe to be true vs. the actual reality of the situation at hand?

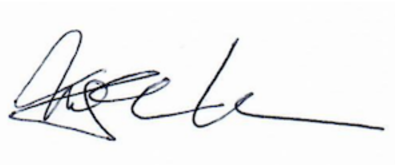
When I write these notes, I don't write them to be negative; I write them from a perspective of what I would want to know if roles were reversed. I sincerely believe markets can move significantly higher from here, I wouldn't be invested if I didn't, but having a greater understanding of how our economy functions, what stress fractures may break and how it more than likely effects markets, helps us all be more prepared to navigate our boat as we head down these rocky waters.

Maybe current Federal Reserve Chairwoman Yellen, should give Hank a call?

As always, we're happy to discuss our market thoughts along with these strategies and more, never hesitate to reach out with any questions or concerns.

Good Investing!

Sincerely,



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