WEALTHSHIELD

Q3 Commentary

What do you do when everything is overvalued?

US stocks and US bonds are both extremely overvalued according to historical measures. In fact, the US bond market has never been more overvalued, and according to the median price to sales ratio of the S&P 500, neither have stocks. This does not mean that stocks and bonds are going to crash tomorrow. Valuations are not a timing tool, but a key element to a multifaceted portfolio construction method. That being said, the extreme optimism apparent in the drastic departure from fair value in financial assets presents a difficult task for portfolio managers and investors going forward.

Buying and holding a balanced portfolio over the next decade will result in below average returns. We expect that a portfolio of 60% S&P 500 and 40% Barclays Aggregate Bond index will gain an average of only 1% over the next 10 years. *So what should a rational investor do?* The most obvious suggestion is that investors need to get creative on adding asset classes that may help diversify from the traditional financial assets of stocks and bonds. However, this is behaviorally difficult because finding assets that would help balance a traditional portfolio are largely out of favor. Historically, managed futures have provided a worthwhile hedge against stock and bond market turmoil, but they have underperformed stocks and bonds since the financial crisis.

Managed futures as an asset class rely heavily on volatility to capture large trends in other classes such as currencies, commodities, and financial markets. Global Central Banks have flooded the markets with liquidity in the form of QE programs and equity index purchases. This level of support has squeezed volatility to all time lows and generated new highs for stock markets across the globe. Managed futures and hedge funds, in general, have been some of the casualties during this unprecedented time.

What do you do when everything is overvalued?

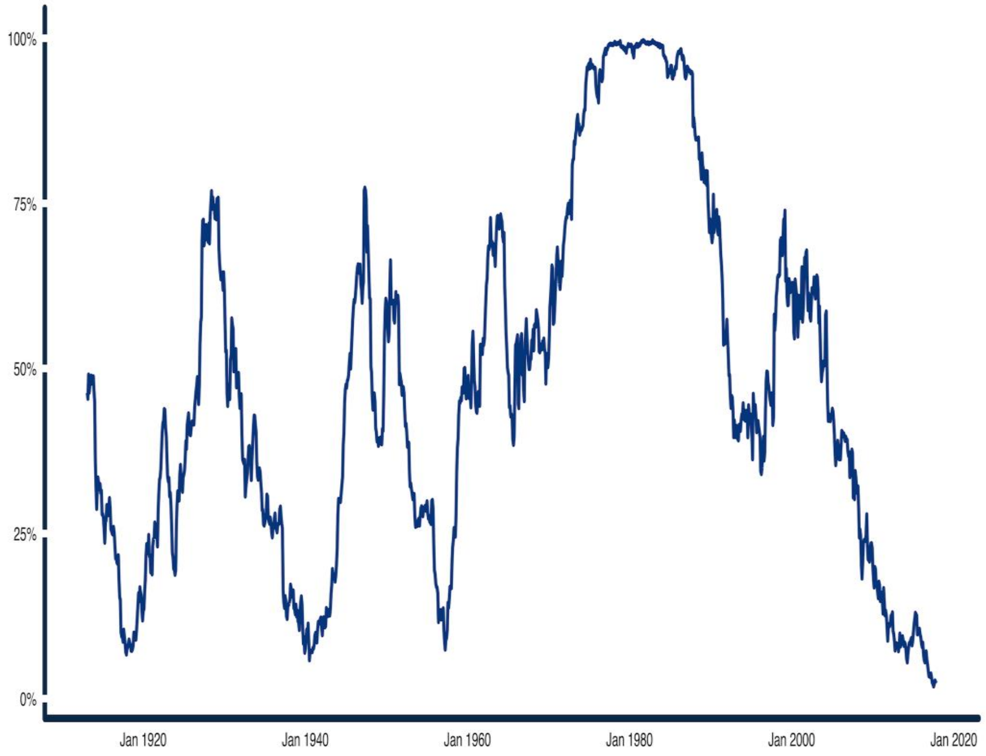
The large scale move to passive strategies is illuminating the herding nature of market participants and forcing us to consider contrarian positioning. We suggest that investors look closely at asset classes that are currently out of favor, yet have historically protected against market downside. Another method for diversifying against market stress is through the incorporation of trend following strategies to traditional asset classes in order to alter their risk/return profile.

Academic evidence suggests that time-series momentum, or trend-following, can add value to a portfolio of stocks and bonds. Trend following systems can drastically reduce drawdown while maintaining significant upside in stocks. This provides a smoother ride for investors and allows for risk reduction during periods of market turmoil. Incorporating a simple trend following system in a traditional portfolio can also allow for a higher overall equity position on average because of the potential risk reduction benefits.

In our overall investment framework, we believe valuations, market trend, economic growth, and Fed policy are imperative to proper portfolio construction. Currently, valuations and Fed policy are extremely bearish for US stocks, while market trend and economic growth are bullish. It is time to re-evaluate portfolios and focus on risk management. Managed futures as an asset class and adding trend following systems to traditional portfolios may provide the potential risk-reduction benefit without sacrificing potential upside.

Chart of the Month: Buy Low?

Percentile of diversified trend factor rolling 10-year Sharpe, 1900 – 2017



Buy Low?

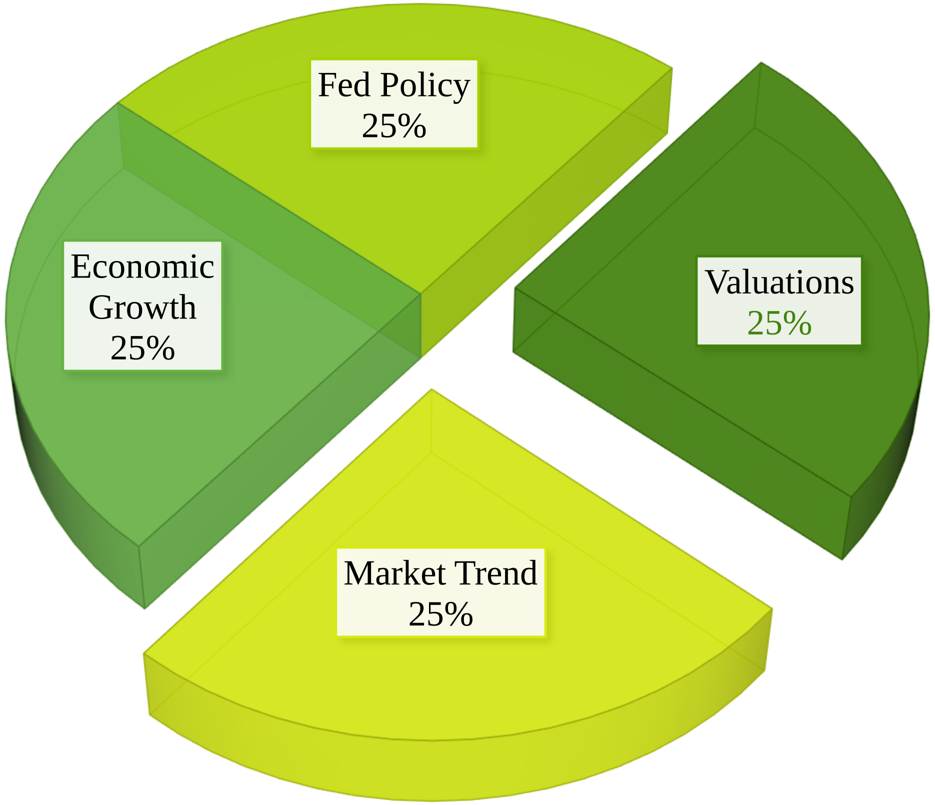
Managed futures as an asset class and trend-following as a factor are extremely out of favor at a time when traditional asset classes like stocks and bonds are at euphoric extremes.

The charts of the month illustrates the mean reversion nature of returns in managed futures and trend. We suggest that a disciplined investor consider diversifying their portfolio away from the overvalued traditional asset classes.

The difficulty lies in moving away from the herd when it is just getting fun. In fact, behavioral research suggests being a contrarian is actually considered painful for the brain. I would encourage you to embrace the discomfort in order to generate potentially better long-term investment outcomes.

Source: Calculations by ReSolve Asset Management. Data from Hurst, Ooi, and Pedersen, "A Century of Evidence on Trend-Following Investing" (2017) for period 1903 – 2012, and Moskowitz, Ooi and Pedersen, "Time-Series Momentum" (2012) for period 2013 – 2017.

Investment Framework



Investment Framework

Valuations, market trend, economic growth, and Fed policy are what drive our portfolio construction decisions.

Market valuations tell us if stocks are expensive or if they are bargains, which helps us to take advantage of undervalued assets and avoid overvalued ones.

Market trends help us determine whether market psychology is supportive of further price increases or declines. This helps us position portfolios in alignment with the larger market trends.

We determine whether the Fed is accommodative or not by monitoring monetary policy. Also, we watch economic growth to make sure that we are positioned properly relative to the business cycle.

Summary

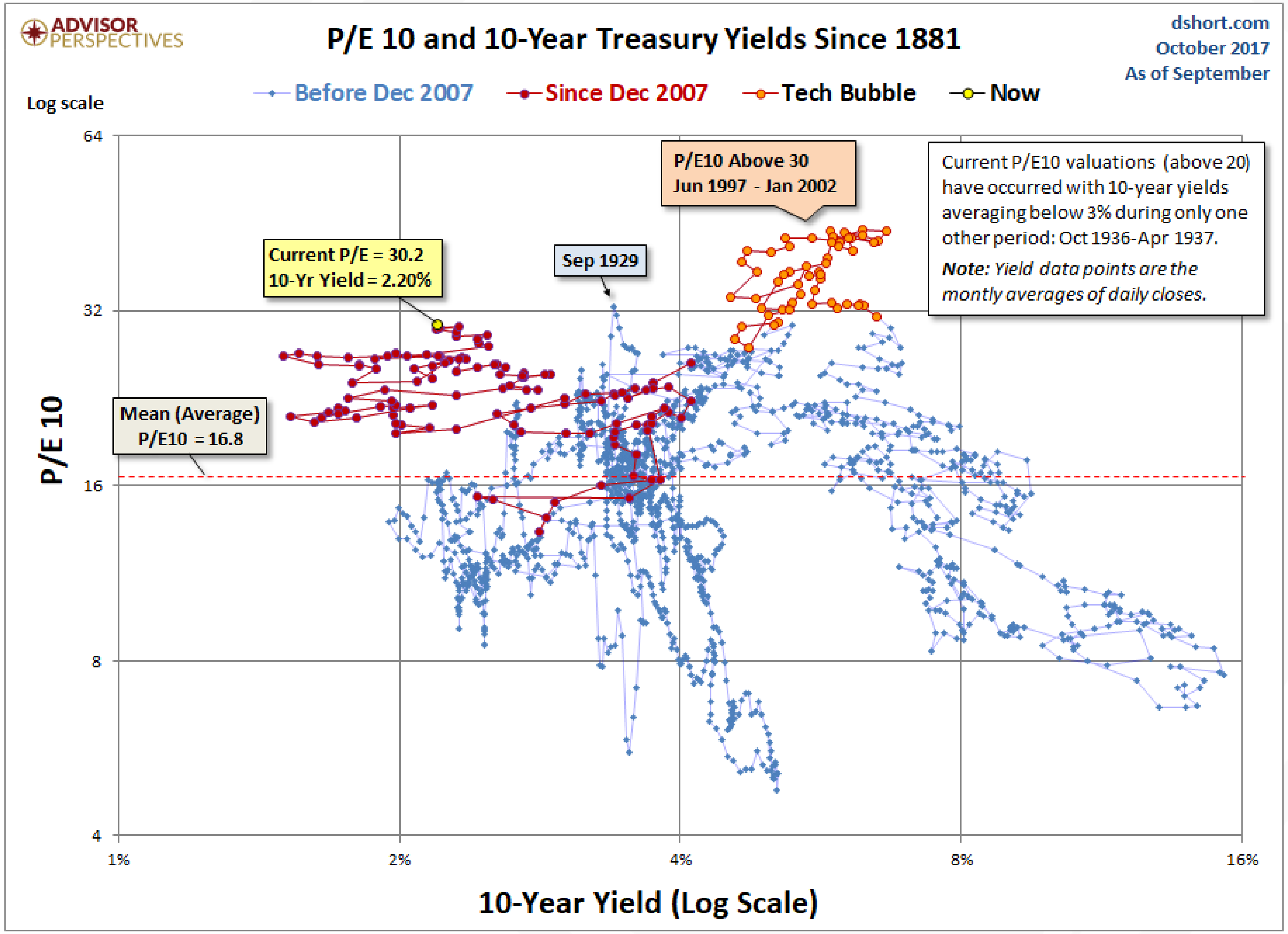
Valuations	Trend	Fed Policy	Economic Growth
US stocks are 96% overvalued	Market Trend is still positive	Tightening	Accelerating
Bearish	Bullish	Bearish	Bullish

Valuations

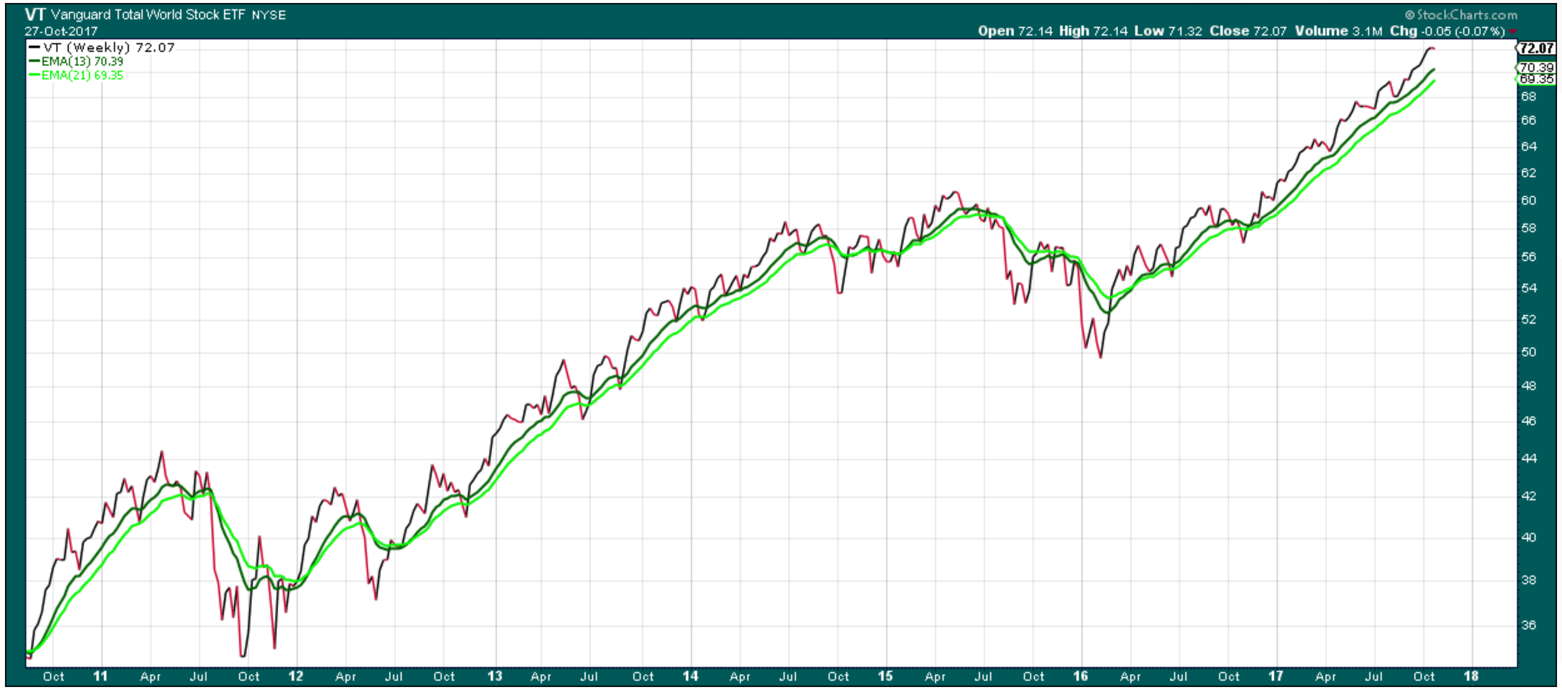
Both the US stock market and bond market are extremely overvalued according to historical norms.

The current CAPE ratio (30.2) suggests that stocks are over 100% overvalued.

CAPE values of over 20 have only occurred with 10 year yields averaging below 3% during one other period: 1936-1937.



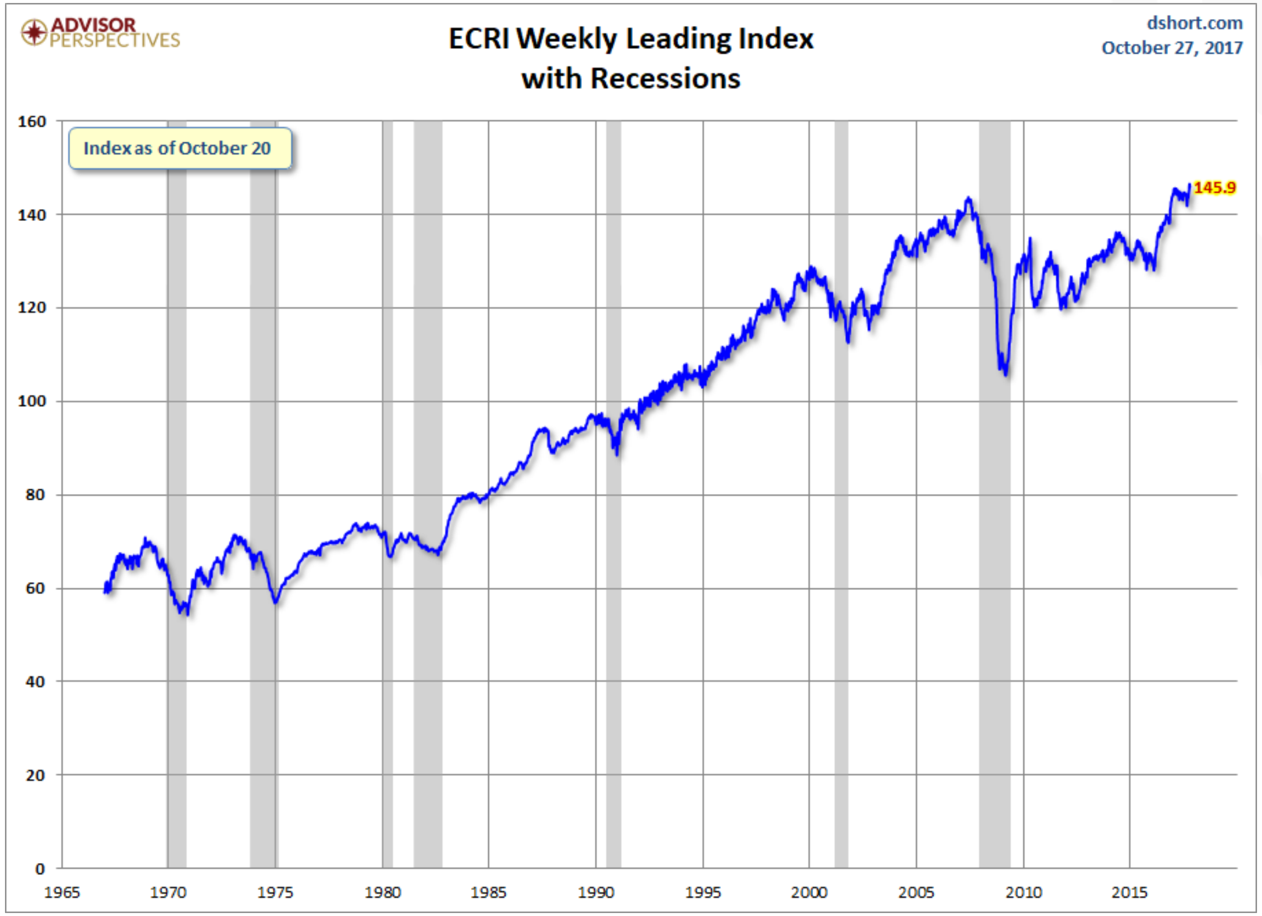
Trend



The market trend is still positive for global stocks. The chart illustrates the Vanguard Total World Stock ETF, which tracks a global index covering approximately 98 percent of the global investment universe.

In the chart, the market trend can be visualized by the line(s) move from lower left to top right. This is typical of a strong positive trend.

Economic Growth



The Economic Cycle Research Institute compiles an index of leading economic indicators that they track on a weekly basis.

The index gives us a good glimpse into real-time economic activity. Currently, the index is at an all-time high.

The positive trend in this index is indicative of strong economic growth in the US.

The growth rate of the index has declined and is suggesting that economic growth may have peaked.

The Federal Reserve

Year	Month	Increase/ Decrease	Total	Grade
	October		-3	Ex Bearish
	September		-3	Ex Bearish
	August		-3	Ex Bearish
	July		-3	Ex Bearish
	June	-1	-3	Ex Bearish
	May		-2	Ex Bearish
	April		-2	Ex Bearish
	March	-1	-2	Ex Bearish
	February		-1	Mod Bearish
2017	January		-1	Mod Bearish
2016	December	-1	-1	Mod Bearish
	November		0	Neutral
	October		0	Neutral

The Zweig Fed indicator is currently in an extremely bearish posture following the June hike in interest rates.

We believe that if there is not substantial tax reform or fiscal stimulus, the tightening path could result in an economic decline and weak asset prices.

How high can the Fed take short-term rates without triggering a recession?

Disclosure

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Rebalancing is done using closing prices as of the second Friday of the calendar month ("target implementation day") or closest market day. Target implementation dates for new allocations are provided with each rebalancing allocation. Rebalancing does not always result in a change. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this list or past hypothetical performance.

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