The Conservative Strategist

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Hope for value investors: Short-term rates rising

The entire super-bull market since 1982 has been powered by the rocket fuel of declining short-term rates. These rates started in the high teens in the early Eighties and have declined to a fraction of one percent recently: The Fed and other central banks reached the endgame of their strategy. Real interest rates (the benchmark short-term rate, minus the current inflation rate) turned negative. This makes little economic sense, as lenders naturally demand a real return on their money. So the Fed's artificial suppression of rates has created widespread economic distortions, including excessive borrowing and a run for risky assets out of proportion with improving underlying earnings.

I've used the analogy before: The major developed economies have persisted for quite some time on the opioids of artificially low rates. The longer it lasts, the more painful likely is the withdrawal.

Rates have been rising

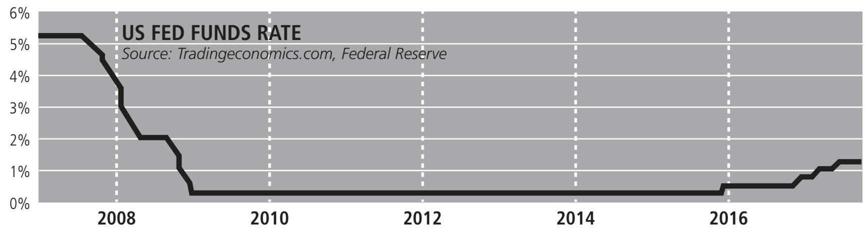
That painful withdrawal has begun. Short-term rates have been rising since late 2015, but in earnest this year. From a post-crisis low of 0.25% on Fed Funds, we're now at 1.25%.

Rates will likely continue rising

The Fed has only begun reversing rates. In October, it will begin normalizing its balance sheet, reducing $4.5 trillion of bonds and notes to something closer to $3 trillion over the next thirty months. Doing the math, that means the Fed will have to sell an average $50 billion per month in bonds, to a marketplace that will likely demand much higher rates to absorb that supply.

The Fed itself plans to raise the Fed Funds rate to 1.75% by year-end and as high

After six years near zero, short rates finally trending higher



In response to the growing financial crisis of 2007 to 2009, the Federal Reserve lowered its benchmark short-term rate from 5.5% all the way to 0.25% in little more than a year, then kept it kept it there for six more years, until it inched it up to 0.50% in late 2015. It resumed its series of hikes this year, and we're now up to 1.25%, with several more rate hikes planned in the coming months.

as 3% in the next two years, which would once again likely restore a premium above inflation — that is, a positive real rate.

So where once we had the Fed and private investors working together to push interest rates lower, that animus is reversing, and all parties will likely be pressuring rates higher.

Higher rates will hurt

If declining rates of the past few years bore most of the (excuse the pun) credit for higher stock prices, then higher rates will pressure stocks, as they've done historically. First higher corporate and consumer borrowing rates mean a slowdown of economic activity. Second, higher margin rates mean less speculation, kicking out a major leg of the stock market's recent gains. Third, higher rates on bonds and cash compete with dividends on stocks for investors' attention.

It's the real rate that matters

That last point is especially important. Investors have been losing purchasing power on their cash for some years, but today, the one-year Treasury Bill rate has crept up to 1.30% from a low of 0.11% in 2015, and only 0.45% as recently as the middle of last year. With inflation at about 1.8%, that means investors can keep their money safe and lose only 0.5% per year to inflation, versus 2% or more just a couple of years ago. As that real rate turns positive, the calculus of many investors will lead them to take cover from risky assets. ■

The Markets September 30, 2017	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	2519.36	3.94%	12.59%
International Stocks (Vanguard Index)	17.57	5.96%	21.56%
Emerging Markets Stocks (Vanguard Index)	27.49	7.71%	23.46%
Real Estate Stocks (Vanguard REIT Index)	27.60	-0.14%	0.77%
Bonds (30 year US Treasury/Vanguard Index)	2.86%	-0.33%	3.92%
Dollar (US Dollar Index)	93.05	-2.73%	-9.12%
Gold (London Afternoon Fix)	$1283.10	3.29%	11.97%
Money Market Funds (IBC Index/7-day yield)	1.12%	+0.05%	+0.43%*

*change in yield

Portfolio Planning

Privacy: Only the paranoid survive

With a recent one billion compromised accounts at Yahoo, 140 million now at Equifax, and even 104,000 at the Internal Revenue Service (!), it's easy to throw up our hands and say: "We have no privacy anymore, so what's the use of protecting it?"

That would be unwise. Sure, a hacker's more likely to obtain your data from a breach at a large firm or institution that has let its guard down than from your own mistake. But that shouldn't keep you from doing everything you can to safeguard your identity and your financial privacy. Most privacy measures are still under your own control. Where to start? People who know me know I'm big on task lists. Here's an excellent list of *preventive strategies* from Rob Cordeau, CFP, Director of Financial Planning at *RetirementResearcher.com* (September 12, 2017), with my own comments in italics.

- Shred all sensitive documents, credit card offers, expired cards, etc. *(Buy a quality shredder, or use a local service where you can watch them shred your docs.)*
- Use complex passwords. *(Do not employ your SS, birth date, address, or phone number in the passwords; If a hacker has obtained yours, that's the first thing they'll try.)*
- Never give your sensitive information to unsolicited phone callers.
- Install anti-virus and anti-malware software *(I use Malwarebytes)* on your computers.
- Enable security features on mobile devices.
- Exercise caution in clicking links and opening attachments on emails.
- Don't submit *(or even access)* sensitive data while using non-secured, public WiFi.
- If you don't have a PO Box or locked mailbox, collect mail promptly and suspend it while away.
- Be prudent in deciding how much information to disclose on social media. *(Aside from your opinions, zero would be the recommended amount.)*

Yes, even all of these measures may not suffice if there is a breach beyond your control. Your identity may be in the public sphere. So it's important that you also implement *monitoring strategies,* so you can catch early any unauthorized use of your personal information. Again from Mr. Cordeau:

- Review bank and credit card statements for unauthorized transactions. *(Do this monthly.)*

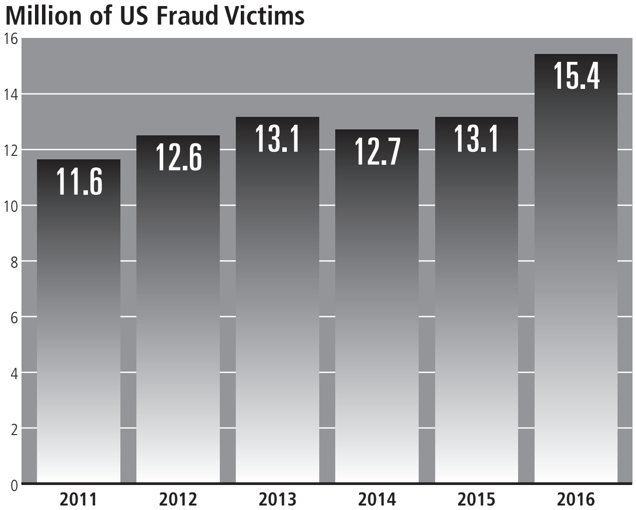
> In the early 1980s, I wrote a book called *The Complete Guide to Financial Privacy.* If I would write that book today, it would be a pamphlet. There is precious little privacy left.
> — *Mark Skousen*

- Choose to use credit rather than debit if your card has both options — credit cards enjoy greater federal protections in the event of fraudulent activity. *(And you get points.)*
- Review your credit report regularly. This can be done either manually or via a credit monitoring service. *(You can obtain a free credit report once per year from each of the three main services, so if you stagger your requests, you can obtain one every four months. But if you want to be more vigilant, pay a credit monitoring service $15 to $30 per month, and it will scan all three services daily.)*

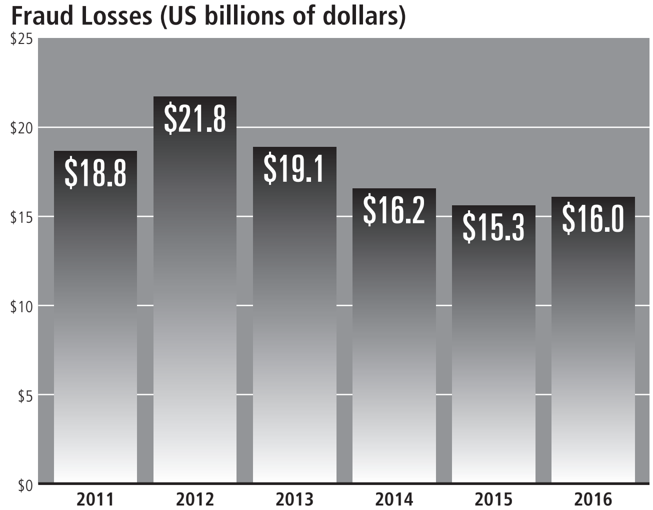
What do they say? *The price of freedom is eternal vigilance.* Yes, the above steps are a bit of a pain, but they are the price of the great convenience that we enjoy as consumers. ■

The fraudsters are winning

Million of US Fraud Victims



Fraud Losses (US billions of dollars)

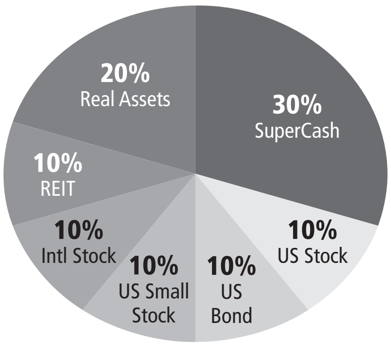


Javelin's 2017 Identity Fraud study found that the number of fraud victims is up 16% in 2016 from the prior year, though total losses were only up about 5%. The study found that digitally connected consumers have a higher risk of fraud, but also detect it quicker, perhaps explaining why the average fraud claim has decreased over time. Source: Javelin Strategy & Research

SuperDiversified Portfolios (SDPs)

Bubbles abound

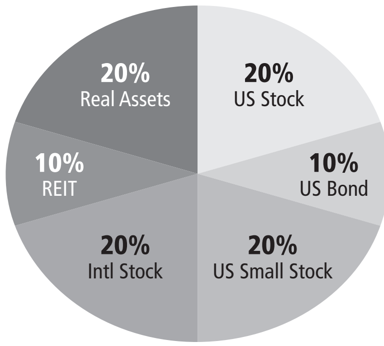
SDP1 *Conservative*



3rd Quarter **2.13%** *Year-to-Date* **4.79%**

Near major credit-related tops, bubbles often break out in several different areas. We seem to be witnessing that now. Bitcoin has reached a recent high of $4,500 per coin, up from the mid-hundreds just two years ago. Tickets for Bruce Springsteen's upcoming solo Broadway show are being scalped for $10,000 each.

SDP2 *Moderate*



3rd Quarter **3.38%** *Year-to-Date* **8.47%**

And a rather plain 1900-square foot ranch home in Sunnyvale, CA just sold for $2.47 million — $782,000 over the asking price. Silicon Valley realtors say that it's the highest premium over asking that they've ever seen. We are reaching the point where "capital becomes blind" in Bagehot's term.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Think markets efficient? Then consider this.

Asset Class	Mutual Fund	Performance 3rd Quarter '17	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	0.51%	0.51%	Best
	Merger	0.31%	2.43%	Worst
	Calamos Market Neutral	0.75%	3.45%	
US Stock	Vanguard Index Trust 500	3.94%	12.59%	
US Bond	Vanguard Long-Treasury	-0.33%	3.92%	
US Small Stock	Vanguard Small-Cap Index	4.19%	9.60%	
Intl Stock	Vanguard Intl Index	5.96%	21.56%	
REIT	Vanguard REIT Index	-0.14%	0.77%	
Real Assets	Pimco Commodity Real Return Strategy	3.04%	-2.85%	

In a mid-September webinar, bond king Jeffrey Gundlach of *DoubleLine* marveled that today, **the average corporate junk bond in Europe yields less than a US Treasury of comparable maturity**. Perhaps like politics and real estate, all bond investing is local. *Or* investors have grown complacent, yield-hungry, and indiscriminate.

Investors have been making money for so long in bonds (fairly consistently since 1980) that risk consideration has taken a backseat to grabbing what seem like rapidly disappearing yields. This is the kind of anomalous behavior you see just before a market begins to come apart.

Inflation expectations on the rise. But high enough?

You don't get many opportunities to know what the public is thinking, right down to a couple of decimal places. After all, many a pollster this past season has failed in their estimations.

But there's one area where it's not hard to quantify precisely what the public is forecasting: The outlook for inflation. Specifically, by comparing the price of Treasury Inflation Protected Securities (TIPS, the income of which floats higher as inflation does) with the price of straight 10-Year Treasurys, we can derive an exact figure for the investing public's *10-year expected rate of inflation.* It's called the Breakeven Inflation rate, because it's the inflation rate at which an investor in TIPS would break even in return with an investor in straight Treasuries.

As of late September, the Breakeven Inflation rate is **1.84%.** Given that historical inflation has been roughly 3%, and even the Fed has expressed its intention to get inflation back to 2%-plus, the breakeven rate seems too low, and thus the bond investor should prefer TIPS (and other floating rate instruments like bank loan funds) over straight Treasuries.

Inflation expectations: Still modest but rising

10-Year Breakeven Inflation Rate

Inflation expectations for the next ten years bottomed out in early 2016 at under 1.2%. today they stand at 1.84% and the trend has been irregularly higher for the past 20 months. We're still nowhere near the mid-2 levels of 2013, not to mention the even higher levels earlier in the decade.

Source: Federal Reserve Bank of St. Louis, fred.stlouisfed.org

SEASONAL STRATEGY

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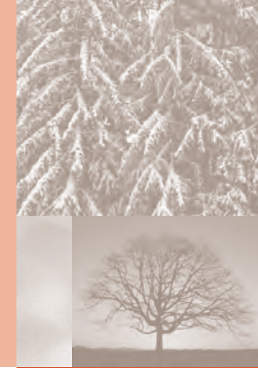


For data security: smaller is better

Good news for clients of investment advisers: Very few have reported a firm- or client-level data security breach. Even better news for *Seasonal Strategy* clients: The smallest financial firms report two-thirds fewer breaches than the largest firms.

According to a *Financial Planning Association* report on CyberSecurity sponsored in part by *TD Ameritrade,* roughly 2.5% of firms with under $500,000 in annual revenue report that data has ever been compromised, versus 8% among firms with more than $2.5 million in annual revenue.

It makes sense when you think about it. Large firms are more vulnerable for at least three reasons:

1 Target size

Asked why he robbed banks, famed criminal Willie Sutton said: "That's where the money is." For the same reason, hackers target firms with hundreds of thousands, even millions of clients. Few hackers who could even find *Seasonal Strategy* would waste the time, energy, and resources to compromise our fewer than forty clients.

2 Access

The distributed network of the typical large firm, with perhaps dozens of servers and hundreds or thousands of PCs, harbors many access points and thus many vulnerabilities. Multiply further by all the laptops and other mobile devices that proliferate at large firms and you have quite a porous structure. One example: In February, 2004, a laptop containing confidential information on more than 35,000 *Wells Fargo* customers was lost by a company employee when it was left in a car that was stolen from a gas station.

Seasonal Strategy's only point of access is a single PC, continuously backed-up to a secure online repository. And absolutely no sensitive information leaves my office on a mobile device.

3 Personnel

One of the key sources of data compromise at large firms is their people. Fallible people. Disgruntled, disillusioned, desperate employees who may steal or illegally sell data. Or well-intentioned employees who just plain make mistakes. Not to pick on Wells again, but earlier this year, the personal information (including Social Security numbers and account numbers and balances) of 50,000 high-net-worth clients of *Wells Fargo Advisors* was leaked when it was inadvertently added to a disk shared with lawyers working on a defamation lawsuit. Whether deliberately or accidentally, once data leaves the firm, so do most or all security controls.

At *Seasonal Strategy,* I'm the sole proprietor, so there is zero personnel risk, and 100% accountability.

A clean record

In 29 years in business, Seasonal Strategy has never suffered a data security breach, either at the firm or client level.

Schwab and TD Ameritrade's Fraud Guarantees

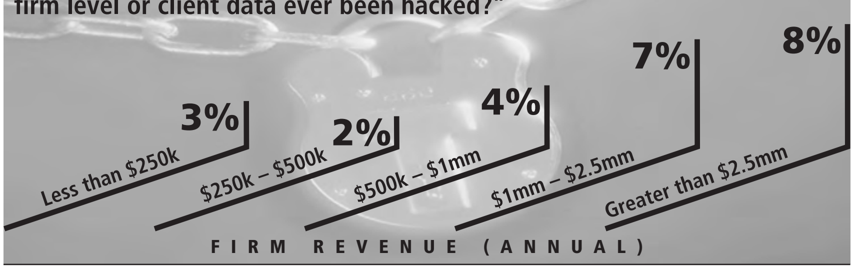
What about data security at the custodian level — namely, *Schwab Institutional* and *TD Ameritrade Institutional?* Both firms use cybersecurity Best Practices, including advanced firewalls, anomaly and intrusion detection technology, the separation of public and private servers, and 128-bit encryption technology.

Both also guarantee that if you lose cash or securities from your account due to unauthorized activity, the firm will reimburse you for the cash or shares of securities you lost. This is contingent upon you keeping your PIN and account info confidential, keeping your contact information up-to-date, reviewing your accounts frequently to check on any suspicious activity, and cooperating with the firm should your account ever be compromised.

I give *Schwab* the edge because it allows me to employ two-factor authentication. When I input my password to gain access to *Schwab's* adviser site, I hit a button on a fob supplied by *Schwab* (call it the Schwab fob), and it gives me a unique six-digit number, good for 30 seconds only, that I add to the password. While not technically foolproof, no fob-equipped *Schwab* adviser has ever been hacked. ■

Been hacked?

% of investment firms responding YES to the question, "Has any of your firm level or client data ever been hacked?"



Source: CyberSecurity: Current Threats and Risk Management, *www.OneFPA.org/Cybersecurity*