INVESTMENT NOTES: WEEK OF OCTOBER 28 - NOVEMBER 3, 2018

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Last week was not a good week for the markets, especially the US equity market. Perhaps the US market's stellar outperformance is being corrected as we wrote about in an earlier note (outperformance was 4 standard deviations from norm) and is taking the form of a lower market price versus an adjustment in currency.

The US market had a large reporting week last week. Although earnings did not disappoint (they were actually above expectations generally), revenues and profit margins did indicating that higher costs are being translated into lower profit margins and when they are passed onto consumers the result is lower sales. This is the perfect recipe for stagflation. Hence, we are buying TIPS in the fund to protect against inflation as we don't see tariffs, duties and supply constraints changing anytime soon.

The other reason for the correction in the US is the increase perceived risk due to the upcoming mid-term elections. The consensus is that the Republicans will keep the Senate and maybe lose the House (whoever takes the House will have a slim majority). It is thought that if the Democrats take the House- President Trump will not be able to get his economic legislation passed and the economy will falter. We don't think this will be the case- as the difficult legislation of tax cuts (especially those for corporations and the rich)- are already passed and will not be able to be overturned and the legislation that is proposed for the second phase of the President's economic plan is fiscal spending- which the Democrats would find difficult to block. President Trump's phase two of his economic plan will probably look more like a Democrat program than a traditional Republican program. Hence, we are buying a leveraged S&P 500 ETF for a short-term bounce in the market.

Another reason for doing this is that the lock-out period for corporate share buy-backs is ending for this quarter- so the largest buyer of US equities will be allowed back into the market and there is a limited amount of time to increase share prices in order to receive performance compensation for the C-suite.

We said last week that Europe was the place to watch and many of the predictions came to pass. Angela Merkel announced that she would not be the leader of the CDU party (it remains to be seen who will be- the convention isn't until December 7th). This leaves her to be a lame duck Chancellor until the 2021 election- or does it mean she will not be the Chancellor soon? In either case, she will be walking on egg shells- not a good place to be for the leader of the most powerful nation in the EU- especially with Italy not complying to budget and Brexit looming around the corner. This is why, although we are USD bears in the long-run, in the short-run we are USD bulls. We also observe that the Fed is the only central bank that is raising interest rates and the interest rate differential will always prevail in the foreign exchange markets.

We also believe that due to the situation in Italy, the ECB will not tighten- nor can they. Last week, Giancarlo Giorgetti, the statesman of the Lega party in Italy, announced that if Italian vs. Euro Bond spreads rose to 400bps, the margins of Italian banks and their capital positions would deteriorate to a point that emergency action would have to be taken. Currently the spread is 320bps- not far away from 400bps especially if the ECB begins quantitative tightening or Italian yields blow out on the upside. The Italian stand off with the EU is very similar to the Greek standoff. However, it appears Lega is prepared to set up a recap plan for the Italian banks, something Greece did not do. The problem is whether it is similar to the Fed's TARP plan or something else, it is not in Brussels interest to allow it to succeed as other countries would then be incentivized not to follow Brussels' policies. Therefore a run on Italian banks could have a fairly high probability. This is not good timing especially since we are in the midst of UK-EU negotiations. The EU is looking weak now and that is why we don't have any investments there and we are hedging our Euro into other currencies.