Slocum, Gordon & Co. LLP
INVESTMENT COUNSEL • EST 1978

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A crucial element of long-term investment success is an understanding that certain themes re-emerge in nearly every market cycle. While the timing, pace, and amplitude of fluctuations varies from one cycle to the next, the cognitive and emotional biases of market participants remains a constant. Periods of optimism, characterized by increasing consumer confidence, expanding debt levels, lower lending standards, and high asset prices- like we see today - inevitably create positive feedback loops where caution is thrown to the wind, precisely when more caution is deserved.

We are now in the tenth year of an economic recovery in the US that's been propelled almost entirely by quantitative easing and artificially low interest rates, yet valuations continue to suggest the market upswing is far from mature. We do not pretend to know the precise timing or severity of the eventual market reversal, but what is clear to us is that the current environment warrants more defensive positioning in our portfolios. From our perspective, the present behavior of borrowers and lenders suggests the trauma of the Great Recession has faded. Across all sectors of the economy, the Puritan ethos to save first and enjoy later is once again nowhere to be found.

In the public sphere, as a result of recent tax reform, the US is poised to run budget deficits in excess of $1 trillion over the next three years, according to the IMF. Since 1981, US public debt has surged from 32% to 105% of gross domestic product, its highest level since the immediate aftermath of World War II. We disagree with the logic of the most recent fiscal stimulus, which would've been better served as a countercyclical measure in a more challenging economic environment. However, given the US dollar's privileged

position as the world's reserve currency and the role of US Treasury bonds as the preferred holding for global investors during an economic storm, it is unlikely that the soared US public deficit would in itself trigger a crisis. Our greater concern, with respect to excess leverage, lies in the private sector.

In corporate credit markets, amounts outstanding are rising, debt ratios are increasing, covenants on new issues are almost non-existent, and yield spreads are at historical lows. Over half of the $6 trillion investment grade bond market is now rated triple-B, only one notch above junk. A large percentage of these bonds will mature and need to be refinanced at higher interest rates in the next few years, at which point the term "fallen angel" may become a national buzzword.

In the energy sector, companies engaged in hydraulic fracturing in North American shales are particularly vulnerable and a notable example of deteriorating lending standards. In the first quarter of 2018 only five of the largest 20 exploration and production companies generated more cash than they spent, and between 2012 and 2017 the 60 largest E&P companies had an aggregate free cash flow of negative $36 billion per year. Despite their abysmal track record of profitability, "frackers" were nonetheless able to raise another $60 billion from Wall Street lenders in 2017, a 30% increase from 2016 levels.

At the US household level, a painful deleveraging occurred between 2008 and 2013, but total consumer indebtedness has since rebounded and eclipsed its peak in 2008, driven by substantial growth in student loans (+$770 billion) and automobile loans (+$450 billion). Mortgage debt has also steadily climbed to $9.4 trillion in recent years, and is now back in line with 2007 levels. Here it should be noted that because the economy has grown since 2007, household debt as a percentage of GDP is not at the same alarming level it was, and much of the new debt has been issued at lower interest rates than pre-2008 loans.

We do not think the next recession will stem from delinquent US household borrowers, but we must acknowledge that consumers are once again supplementing their purchasing power with debt at the point in the cycle it is least needed: when incomes and employment are high, and the general outlook is sanguine.

Should economic circumstances deteriorate, a family that has committed 40% of its income to installment payments, as many do, will have to significantly reduce its spending if one or more members of the household lose their job, and will then generally avoid new debts as it focuses on repaying old ones. When this trend proliferates, as it did a decade ago, government must make prompt and drastic maneuvers to cut taxes and increase public outlays in order to avoid a dangerous deflationary spiral. A wholesale deleveraging of household debt would have a protracted and crippling effect on the economy.

Growing corporate and sovereign indebtedness in emerging markets is perhaps the most immediate risk for global financial stability. Approximately $500 billion of the ~$3 trillion in US dollar-denominated emerging market debt is slated to mature in 2019. With a stronger US dollar and rising interest rates, exacerbated by trade tensions and slumping commodity prices, emerging market borrowers are facing a much less accommodative environment going forward, at a time growth is also slowing. The damage thus far has been contained to Argentina and Turkey, and to a lesser extent Brazil and South Africa. We do not anticipate an emerging markets crisis of the same scale as the late 1990's, when the Fed was compelled to cut interest rates as a result of the collapse in the Russian ruble, but we nevertheless sleep well at night knowing we have no direct investments in emerging markets.

In conclusion, the tendency of governments, corporations, and households to increase borrowing at the least propitious time appears very much intact, and represents just one of a several of factors that lead us to believe we are approaching the peak of the economic cycle. Although we don't believe today's market

imbalances are as extreme as the dot-com bubble of the late 1990's or the housing bubble of the early 2000's, the amount of leverage throughout the financial system is excessive, by any standards, and warrants a more cautious stance in our portfolios.

This quarter we will also be releasing a supplementary video presentation, back by popular demand, where Jeff will discuss a number of other themes currently influencing our thinking. We also look forward to seeing many of you at our upcoming 40th anniversary celebration in Newport on November 1st.

-Peter Hatfield, CFA

The Partners and Associates of Slocum, Gordon & Co. LLP cordially invite you
to our 40th anniversary cocktail reception and commentary at
The Newport International Tennis Hall of Fame on Bellevue Avenue in Newport
at 5:00pm on Thursday, November 1, 2018.

RSVP: 401-849-4900 or cmedeiros@slocumgordon.com

Slocum, Gordon
& Company LLP
INVESTMENT COUNSEL
EST 1978

39 Mill Street • Newport, RI 02840 • (401) 849-4900

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