Investment Strategy Update June 30, 2018

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Rule #67 // Do your time in the wind. - Velominati.com

Cycling is a favorite pastime for partners at Blue Oak Capital. Tom relishes the occasional jaunt from Oregon to San Francisco after visiting his daughter, Matt savors never-frequent-enough ride commutes from San Francisco to our office, and Loren delights in regular whirls up Old La Honda. Cyclists often travel together in a pack also called a "peloton". The reason for this bunching up is because there are significant drafting advantages. The shorter the distance to the bicycle in front, the larger the decrease in wind resistance. Effort, speed and strategy are active components to successful peloton riding. Cyclists must make calculated decisions about their location in the group. Up front, you expend more energy, but you are in first place. In the middle, you benefit most from the draft but have the highest risk of carnage in the event of a crash. Off the back, you benefit from less of the draft but distance yourself from crash risk.

As stewards of your capital, carefully considering current market and economic dynamics, we are most comfortable with an "off the back" strategy at the present time.

Data that supports the bull case is readily available: unemployment is extraordinarily low, the U.S. economy continues to grow, inflation remains benign and overall global growth remains low but stable. The recent sweeping tax cuts for corporations enabling enhanced stock buy-back programs add a nice leader to draft. Considered in isolation, the bullish case supports an "in the middle" strategy.

However, there are undeniable signs of heightened risk due to: increased market volatility, trade war escalations, wage inflation pressures, rising interest rates, corporate debt levels as a percentage of GDP at post war highs, a faltering Chinese stock market and higher oil prices. The market cycle appears to be peaking and the potential rewards of an "in the middle" strategy are out-weighed by the risk of being aggressive.

With risks increasing, caution is warranted. That is not to say we believe that a market meltdown or a recession is imminent. We and our bond managers are carefully monitoring the difference between short-term rates (less than 1-year) and the US 10-year treasury bond. Every recession to date has been accompanied by an "inversion" of these rates whereby longer-term rates are lower than short rates. We believe there are two important forces on longer term rates that could further push long-term yields higher and bond prices lower: 1) the Federal Reserve is intent on reducing its balance sheet thereby removing demand for treasury bonds, and 2) the 2017 Tax Reform Act results in deficit spending financed by the issuance of new treasury bonds.

Since 2009 the Federal Reserve was the largest buyer of government bonds. Bond holders were drafting the Fed, so to speak, and because of the end of special quantitative easing and Trump's fiscal stimulus, that leadership is gone. We wonder who will buy all these bonds and lead the pack and what yield they will demand? Bond prices are falling, and bond yields are rising to entice new leaders to pull. This change of leadership keeps us at the low end of our allowable bond allocation, utilizing short duration and high-quality investments that distance us from carnage.

The potential for higher bond yields also plays to our equity strategy. We still are in the middle of our allowable allocation to stocks but are wary of the most aggressive investments due to valuations. We are reminded that in the long run, dividends play a critical role in a portfolio's total return and certain segments of the *market peloton* offer better and safer opportunities to garner returns than the current leaders.

In the meantime, consider Aesop's fable of the Tortoise and the Hare. Tortoise emerged the victor because it established a steady, sustainable pace without bending to the pressure to keep up with the arrogant Hare. Patience and time rewards diversified investors. For now, we will remain "off the back" carefully gauging the bull case and global market risks until we can more confidently seek higher returns by taking more risk. In other words, we'll happily do our time in the wind … but not until the rewards of doing so are more certain.

It is a privilege to work with you.