

# Market Commentary Third Quarter 2018

Did you ever try to learn a new skill and fail repeatedly? And then one day, break through? It's a mysterious process—to try and fail, try and fail again—and then suddenly, unexpectedly, succeed.

I experienced this a year ago when training to swim long-distance. My goal was to one day swim 20 ocean miles to Catalina Island. Tracy, my coach, worked with me to adjust my stroke in hopes of getting to the "catch and pull." Unless I learned to do it in the pool, I wouldn't have the efficiency required.

I couldn't get the hang of it. Mentally, I thought my form was correct. But when Tracy showed me the video, I could see it was wrong. While my brain knew what to do, my body refused to follow its instructions. Until one day.

Suddenly, I surged through the water with such force that I banged into the wall at the end of the pool, having neglected to sync my flip turn with my new speed. In hindsight, all those months of seeming failure prepared me to succeed. The process required patience and a willingness to keep trying. But success required something even more fundamental. First, I had to get in the pool.

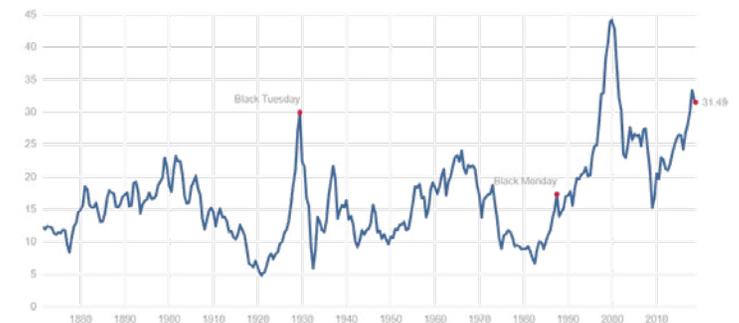
Which brings me to the financial markets. As value investors, 7Summit Advisors takes positions in stocks that look cheap to us, but whose true worth may not be realized for a year or more. We have learned to be patient. Hoping to jump into a stock like Twitter as it begins its ascent, or selling it right before it declines, strikes

us as a fool's errand. Our goal is a "10-bagger," a stock whose price jumps 10 times. (The famous mutual fund manager Peter Lynch coined the term to refer to "bags" or bases that a player reached as way to measure a play's success.) Forgive the mixed metaphor, but to achieve our goal, we must be in the pool.

Our portfolio reflects this philosophy. We continue to be defensive and we were prepared for the stock market's tumble in early October. Even though U.S. interest rates are rising, we are buying high-quality debt in anticipation of a flight to safety. What could cause investors to flee to the safety of U.S. debt? Any number of factors.

Although the U.S. economy has remained strong, with GDP growing 4.2% in the 2nd Quarter and expected to exceed 3.5% in the 3rd Quarter, stocks are still selling at above-average prices. After early October's sell-off, the Shiller PE Ratio stood at around 31 versus 16.1 average.

## SHILLER PE RATIO



Source: multipl.com

Emerging markets are also a cause for concern. In India, the value of the rupee has fallen about 13% against the U.S. dollar so far this year. This has occurred in part because investors, spooked by financial problems in Turkey and Argentina, have shifted money away from emerging markets. Because India's currency has fallen, the country must pay more for oil imports, which are priced in dollars. Thus, the cost of powering India's 7% economic growth increases, given that the country imports more than 75% of its oil and has only 10 days of reserves. I don't expect much global spillover, but we've seen before how seemingly minor events in an emerging economy can set up financial panics.

Here in the U.S., an additional worry is what happens when investors start getting margin calls. As of August 2018, investors have borrowed more than \$652 billion from their own portfolios to buy more securities. That's near the \$665 billion level reached last January, which prompted federal regulators to issue a warning to investors about the downside of owning stocks on margin. If history is any guide, investors will meet their margin calls by selling their best positions first, the ones that have held up during the decline, leading to even more selling.

Market corrections are inevitable. It's the impact that is navigable. Our positions in undervalued stocks and bonds, along with high-quality debt, may seem dull in comparison to a portfolio of FAANG stocks (Facebook, Apple, Amazon, Netflix and Google), but we feel our patience in them will be justified. Which is to say, we're in the pool.

As always, thank you for the trust you have placed in me and in 7Summit Advisors. We work hard to earn that trust each day.

Sincerely yours,

Li Chang