NCM Capital Management, LLC
Newsletter – March 1st, 2018

To all clients and friends:

After suffering the first 10% correction since early 2016, the markets rebounded quickly off the lows, before again showing more volatility this week; for the month of February global markets were down between 4-5%. As we last wrote, it seems that the correction began with concerns about higher inflation and higher interest rates and then was exacerbated perhaps by margin calls (margin is at record levels) and by the destruction of some leveraged, derivative products (…A topic we cover later in this newsletter.)

Certainly, the market is worried about interest rates. Since Tuesday, the markets have declined by over 2% after our new Fed Chairman Jerome Powell's testimony on Capitol Hill. Powell remarked that his views of the economy have strengthened since December. The markets had been expecting three interest rate hikes this year, but now are starting to price in the possibility of a fourth. As the Fed begins "normalizing" (i.e., raising) rates, the reaction to this can be mixed; yes, it is a positive sign that the economy is strong enough to sustain higher rates, but what effect will higher rates have on possibly slowing the economy and, specifically, hampering corporate earnings by raising borrowing costs?

To date, corporate America…and the US economy have benefited from some of the lowest interest rates in US history. As these begin to rise, how will companies and consumers respond? Did consumers take on too much debt when rates were extremely low? How well will consumers be able to service that debt at higher interest rates? As Buffett says, "We will find out who is swimming naked only when the tide goes out." This same quote also relates to the volatility product blow-up we will discuss later.

A second concern is that of rising inflation. As currently defined, inflation has been very muted over the past years. Technology, global supply and workforce…and yes, Amazon—all have contributed to keeping prices in check and wages moderated. Now that domestic employment is at very tight levels while costs for companies--like borrowing-- may be going up, end prices may start to tick higher. And though a little inflation may give companies greater pricing power, too much inflation could dampen consumer demand and put pressure on wages, thus impacting corporate earnings.

All of this has been reflected in the stock market……and certainly the bond market as yields (which move inversely to bond prices) have moved up dramatically on a percentage basis. Even though yields on treasuries are still historically low, they are now moving up to levels that have started to make investors take notice. And ironically, as yields move higher as bonds are sold---reflecting greater future economic growth, higher interest rates, etc.---they also eventually begin to reach levels that start to ATTRACT new money.

Buying Treasuries for the First Time in Over 10 years!

For the first time since before the financial crisis, we have recommended the purchase of short-term individual treasury bills (or notes) as an attractive short-term, safe investment. It actually felt very strange placing the orders! It has been over 10 years since we last thought this was a good investment idea! But with interest rates finally rising, returns on short-term treasuries are very reasonable compared to other alternatives on a risk-adjusted basis. Of course, government bonds at these (still-low) yields are not going to make anyone rich, especially in the near-term, but this is not a bad place to park some short-term money safely. Remember, treasuries are also exempt from state and local taxes which make them even more attractive with the limits on SALT deductions in the new tax laws.

Sell-off in Stocks Triggers Destruction of Volatility Funds

For quite some time, the volatility in the markets was nil. So calm had the markets been that investors were placing more and more leveraged bets that it would continue in perpetuity. And, of course, as is often the case on Wall Street, when there is a chance to profit from a strategy or trend, there is never a shortage of players who are willing to create a supply of these specialized products. In this case, there were many ETF's and ETN's (exchange traded notes) that not only allowed investors to speculate that volatility would stay muted, but actually allowed them to leverage their bets exponentially. So when volatility finally did come back to the market in early February and stocks began to sell off, these funds--which were betting against such an occurrence--were not only facing redemptions, but because of their leverage, they were facing liquidation.

At this point, we feel it is appropriate to briefly comment on the fund that was the poster child for this monumental sector collapse: The…Velocity… Shares… Daily… Inverse…VIX …Short… Term…Exchange… Traded …Note (symbol: XIV).

The name alone should be enough for most investors to take pause and consider if they fully understand their investment! Of course, if the name was not enough to scare an investor, certainly reading the prospectus should have been.

> "The long-term expected value of your (investment) is zero. If you hold it as a long-term investment, it is likely that you will lose all or a substantial portion of your investment."

That is an accurate quote from their prospectus! These products were designed as short-term trading instruments, but how many investors really knew and understood this? Instead, for the last few years as volatility was non-existent, investors were content to stay "in the trade" and profit as these types of funds moved higher and higher. In the end, however (and unfortunately in the case of XIV), many lost their entire investment as the fund was wiped out.

The Motley Fool wrote a good article on this phenomenon called: "The VIX, the XIV, and the Intersection of Greed and Stupidity." In the piece they highlight an important fundamental element of investing. You should not be invested in anything that has a (high) probability of going to zero. Notwithstanding the fact that most investors may not have understood this particular investment, greed is a big factor that takes over an investor's mindset. While they were very happy with the performance over a few years, investors never considered the downside…which turned out to be complete loss in many cases.

And XIV was not the only culprit; there were other ETF's, ETN's, and even mutual funds that suffered significant losses---and we are talking billions of dollars. And it was also not just "novice" investors in these products that were victimized. In an article in the Wall Street Journal on February 15th titled "Wagers on Calm Market Turn Sour", sophisticated investors such as pensions and endowments were listed as being investors on the wrong side of these strategies.

Once again, the lesson here is to be skeptical of anything that looks too good to be true. For a few years this was a lucrative and profitable strategy (i.e., "a can't miss strategy" according to some), but if you were in some of these funds when volatility spiked a few weeks ago, your investment was most likely wiped out.

How the New Tax Law Relates to Mortgage Interest

At NCM, we help our clients in other ways besides investments. As life seems to become more complicated as we get older, certain financial matters become more significant and impactful on our lives. Tax planning, education costs, mortgages, retirement and social security planning are all extremely important topics on which we provide guidance.

At the beginning of 2018, as most will know, a new tax law came into effect, referred to as the Tax Cut and Jobs Act. A couple of the significant takeaways from this new legislation pertain to how mortgage interest is handled. Previously, homeowners could deduct interest on up to $1million of mortgage debt (or $500,000 for married filed separately.) Additionally, homeowners could treat home equity loans or lines of credit of up to $100,000 similarly ($50,000 for married filed separately.) That is, the home equity loans or lines of credit could be used towards a purchase or improvement on a first or second residence, or either could be included in a bigger first mortgage or a traditional home equity loan.

Under the new law, however, interest is deductible now on mortgage debt up to $750,000 (or $375,000 for married filed separately.) And in terms of home equity loans or lines of credit, there has been much debate. Initially, it was determined that the new tax law eliminated any deductions for them. However, in late February, the IRS clarified that the deductions would NOT be allowed UNLESS the funds were being used to buy, build or improve the taxpayer's home that secures the loan. Further, the interest on these loans would NOT be deductible if the funds were being used for other purposes: e.g., credit card debt, a vacation…. or college costs. Lastly, there are clauses in the law which grandfather in loans that have been taken before December 16, 2017 or on binding contracts as long as the property closes by April 1, 2018.

So, to briefly summarize, if a homeowner has a mortgage of $650,000 on a primary home and a home-equity line of credit or loan of $80,000 used for an addition on this home, then interest for both would be deductible, as the total debt is less than $750,000. If, conversely, that $80,000 is being used to pay college tuition, the interest on this loan or line will not be deductible.

For our clients, we often advise them on different cash-flow strategies utilizing mortgage re-financing, home equity loans/lines of credit and in some rare cases, reverse mortgages. However, with this new law, there will certainly be changes in the way we approach these issues with our clients. If you were interested in using a home equity loan, line of credit or re-fi to fund a large expense (such as college tuition) or are interested in other cash-flow strategies and would like to discuss other alternatives, please give us a call.

All the best,

Nick