CAZ Investments
Quarterly Letter

The Tug of War Continues….and Grows More Complex

The 2nd quarter was very good for stock prices, but the momentum ran into a wall in July. The trade war escalated, and the Federal Reserve lowered rates but indicated that perhaps they were not going to be aggressively lowering rates as quickly as market participants hoped. The result has been a very choppy start to the 3rd quarter with a return of volatility in a material way.

We have spoken several times about the tug of war going on inside the market internals, and this quarter it rings true again. The difference is that this quarter we have to consider another dimension to the tug of war. For the last few years the struggle has been between earnings growth and valuations, and valuations have been winning, with stock prices rising faster than the rate of earnings growth. Now we have another dimension to consider which is interest rate impact on valuations. So, now we have a three-pronged tug of war between valuations, earnings growth and interest rates.

For some background, interest rates impact the valuation of all assets, with very few exceptions. As rates rise, valuations should come down and as rates fall valuations should increase. Therefore, it should be good for stock values that the Federal Reserve lowered rates, right? Well yes, but it depends why they are lowering rates. Are they lowering rates because the economy is weakening a great deal? Or are they lowering rates because they want to offset the impact of the trade war? Or are they lowering rates to weaken the dollar and make our exports more competitive? Or are they lowering rates because… you get the picture. And, of course, Fed Chairs are not known for telling the world exactly why they are doing what they are doing… so, everyone must form their own opinion and that impacts stock prices and creates volatility.

What can be said for certain is that earnings reports have been pretty good, and guidance for the 2nd half has been decent. That has been more than offset by concerns about the economy weakening and the trade war, along with somewhat disappointing/unclear guidance from the Fed Chair on the speed of rate cuts in the 2nd half. Thus, the sharp selloff that we have experienced the least several weeks.

We remain very cautious here and would strongly advise investors to maintain the lowest level of U.S. stock exposure that their asset allocation guidelines permit. The risk/reward from here is simply not favorable. Stock prices may well rally based on positive geo-political news, but the downside ferocity and velocity could be quite severe, and investors should have less exposure to those risks. We just don't feel the general U.S. stock market is capable of paying us the kind of returns we would demand in return for taking those risks. Thus, we maintain our rating on the **CAZ Scale of a 1, our lowest level**.

The Emerging Opportunity

Yes, that was an intentional play on words. If one has read many of our last few letters, they very well could ask the question, "other than reduce U.S. exposures, what should I be doing." The answer remains that we believe the private markets offer vastly superior risk/reward in some specific areas than the public markets. That leads to our suggestion that investors maintain as much exposure to private assets as their asset allocation guidelines permit, particularly with a focus on thematic investments that have significant tailwinds, preferably with strong cash flows.

The trade war, general consensus that the economy is slowing around the world, a strong U.S. dollar, and other factors have all created a situation where Emerging Market equities have materially underperformed the U.S. market. We have not created a vehicle to specifically take advantage of that disparity…yet. We will let you know when/if we choose to do something that is compelling. What we can tell investors is that, if they are required/desiring to shift stock market exposure, we believe there is a much better risk/reward if they allocate more capital to Emerging Markets, particularly value stocks.

Our team continues to grow, and we look forward to introducing you to the new additions and how they will help us add even more value to your relationship with us. As a reminder, you can now access our quarterly videos in one location via a private page on our website. Those videos will give very straightforward updates on all your investment vehicles with as much current information as we can provide. Please let us know if you have any problems accessing that website or watching the videos. Don't forget to mark Tuesday, January 14, 2020 on your calendar for our Themes for 2020 event. We have confirmed two exceedingly talented speakers for the evening and will be sending out those details shortly.

We appreciate you choosing to co-invest with us and encourage you to continue letting us know how we can better serve you. It is hard to believe that we are on the back end of 2019 and will begin a new decade in a few months. We hope you have a wildly successful fall and look forward to seeing each of you very soon.

All our very best!

The CAZ Investments Team