HIGHTOWER
AN UNOBSTRUCTED VIEW
THE MORGIA GROUP

Semi-Annual Update **July 15, 2018**

Michael Morgia, CIMA®
THE MORGIA GROUP
at HIGHTOWER ADVISORS
Managing Director, Partner

HighTower Advisors, LLC
151 Mullin Street
Watertown, NY 13601
Tel. (315) 222-7148
Fax (315) 836-0058
mmorgia@hightoweradvisors.com

Visit us at:
morgiagroup.com

The Stock Market:

> *...when life looks like easy street there is danger at your door*
>
> Uncle John's Band
> by the Grateful Dead 1970

Well, it had to happen eventually. Volatility was just too damn low. Everything was too simple. The Dow Jones was ticking off new thousand point high-water marks by the day (ok maybe by the month). January alone saw the index cross 25,000 and then 26,000 less than two weeks apart! When viewing a graph of the stock market in mid-January, we joked that if the upslope on the market got any steeper it would curl back upon itself. The mood seemed to be: Just buy any technology related stock, sit back, and watch the money start pouring into your account. But perhaps the best part of the upward move was how very stable it had become. There were only ten days in *all* of 2017 that saw the Dow Jones Industrial Average move by 1% or more.[1] That is extremely calm, in case you were wondering.

And then …

Continued on Page 2

A good old fashion correction hit. Closing right at the all-time high on January 26th, the Dow peaked at 26,016. A short ten days later, it was down well over two thousand points for a 10.2% "correction." Since then it has been on a wild ride with the market fluctuating back and forth in a 2,000-point range. For now, at least, we are on the upside of those swings. Oh wait, let me check … yes, still up.

The State of Many Affairs:

Over the years, we have usually preferred to write on big picture ideas and concepts as we find that to be infinitely more interesting and important compared to simply regurgitating a bunch of short-term market statistics. This time, however, we thought we would do something different.

We will regurgitate a bunch of short-term market statistics.

But… we will do so in the context of how those data points tie into some very important longer-term trends that we believe actually matter for investors.

Although we strongly caution clients not to get sidetracked away from the big-picture strategies and thinking, we *do*, on occasion, pay attention to the day-to-day gyrations. However, as your mother warned you about the sun: don't stare at it – you will ruin your eyes! So, although we will gaze upon the short-term for this issue, we won't make a habit out of it.

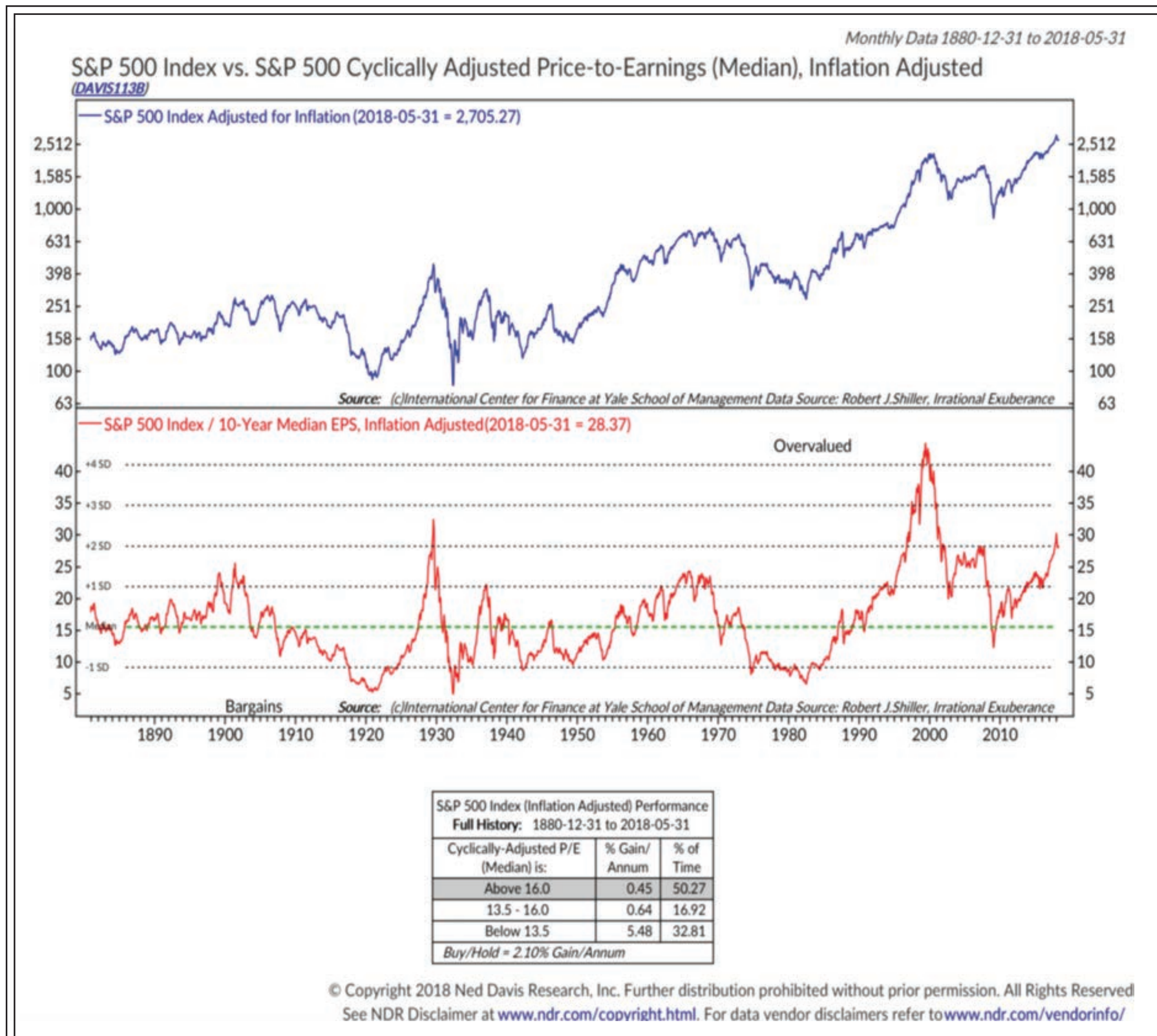
The Stock Market in General:

In January, we hit a peak in the market's upward march and currently seem to be biding time. What's next? Can we move on upwards to fresh new highs or is it time to worry that this nine-year-old bull market is *getting on* in years? To be frank, we don't know - no one does. That is because the market does not lend itself to easy predictions. It is one part mathematics and one part psychology/emotion, and both are complex.

Despite these difficulties, certain factors have been quite reliable in foretelling the future

course of stocks. We know that when the stock market price-to-earnings ratio (PE) gets as expensive as it is right now, it usually means that the following decade is likely to have rather anemic investment returns. Historically however, such high PEs have been much less useful in predicting stock returns over the following one to three years. Nevertheless, when prices have been this elevated in the past, we have always ramped up our watchfulness and have begun increasing our use of some defensive tactics. This time will be no different.

Notice the red line in the chart below – it is the PE ratio on the S&P 500 since 1880. There have only been a few times in the history of the US where this measure of expensiveness has been higher than it is now.



S&P 500 Index (Inflation Adjusted) Performance
Full History: 1880-12-31 to 2018-05-31

Cyclically-Adjusted P/E (Median) is:	% Gain/ Annum	% of Time
Above 16.0	0.45	50.27
13.5 - 16.0	0.64	16.92
Below 13.5	5.48	32.81

Buy/Hold = 2.10% Gain/Annum

If the market starts to act poorly, we will not be afraid to sell some shares and sit on a little extra cash. Yet we don't want to get too nervous too quickly – like we said above, a high market PE will not necessarily stop the market from going up further for a few more years. It's just that with these elevated prices, we will have less patience than normal if and when the stock market begins to misbehave.

In spite of the generally high stock prices for the market as a whole, we are currently having no problem finding many reasonably priced companies and sectors. We will speak on these distinctions below.

Growth vs. Value:

The two major schools of thought in the stock market are growth investing and value investing. Proponents of each tend to cast aspersions toward the other. Think of it as Yankees vs. Red Sox, Yin vs. Yang, Republicans vs. Democrats – ok that last one was perhaps a bit much (growth vs. value is not *that* contentious).

Think of value investors as bargain hunters. Think of growth investors as buyers of rapidly growing, but usually more expensive companies. Each style has its merits, and each has its risks. We are always very interested in the trend here – which of the two strategies has the wind at its back and which one is not cooperating? Over the long-run, each has had its seasons in the sun, yet with "value" clearly demonstrating a better overall track record. But… there are many *lengthy* stretches of time when growth stocks outshine value stocks by a wide margin. This past decade has clearly been one of these periods.

We are currently deep into the longest period of growth stock outperformance in history (at least as far back as the Great Depression). This run is only a few days from completing its 12th year.

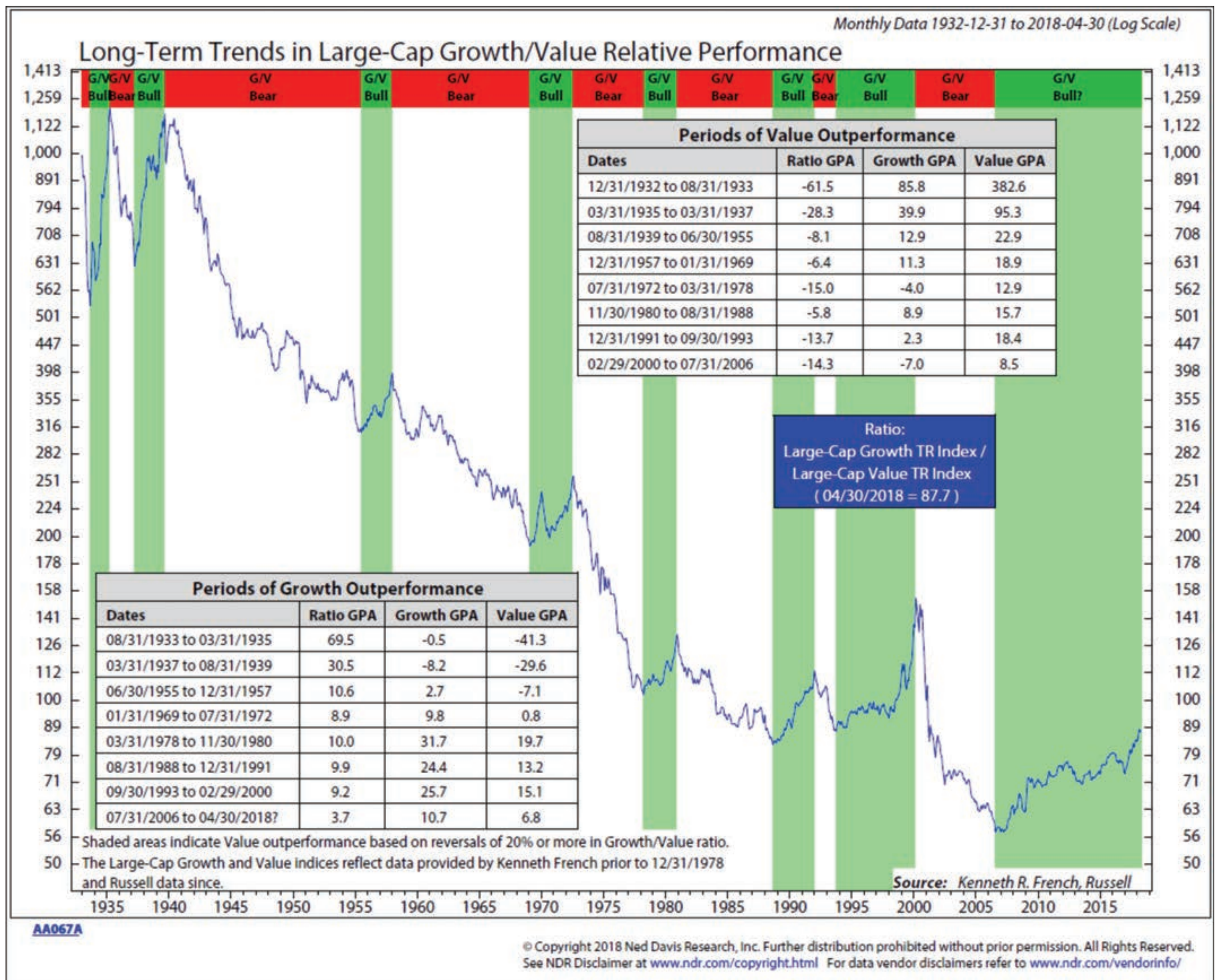
Why?

Well, during the real estate and financial crisis it was not so easy for companies to grow their profits. After the crisis and until 2016 the US and world economies recovered, but at a snail's pace relative to past rebounds. When earnings growth is this difficult to come by (rare), the companies that are somehow able to grow their profits, despite the slow environment, become relatively more attractive. They usually see their stock prices rise faster than average under these conditions. Although an oversimplification, it comes down to basic supply and demand principles from your Economics 101 class. The "supply" of companies that can grow their earnings is low – therefore their "price" (PE ratio) goes up and up.

Don't get us wrong – we are not complaining that our growth stock holdings keep going up. It's just that we have learned from experience that when it gets too easy, "there is danger at your door," as we quoted Jerry Garcia at the opening of this update. What to do? Over the last six months or so, we have been trimming back portions of some of our growth holdings. Certain prices have become just too high to ignore – even for companies of high caliber. We actually hope that our move is wrong – because we still hold the remaining shares and obviously wish them to keep rising. Right *or* wrong in this regard is irrelevant, what matters is that we thought it prudent to dial back exposure to some degree.

When might the growth over value trend change? When will value stocks come back into favor? The last growth cycle ended in March of 2000, in a final buying frenzy of technology and telecom stocks, meaning that the growth stocks actually *accelerated* in their advance before turning sour. The six years that followed this occurrence were terrible for growth stocks. Value stocks came back into favor in a big way and climbed to respectable gains as the growth stocks were decimated.

The chart on the following page shows the historical cycles. Note that when the blue line is rising, growth stocks are outperforming value stocks (areas shaded green). When the blue line is falling, growth stocks are doing worse than value stocks (areas shaded white).



Periods of Value Outperformance

Dates	Ratio GPA	Growth GPA	Value GPA
12/31/1932 to 08/31/1933	-61.5	85.8	382.6
03/31/1935 to 03/31/1937	-28.3	39.9	95.3
08/31/1939 to 06/30/1955	-8.1	12.9	22.9
12/31/1957 to 01/31/1969	-6.4	11.3	18.9
07/31/1972 to 03/31/1978	-15.0	-4.0	12.9
11/30/1980 to 08/31/1988	-5.8	8.9	15.7
12/31/1991 to 09/30/1993	-13.7	2.3	18.4
02/29/2000 to 07/31/2006	-14.3	-7.0	8.5

Periods of Growth Outperformance

Dates	Ratio GPA	Growth GPA	Value GPA
08/31/1933 to 03/31/1935	69.5	-0.5	-41.3
03/31/1937 to 08/31/1939	30.5	-8.2	-29.6
06/30/1955 to 12/31/1957	10.6	2.7	-7.1
01/31/1969 to 07/31/1972	8.9	9.8	0.8
03/31/1978 to 11/30/1980	10.0	31.7	19.7
08/31/1988 to 12/31/1991	9.9	24.4	13.2
09/30/1993 to 02/29/2000	9.2	25.7	15.1
07/31/2006 to 04/30/2018?	3.7	10.7	6.8

Reversions to Reality:

Just because the stock market in general is on the pricy side, this in no way means that all stocks are equally expensive. Remember that most stock market measures are heavily influenced - perhaps we could even say *controlled* - by a handful of giant companies. This is due to the fact that most of the indexes are weighted according to company size, so that the larger companies by default basically ARE the market. Whereas a decade ago, the top five companies in the S&P 500 represented a cross section of the economy, today they are *all* technology stocks. Of those five, you *might* be able to call one of them inexpensive.

Expensive or cheap, you could argue that these tech giants are all fantastic companies – and you would be right. But when great companies have potentially overdone stock prices, investors must be prepared to exercise patience. Consider one of the large tech companies: As well as this stock has done over the past ten years, there have been many lulls and many retrenchments. The stock went through one 3-year period where it made 0%. Later it went through another lull for 2 full years. Then there were two separate times where it went nowhere for a period of one year. So, all of this company's gains during the past ten years happened outside of those seven boring years where it sat still. The point is that even good long-term holdings can get ahead of themselves – they make a big leap, and then they sit, and they make no money, and they try your patience. They revert back to reality – to a more realistic value. NOTE: As the current law stands, we are only permitted to mention specific stocks by name for existing clients, so we must be generic in this version of our update. If you become a client, we would be allowed to send the unedited version. (a hint perhaps?)

We have been sounding the alarm on a few areas of the market for the last couple of years. We named one of the consumer growth stocks as our posterchild for nosebleed high priced stocks back in 2015. Despite the rising stock market since then, this stock fell around 80% from its high point to its low point. Similar things happened with many of the growth stocks in that category.

Last year we worried that many blue-chip stocks had extreme prices: many of the household name type companies fell in this category. Over the last six to twelve months, many of these stocks have become black-and-blue-chips, falling between 20-30%. Some are even back to attractive buying points.

Counter to these drops, many stocks that seemed overly depressed have recently regained a spark of life. Some oil and metal stocks have bounced back from the dead as have a few retailers. One retail store stock, for instance, had dropped 79% over the last few years. At its low point, some investors believed that the company's depressed valuation was so low that its prime real estate holdings *alone* were worth more than the going price for the shares. Investors in the stock were technically getting the retail business and all the other real estate for free. The

stock has made a nice 128% rebound from its November lows.

All of this is what we mean by reversion to reality – a return to what we feel are more normal stock prices. That, at least, is very encouraging to us. We **like** rationality! Ok… so we actually *need* some irrationality for a while so that opportunities are created. *Then* we like rationality to come back… but very slowly at first, so we have ample time to take a position. After that, the market can feel free to rapidly return to fair value, so we may finally bank a profit. If only it would go that smoothly!

Expensive but Still Going Up:

The giant technology stocks have yet to correct very much and are still close to all-time highs. Because they constitute a large percent of the market as a whole, you might say that they are contributing mightily towards maintaining the indexes near record levels. Other areas within the tech sector, however, have seen substantial corrections this year. Semiconductor stocks come to mind.

A couple other stock types that have yet to back down much from their highs would be companies in the industrial sector and a small handful of the blue-chip stocks.

Cheap but Still Going Down:

Many Health Care companies seem to have been left out of the last few years of this bull market. Biotech in particular, has been fairly bruised, contrasting sharply with their not-so-distant glory days. From early 2012 until mid-2015, the bio-tech stocks could do no wrong - they were temporary kings of the world, rising 4 to 5 *times* in value over that span. Since then… not so much. A few of those bio stocks occupied our top holdings list during their hay-day and we eventually sold out (probably too early to some degree) into the rising prices. Good times. They have since come back down to earth and are actually looking very cheap.

We have been slowly accumulating some small positions here as of late, but are watching closely to perhaps add more. The problem is that their stock prices are acting terribly and each time over the past few months that we have dipped a toe in to test the waters (bought a few shares), that toe has come back mildly frostbit. We are glad we did not jump in for a swim yet.

The Economy:

It's been a long slow recovery since the financial crisis of 2008. Since late 2016 however, the economy has been picking up steam, with the OECD recently forecasting nominal GDP in the US to hit a remarkable 5% for 2018.[2] I actually had to triple-check that number as it seemed too high.

There are, unfortunately, some worrisome data points as well. The US savings rate is currently very low. Combine that with the high levels of US debt and we have a potential problem on our hands. Unlike China with their historical infrastructure focus or Germany's export-based focus, the US clearly is a consumer economy. Something like 70% of US GDP is made up of personal consumption expenditures. When looking at the potential of any entity, it is always a good idea to measure the financial health of its customers or members. If the US economy currently relies heavily on US consumers consuming, then one would think it must get harder to do if everyone's savings are tapped out and they have already borrowed too much. Add in the fact that the Federal Reserve is raising interest rates, which has the effect of draining money out of the economy, and it seems like there are some potential dangers lurking.

Luckily, the economy is currently getting stronger – globally for sure, but even more so in the United States. If the environment can continue to be conducive for business development and growth, then perhaps the economy will have more legs than expected. Pro-business tax rates and lessening regulatory burdens seem to be having a positive effect on business spending, hiring, and investment. For now these positive factors are outweighing the negatives. As always, we need to be vigilant for things that might go wrong or economic strength that begins to wane.

The Bond Market:

For the first time in almost a decade, short-term interest rates (savings and money market) are not zero. It's pretty sad when we find ourselves getting excited by 2% short-term CDs, but there it is. After almost ten years of earning nothing on bank deposits, money market, and short term CDs, 2% seems like a windfall.

There are some that believe the 36-year bull market for bonds is over. During that time, interest rates have been falling, notwithstanding a few periodic rises, of course. If the global economy stays healthy, and if wages and inflation start to rise, then the three decades long downtrend may be about to shift. Those factors are some of the typical ingredients that lead to climbing interest rates and to falling bond prices.

The flip side argument is that the world has too much debt for there to be a long-term booming world economy. It is said that the world has borrowed sales from the future and, as the debts are paid off (or defaulted on), consumption and business will be forced to slow. That would normally push rates *lower* not higher. Also, with automation, robotics and artificial intelligence all making great strides, some believe future rising wages are wishful thinking. Flat wages should keep inflation flat and interest rates low.

So which will it be? Rising rates and falling bond prices or vice versa?

At the present time we are still positioning bond portfolios for rising rates. Although, after the jump in rates we have witnessed over the past year, there may be a breather for a few quarters. This stance we have taken means that we have not locked in any long-term bonds as they would take a bigger hit in price if rates keep going up. We prefer to stay short-maturity oriented in the bond world – for now at least.

Bitcoin:

What IS it you ask? It's that thing that keeps rising in price, of course. It doesn't really matter

what it IS, does it? Well yes, eventually it always matters - but eventually is a long way off. Or so thought the bitcoin traders. "Eventually" turned out to be right before Christmas.

Bitcoin is a crypto currency. That's not helping? OK…a crypto currency is a digital currency in which encryption techniques are used to regulate the creation of more units. In English: They are supposedly impossible to copy or forge. They also use these encryption techniques to verify the transfer of funds. In English: You can trust that if you send some of this "money" to someone else, that they will receive the correct amount. Furthermore, cryptos operate independent of any central banks (at least so far). They can be used like an electronic cash of sorts, as they are non-traceable. Also, unlike fiat currencies such as the US dollar, there is supposedly a known and limited amount that will ever be produced. Bitcoin was the first and is the most popular of the crypto currencies, having starting back in 2009.

Our problem with cryptos in general, and bitcoin in particular, has always been that there is no real backing – no true underlying value.

There is no *there* there, as they say.

But Mike, you ask: The US dollar is just a piece of paper, and gold is just a rock, so how are those any better of a currency than bitcoin?

True, but the ability of the United States to tax the labor of its citizens is a backing of sorts for our paper money. You can protest your tax bill all you like on your way to jail.

Gold has a 5,000 year history of being accepted as a currency. Out of all the elements on the periodic table it has the most compelling characteristics for use as a currency. It won't dissolve in water, it isn't flammable, it doesn't rust and it's malleable. It isn't too plentiful nor too rare, and perhaps best of all, it is not one of the radioactive elements. Uranium coins never really caught on for some reason.

We will be clear on this: We don't think of bitcoin as an investment, but that does not mean it

can’t rise in price – it can. And it did just that, rising tremendously for the last few years from $100 to $20,000! Of course, that rise attracted a lot of speculators- many bought in just in time to pay top dollar before it crashed 70% in a month and a half. By early February, it hit a recent low and has been stuck around there ever since.

We will pass on this one. Also we don’t think this new form of money has enough of the prerequisite characteristics of a good currency. Things such as being a *stable* store of value are paramount. The extreme volatility of its price is proof enough that bitcoin is not yet useful as a real currency. Also, although bitcoin has a limited supply, what is to stop many other different cryptocurrencies from flooding the market? All this leaves it as a speculation in our eyes.

The technology underlying bitcoin is called blockchain and we see *that* as a major, useful and disruptive technology for many industries. That might be the best way to play this area. But we think that it will take a little while to develop.

Gold and Silver:

Not much to report here other than that prices seem quite reasonable, yet boring. With interest rates rising, sitting on gold or silver (which have no yield) becomes more costly. Still, we hold small positions of each - just in case. We are not advocates of worst-case scenario investing like some of the “gold bugs” tend to be, but what’s the harm in a little insurance? If the financial world doesn’t come to an end, as we highly suspect it won’t, then our small percentage of gold and silver should act like cash that doesn’t degrade with inflation –not so bad. If the US debt problem gets worse, it might be useful to have something other than dollars as our currency of choice – gold and silver fill that role.

Oil:

Doctors warn that when you try to kill off a germ, but don’t take your full course of medication as directed, you are potentially creating a superbug. This is a strain of bacteria that has become highly resistant to the strongest of antibiotics. Basically, you hit the germ with enough medicine to kill most of it, but not enough to kill ALL of it – thus creating a stronger version.

Well, the OPEC cartel seems to have inadvertently committed this same type of mistake. The cartel purposefully maintained their high output just as a glut in the world oil supply was building. They seemed to be hell-bent on pressuring the US shale producers into extinction. Normally, Saudi Arabia would slow down their pumps as global oil supplies build and prices start crashing – not this time however. Having the lowest production costs in the world, the "Kingdom" seemed to decide it was a good opportunity to get rid of their pesky US competition. They did this by holding the price per barrel well under the US breakeven point. But just like our medical example above, all they ended up doing was to create an environment that greatly strengthened those US producers that could adapt quickly enough to the assault. Using technology and much more efficient methods, many domestic US oil companies drastically lowered their cost of producing their product. At the same time, they cleaned up their environmental impact to a large extent and dramatically lessened the amount of water consumed in their fracking process – further reducing costs. Lastly, (according to them of course) they made their process less prone to leakage of hydrocarbons into the water table.

When the excess supply was eventually worked off and oil prices rose from a low of $29 to a recent $75 per barrel, the US companies were primed for profit with their newly lowered cost structure. OPEC ended up creating their own form of corporate superbugs with the surviving US shale oil producers now running at much lower breakeven levels. Some estimates are that US production costs have dropped from $50 per barrel a few years back, to now more like $20.[3] Over the last few years the oil stocks in general had been given up for dead. With the recent rise in the price per barrel back up to $74, however, stocks in this sector have begun to perform much better.

We took a decent position in a handful of oil stocks over the last 12 months. So far so good, but being the cyclical companies that they are, we don't foresee a very long holding period, relatively speaking. However, there are some highly respected analysts and money managers calling for a major upcycle in commodities over the next few years. They argue that if you look at the relationship between the stock market and commodities, you will find long periods of time (ten years or so) where one asset group will outperform the other by a wide margin and then it will reverse. The current cycle (stocks over commodities) is about 10 years old. With oil

and metals currently on the rise, perhaps we are witnessing a new cycle beginning, one where inflation pushes stocks lower and commodities (and commodity stocks) quite a bit higher. So, who knows? Perhaps our oil stocks will end up staying in our portfolios for longer than we expect.

Techsplanations:

We are currently watching a host of trends in the technology space and could probably devote an entire update to this subject alone. For now, we will briefly highlight two tech trends that we see as important at the moment.

Cyber Security: If the past year has taught us anything it's that there are a myriad of vulnerabilities to society throughout cyberspace. The more we rely on computers for every aspect of our lives, the greater this threat becomes. Daily there are online attacks of all sorts, from simple scams and theft to sophisticated breaches of corporate intellectual property and governmental systems. Unfortunately, there is a rapidly growing population of bad actors around the world.

The worst part is that we will soon have a much greater threat surface. The so called "Internet of Things" is a trend whereby everything from vehicles to your refrigerator to corporate factory floors are becoming connected to the Internet. Hackers and cyber criminals will likely have a field day with exponentially more entry points and with much larger potential ramifications. I recently saw an alarming talk about the US power grid vulnerabilities, describing how extremely vulnerable some of these critical systems are to hackers.

Companies that sell defensive products, software and services into this area should have the wind at their backs for many years to come. Needless to say, we want to have investments in companies that attempt to solve this problem. Currently in portfolios, we hold a few companies with strong exposure to the cyber security business, having purchased them several years ago. They still seem to be reasonably priced.

Machine Learning: It seems like all the major tech companies and most large companies in *every* field are getting into "big data" and "machine learning." The idea is that if you feed enough data into computers enabled with artificial intelligence systems, they will be able to teach themselves many things. As opposed to programming software to perform difficult cognitive tasks, machine learning advocates have found a better way. They have shown that by force-feeding supercomputers massive amounts of data and information and then giving them a few instructions, the computers will essentially write their *own* programs with little outside help. This trend is an important one that is rapidly picking up steam. As the smarter computer systems become faster, they can write more advanced algorithms which make them even smarter and cognitively quicker…around and around, faster and faster.

We will need to watch this closely as it develops since the first movers in the field will likely open up a competitive lead that is hard to catch. We think we know what companies are currently out in front in this area and have investments in quite a few of them.

One of our favorite analysts/thinkers in the technology field is Cyrus Mewawalla at Global Data in London. We recently had a conversation with him about some of his current predictions and the rapid adoption of *machine learning* was right at the top of his list.

Ok, that just about covers everything we have been thinking about, worried about and excited about over the last few months. As you can see, we try to keep an eye on many broad areas of the investment landscape. Whether we are watching the economy, stocks, bonds, or sectors, we always have to remind ourselves that, although interesting, these short-term fluctuations and happenings can often be mere distractions. Wise investors should focus their time and effort on factors of more significance. Things such as investment philosophy, strategies, tactics, and methods are the preoccupations of the successful.

Hopefully you found this atypical update interesting, but not *more* interesting than usual, since we will be getting back to our normal long-term focus next time.

As always, please do not hesitate to call or email with any questions, comments. On behalf of Tony, P.J. and the rest of The Morgia Group, thank you for your continued confidence.

Sincerely,
Michael Morgia, CIMA®
Managing Director, Partner
The Morgia Group
at HighTower Advisors

Tony Morgia
Managing Director, Partner

P.J. Banazek, CFP®
Managing Director, Partner

Back Row: Frank Murphy, Katrina Thompson, Mike Morgia, Heather Clement, Tony Morgia, Andrea Fiorentino, Anthony Surber
Front Row: Nico Morgia, PJ Banazek, Joe Cosmo, Shane Simser, Zachary Buskey

The Morgia Group is a team of investment professionals registered with HighTower Securities, LLC, member FINRA and SIPC & HighTower Advisors, LLC a registered investment advisor with the SEC. All securities are offered through HighTower Securities, LLC and advisory services are offered through HighTower Advisors, LLC.

This is not an offer to buy or sell securities. No investment process is free of risk and there is no guarantee that the investment process described herein will be profitable. Past performance is not indicative of current or future performance and is not a guarantee. Before investing, consider the investment objectives, risk, charges and expenses. Diversification does not ensure against loss. Investors may lose all of their investments. The securities mentioned herein may not be suitable for all investors.

These materials are solely informational. In preparing these materials, we have relied upon and assumed without independent verification, the accuracy and completeness of all information available from public and internal sources. HighTower shall not in any way be liable for claims and make no expressed or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in or omissions from them.

1. MarketWatch, The S&P 500 has already tripled the number of 1% moves seen in all of 2017, Apr 10, 2018
2. OECD.Stat https://stats.oecd.org/index.aspx?DataSetCode=EO, May 2018
3. markets.businessinsider.com Here's how much it costs both Saudi Arabia and the US to produce oil, Matthew DiLallo, Mar. 24, 2017