ST. JAMES INVESTMENT ADVISORS

COMMITTED TO VALUE INVESTING

INVESTMENT ADVISER'S LETTER

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646-10 MAIN STREET
PORT JEFFERSON, NY 11777
WWW.STJAMESIA.COM

THIRD QUARTER LETTER

*MARK*ET DISCUSSION

The market's focus was squarely on the Federal Reserve again this quarter. At its September meeting, the Federal Reserve announced another increase in the federal funds rate target range to 2.0% - 2.25%, marking the eighth-rate hike of this cycle.

We have been saying for some time now that as the Federal Reserve continues to raise interest rates, we would begin to experience increased volatility in all market classes.

The main stream financial press has been focusing on the various stock market returns and the Federal Reserve, however, very little discussion has been focused on the bond market.

Presently, the bond market is experiencing a down year with the U.S. Aggregate Bond Market down 1.8% through September. For the quarter, long U.S. Treasury Bonds lost 2.9% and are also down 5.8% in 2018.

Interest rates on the 10-year Treasury are now trading at two standard deviations of their two-year moving average.

This is certainly an increase in price volatility.

We think closer attention should be paid to what is happening in the fixed-income markets.

Let’s look at the 2-Year US Treasury yield which is just now breaking above its own long-term downtrend line.

The 10-year US Treasury yield now appears to be breaking above the horizontal resistance marked by the 2013 high.

Finally, 30-year US Treasury yield is now joining the party and breaking above its long-term downtrend.

Why is this important? As recently discussed by Lance Roberts from Real Investment Advice let's look at why interest rates matter to us:

- The private and public sector have record debt loads today. Rising interest rates increase the cost of servicing that debt and reduce spending and productive investment.
- Rising mortgage rates and higher mortgage payments reduce home affordability and hurt home turnover and the ability to refinance.
- Given record-high auto prices and the difficulty in further lengthening out already long auto loan maturities, rising interest rates will hurt auto sales by raising monthly payments.

- Consumer, mortgage and corporate loans that are variable rate are hurt by climbing interest rates.
- Rising interest rates could possibly impede corporate profit margins, overall profits and earnings per share.
- Debt is issued by corporations to buy back stock and pay dividends. Advancing rates reduce a company's return on investment on those buybacks.
- Corporate capital spending is partially dependent on borrowings. Higher borrowing costs could lead to lower capital spending.
- The deficit/GDP ratio will increase as interest rates rise and the expectation for lower future deficits will crumble.
- Dividend discount models are based on future estimates of cash flow discounted back at an appropriate interest rate. Rising interest rates reduce the value of those future cash flows and, in turn, the value or worth of a company's stock.
- There is now an alternative to stocks for the first time in many years as the yield on the one-month Treasury bill (2.06%) and two-year Treasury note (2.85%) compare favorably to the S&P's dividend yield of only 1.75%.

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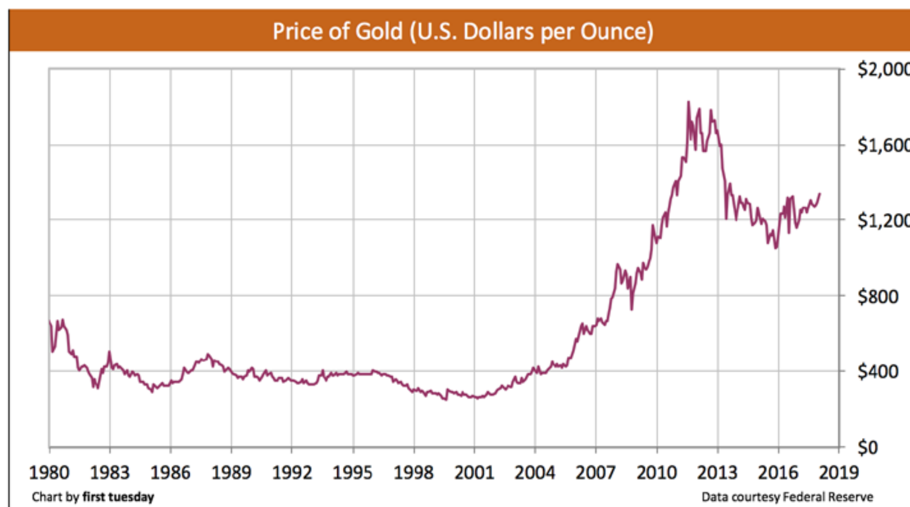
*MARK*ET OBSERVATIONS

Got some gold? We believe gold today is undervalued.



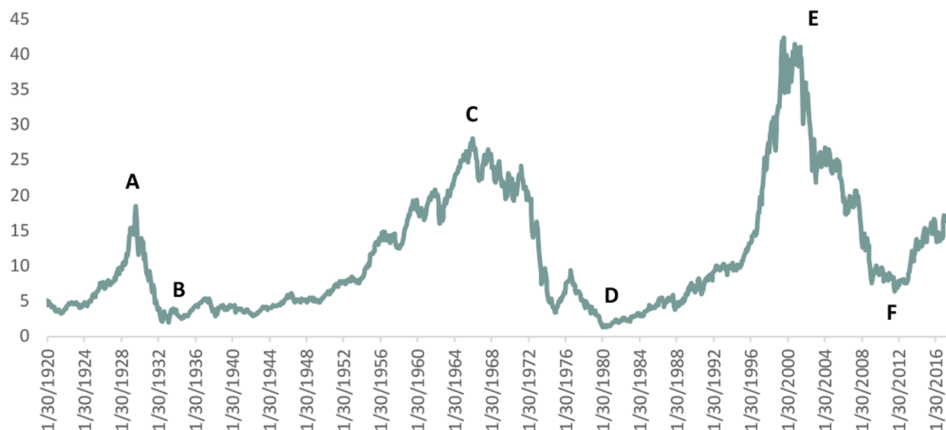
Goehring & Rozencwajg recently discussed gold in their Q2 2018 commentary (www.gorozen.com):

> "We believe gold is like any other asset class. Asset classes (bonds, stocks, emerging markets, commodities or gold) become popular, sustain large price advances and become overvalued. At that point, they represent poor investments. Conversely, these same asset classes will often undergo long periods of investor disinterest, experience sustained and drawn-out price declines, and consequently will become undervalued. At that point, they often represent excellent investment opportunities.

We agree with consensus opinion regarding gold on a *long-term* basis: gold represents a poor investment. As its critics correctly point out, it pays no dividends or interest, and it is expensive to store. However, if investors can properly identify those periods when gold is severely undervalued, then gold (as an asset class), can produce superior (and indeed often spectacular) uncorrelated returns, just like it did back in 1929, 1970 and 1999.

Let's look at how gold has historically been priced relative to financial assets. The popularity of financial assets (especially the stock market) and gold tend to be inversely correlated and by measuring the divergence between stock prices and gold we can see where we stand in the investment cycle. One of our favorite ratios is the price level of the Dow Jones Industrial Average to gold's price. As you can see from the chart below, there have been three distinct periods of extreme overvaluation of financial assets versus gold in the last 100 years: 1929, the late 1960s/early 1970s, and 1999/early 2000s.

Dow Jones Industrial Average / Gold Price



Period	Date		Stock Market (Dow Jones Indu Avg)			Gold Price			DJIA/Gold Ratio		DJIA Book Value per Share/Gold	
	Start	End	Start	End	Return	Start	End	Return	Start	End	Start	End
A – B	9/1929	6/1934	380	95	-75%	$20.65	$35	+70%	18	2.7	4.2	2.3
B – C	6/1934	12/1966	95	1000	+950%	$35	$35	--	2.7	28	2.3	13
C – D	12/1966	1/1980	1000	860	-14%	$35	$850	+2300%	28	1	13	1
D – E	1/1980	1/2000	860	11700	+1260%	$850	$290	-65%	1	40	1	7.8
E – F	1/2000	9/2011	11,700	11,000	-6%	$290	$1,900	+550%	40	5.7	7.8	2.4

Source: Bloomberg

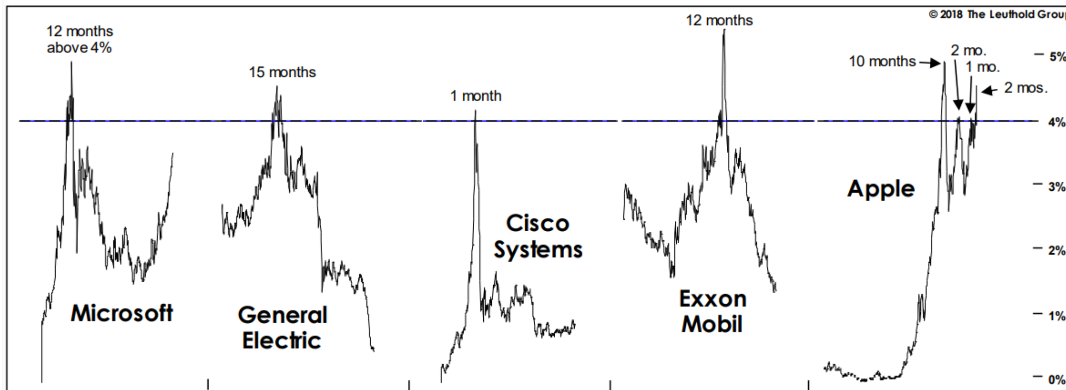
Today, with the stock market having more than doubled since 2011 and gold prices today 35% below their 2011 peak, the Dow to gold ratio stands at 20. Although we have not reached the valuation extremes of 1970 or 1999, we are trading above the ratio of 18 achieved back in 1929, which was the first distinct period of extreme overvaluation during this 100-year span."

The gold exposure we have added to our portfolios ranges from approximately 3% to 5.5%.

Recently, the financial media talking heads have been incessantly discussing Apple's ascent to over a trillion-dollar market capitalization. As investors committed to value investing, we attempt to purchase assets viewed as selling below our estimate of their fair value. Which brings to mind the famous quote from Mark Twain "History does not repeat itself, but it often rhymes."

"The concentrated condition in the US equity market today is as amusing as it is disturbing. It's not every day that you see just two stocks account for nearly 30% of the total gains in the S&P 500, as has been the case so far this year with Amazon and Apple." - David Rosenberg (@EconguyRosie) September 26, 2018.

Such a milestone rarely lasts for long, however. General Electric, the company to hold this designation for the longest, only acted as a 4% weight for 15 months, as seen in the chart below.



In our last quarter's commentary, we pointed out that Value stocks have outperformed growth stocks by almost 3% per year since 1926, even incorporating growth's dominance in the last decade.

Growth investing has beaten value investing for quite some time now, causing investors to question the premise that value investing beats growth investing over long-time frames.

Growth (blue) vs Value (green) - Last 5 days

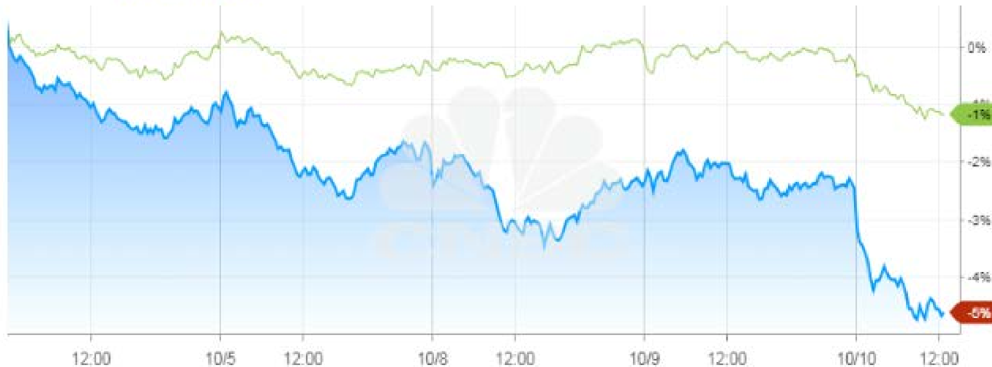
iShares Russell 1000 Growth ETF (IWF:NYSE Arca)

USD

Last | 12:11:35 PM EDT

148.1873 -3.2427 (-2.1414%)

5 Day IWD 125.7187



As we finish the quarter's commentary, for the first time in a long time, we see that value is outperforming growth during this recent market pullback. Maybe, just maybe, the trend for Value investing is beginning to shift back to historical norms.

"Investment success accrues not so much to the brilliant as to the disciplined." - William J. Bernstein.

Looking forward, we continue to apply a disciplined long-term approach focusing in our attempt to produce the best risk-adjusted returns available, based upon the specific portfolio strategy you are invested in.

We believe it is just a matter of time before history repeats itself and value investing again returns to the top.

Sincerely,

St. James Investment Advisors

ST. JAMES INVESTMENT ADVISORS

We are professional portfolio managers Committed to Value Investing.

We are an independent, fee-only, U.S. Securities and Exchange Commission registered investment advisory firm, providing customized portfolio management services to individuals and their financial advisors.

Our investment methodology blends a combination of fundamental analysis, discipline and patience with the goal of creating long-term returns based on the time-proven principles of value investing.

As thoughtful value investors, our sole focus as a firm is to manage private investment accounts for individuals and financial advisors throughout the United States.

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