CAZ Investments

Quarterly Letter

The Battle Between Economics and Excess Liquidity Rages On

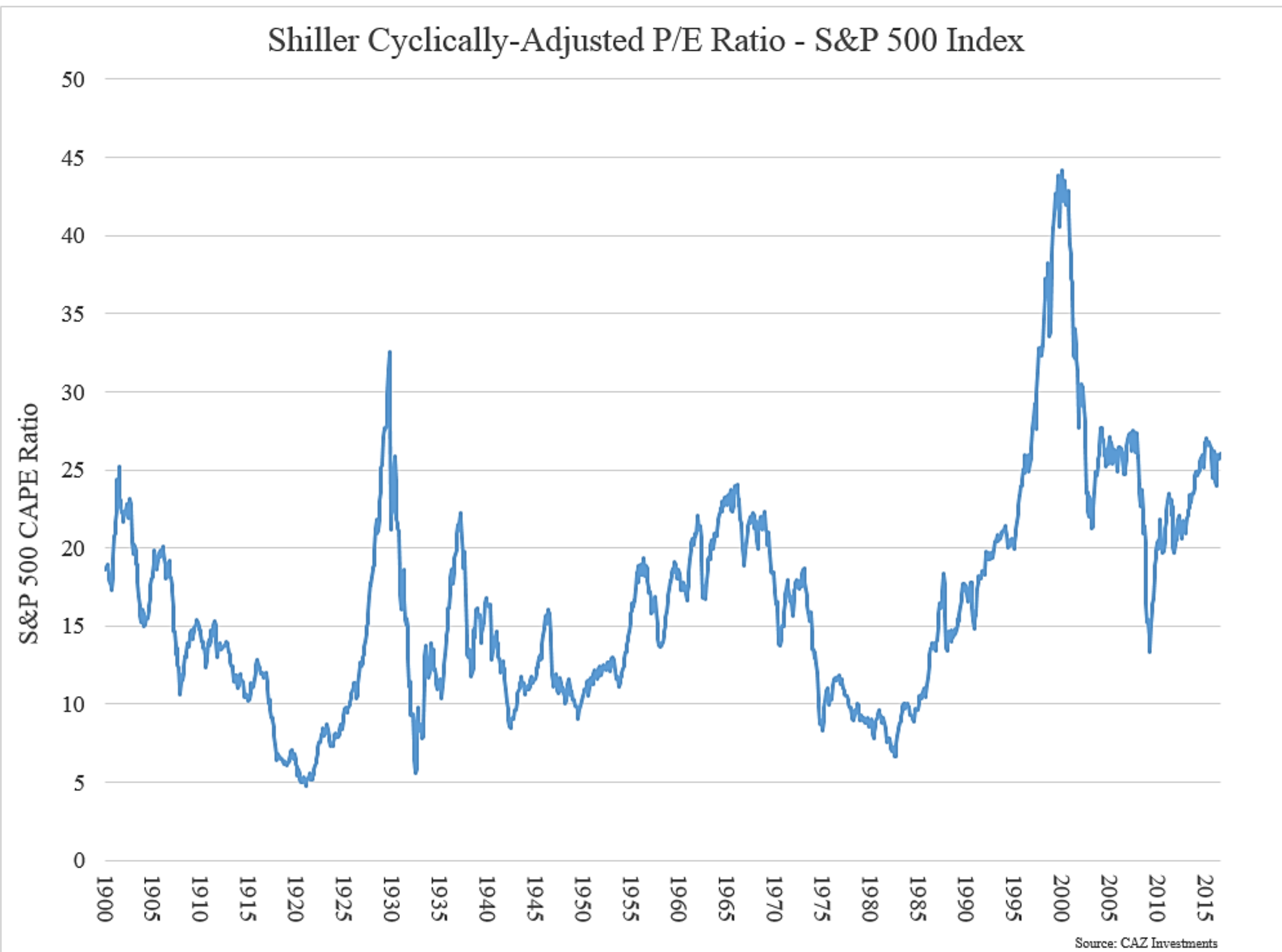
What a bizarre quarter, and world for that matter. One thing is very clear, the market is in a tug of war of epic proportions that is unprecedented in history. On the one hand is the reality that economies around the world are slowing and that there are more threats to stability than we have had in several decades. On the other side is the stimulus of the worldwide central banks, led by the Federal Reserve and ECB, who are pumping liquidity into the system at a level never before seen in history. To get an idea how absolutely "nuts" the bond markets have become just repeat the following sentence out loud. "Approximately 35% of worldwide Government Issued debt is now trading at negative interest rates and the LENDER is PAYING the BORROWER for the right to loan them money!" No matter what amount of education someone has they understand how illogical it is for a lender to pay a borrower for the privilege of lending them money. Yet, that is exactly what is happening today, and the United States may not be far behind. We are living in a time that literally defies economic reason and logic. The last time we can remember saying that was early 2007 when lenders were willing to loan borrowers MORE money than their house was worth. Only time will tell if this situation ends just as badly as 2008, but the hair on the back of our neck is standing up and we remain as cautious as we can be, with a **"1"** on the CAZ Scale.

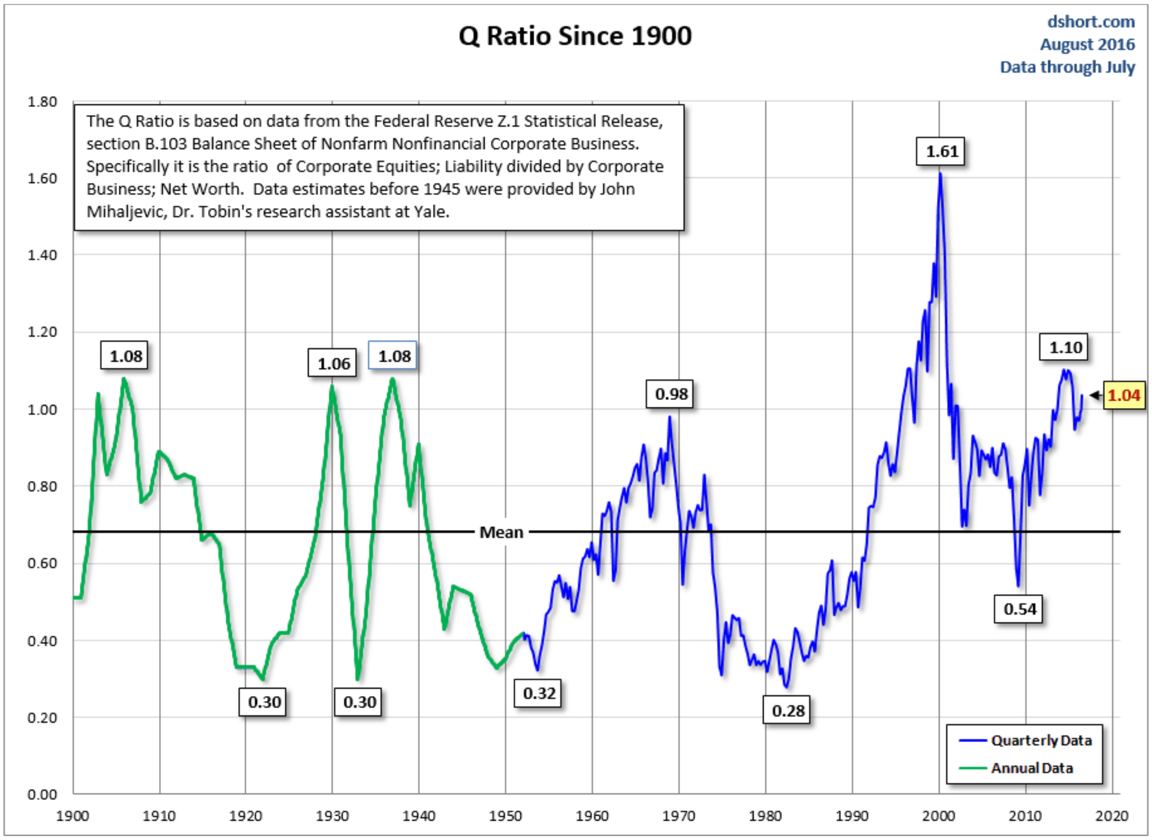
Brexit, what Brexit?

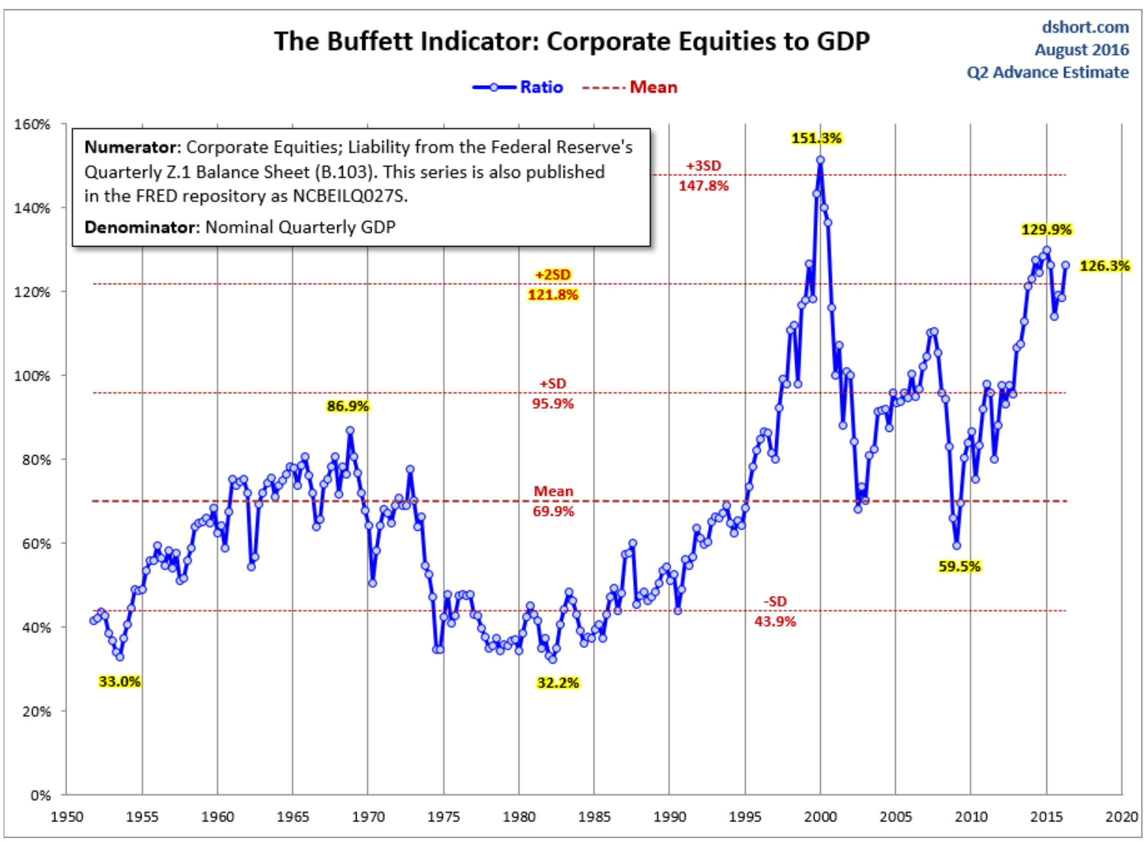
Not much could illustrate the psychotic nature of the markets around the world better than the reaction to the Brexit vote. As stated via email in our special correspondence, that vote absolutely changed the landscape of worldwide economics. Barring some reversal by the people and another vote this is an undeniable negative outcome and will create material uncertainty for the next few years as Great Britain prepares to exit the European Union. The markets recognized that fact, with a vengeance, and worldwide markets sold off sharply. But then market participants thought to themselves, "Wait, all of this negative impact means that the central banks may not raise rates and might actually print even more money to flood the system with even more liquidity. That is great news, isn't it?" And so up we went again, with a rally to fresh highs for the year. Yes, that is how psychotic the markets are right now, terrible news is interpreted as positive because it could mean more central bank easing. And yes, this is the same market that meets positive economic news with a frown because it may mean that the flow of "cocaine" (think central bank stimulus) may potentially slow or, heaven forbid, stop. If we sound jaded, it is because we are… Sometimes the markets are just "nuts" and they can stay that way for a long time. Where does someone go in a psychotic market to determine what is "sane?" There are only two things that we can count on and they are common sense and valuations. Common sense would tell you that lenders paying borrowers to borrow is crazy and valuations are flashing dramatic warning signs. In the last month we have seen extraordinary investors come out publicly and caution that the market is in dangerous territory. Bill Gross, Lawrence Fink, Howard Marks and Jeffrey Gundlach are just a few. Each of these gentlemen have proven their ability as investors and each of them have basically said that this is one of the most difficult investing environments they have ever seen.

Valuation Metrics

The great thing about valuations is that they can be measured, whereas psychology is much more difficult. As we have written before, we have a handful of major valuation metrics that we follow that have stood the test of time and allow us to "see the forest and not the trees." A picture truly tells a thousand words, so below you will find illustrations of three metrics; the Shiller CAPE ratio, Tobin's Q, and Warren Buffet's preferred valuation metric (Corporate Equities/GDP). We won't attempt to explain in exhaustive detail each of these metrics but what should absolutely jump off of the page for you is where we are compared to history. In every case where any of these metrics have been at similar levels, a nasty sell-off was experienced. As shown in 1999, during the Tech bubble, things can stay overvalued for extended periods of time so this doesn't mean prices have to come down immediately, but the odds of sustaining these valuations are quite low so investors must be extraordinarily cautious at this time. As an example, if one looks at the Shiller CAPE and recognizes that the only occurrences where we were more expensive than today were 1929, 1999 and 2006, that is more than a bit scary. Here are the charts:




Q Ratio Since 1900
dshort.com
August 2016
Data through July
The Q Ratio is based on data from the Federal Reserve Z.1 Statistical Release, section B.103 Balance Sheet of Nonfarm Nonfinancial Corporate Business. Specifically it is the ratio of Corporate Equities; Liability divided by Corporate Business; Net Worth. Data estimates before 1945 were provided by John Mihaljevic, Dr. Tobin's research assistant at Yale.
1.08
1.06
1.08
0.98
1.61
1.10
1.04
Mean
0.30
0.30
0.32
0.28
0.54
Quarterly Data
Annual Data


The Buffett Indicator: Corporate Equities to GDP
dshort.com
August 2016
Q2 Advance Estimate
Ratio
Mean
Numerator: Corporate Equities; Liability from the Federal Reserve's Quarterly Z.1 Balance Sheet (B.103). This series is also published in the FRED repository as NCBEILQ027S.
Denominator: Nominal Quarterly GDP
+3SD 147.8%
+2SD 121.8%
+SD 95.9%
Mean 69.9%
-SD 43.9%
151.3%
129.9%
126.3%
86.9%
59.5%
33.0%
32.2%

Uncorrelated and More Uncorrelated

It should not surprise anyone that we are very cautious as a result of these valuation metrics. So what is an investor to do? Get less correlated, and then get even more uncorrelated. We have meetings nearly every single day with managers to identify where we can invest our personal money in a way that will give us a solid return while limiting our market exposure. We pass on nearly every one of them but when we choose to invest our personal money, we want to be sure that you know what we are doing. You should already be aware of our investment that is taking ownership positions in some of the top companies in the private equity industry. We are on record saying this is the best cash flow vehicle we have seen in more than 25 years, and this will be the largest investment we have ever made as a firm. The demand has already outstripped our original allocation by more than 3X and we have been fortunate to get more capacity, but time is growing short. We expect the Fund to be fully subscribed in the next few months, after which we will be forced to cut new investors back. Please let us know if you would like to discuss in more detail.

Operational Improvements

We mentioned this last quarter but it is critical that everyone understand the new communication protocols. So, we will restate how we are going to be providing you with information going forward. You are now receiving all time sensitive information (Capital Call notices, Distribution notices, Quarterly Statements, K-1's) directly via email. All informational material (quarterly updates, underlying fund financials, audits, annual reports etc.) will continue to be delivered via ShareFile so they are available for clients to access them 24/7. But, the default setting will be for no notices to be sent when those materials are deposited in the system. As a client, you can always adjust your settings in the system to receive information notices if you would like to receive them. This should dramatically reduce the number of ShareFile notices that clients automatically receive. We are pleased to be able to respond to client feedback in this manner and believe you will be very pleased with the balance of receiving everything you "need" via email and everything you might "want" via ShareFile. Please continue to give us suggestions how we can improve what we do for you. We are constantly working to improve and your feedback is most helpful!

We are pleased with how our firm is positioned at this point in the economic cycle and we have some very interesting things on the horizon. We appreciate all the families that co-invest with us and we look forward to reaping the harvest of what is already in the ground and planting new seeds for the future. Please let us know if there is anything that we can do for you.

The CAZ Investments team