

Profits and Prices

The idea of an efficient market is that all participants always have all information and markets are perfectly priced at all times. I completely disagree with the pricing portion of the equation. Yes, all information is out there for anyone to peruse but the complexity is real and not many can sift through and properly quantify what is what and where to go and where to be within markets.

The other big thing we see in markets is human action and humans are emotional creatures, very emotional. We are so emotional that most decisions we make are emotional ones and we often use reasoning to justify our emotional decisions to make ourselves feel better. We see this every day in the behavior of people as they work through life's challenges and opportunities.

If there were no emotions involved in markets there would be no fluctuations in prices they would just be a fixed amount. The news causes people to react emotionally in the short term, but long term reality sets in and things land where they land. I LOVE this action, and it's what makes for the opportunities to come. You have to respect this action as well, because when things are out of hand, as they are today, it can hurt you badly if you're paying too much for assets.

A perfect example exists today. People are euphoric about many aspects of financial markets, especially the popular items. The FAANG stocks are the rage, similar to the nifty fifty of decades ago, but much more concentrated today. Tesla is currently valued higher than GM, Honda, Toyota, Ford and Fiat Chrysler and they lose money every year and only make 350,000 cars annually while Toyota is a profit machine making over 10,000,000 cars annually.

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Tough Enough?

We're living in a world often devoid of fact in favor of feelings. There is no reason to purposefully hurt anyone's feelings, but at the same time we must live and make tough decisions every single day. The millennials today are often described as the weakest generation every, many refer to them as snowflakes.

I don't know the answer here but at a certain point in time everyone is going to hit the brick wall of reality and it's not going to be about feelings, it's about performance. The coddling of the youth in that they can never have their feelings hurt, participation trophies, awards for everything without having to earn them is hurting not helping everyone involved. In the spirit of showing some real tough people working through some really tough times I'd like to share with you a few stories of our true heroes that many of us don't even know.

The first is Shilo Harris. Shilo Harris came from a family with deep roots in military service. As a son of a Vietnam veteran, Shilo always knew he wanted to be a soldier. On September 11th his life changed forever:

Shortly afterward he enlisted as a Cavalry Scout in the US Army. His first deployment was to Schweinfurt, Germany with the 1st Infantry Division. From Germany Shilo headed to war-torn Iraq.

On his second deployment with the 10th Mountain Division, he was assigned and worked near southern Baghdad. On February 19, 2007, Harris' armored vehicle was struck by an improvised explosive device (IED). The explosion injured the driver and ended the lives of three of his fellow soldiers. Shilo survived but with severe third degree burns on 35% of his body. The severity of the burns meant the loss of Shilo's ears, the tip of his nose and three fingers. The crushing explosion fractured his left collarbone and C-7 vertebrae.

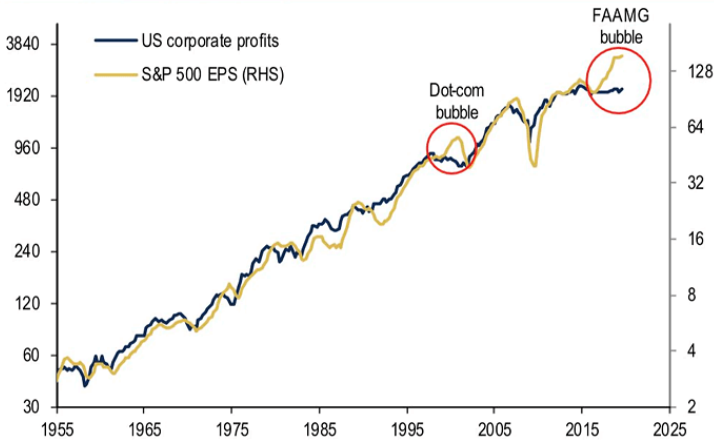
The devastating injuries forced Shilo to remain in a medically induced coma for 48 days; after, he spent nearly three years recovering and undergoing intensive physical therapy at the burn unit of Brooke Army Medical Center (BAMC) in San Antonio, TX.

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We're simultaneously seeing dislocations in the opposite side of this bubble insanity, where areas that are juicy and people feel industries are going out of business or business is never going to be the same. These areas are the mining sector, natural resources, pharmaceuticals, retail and energy.

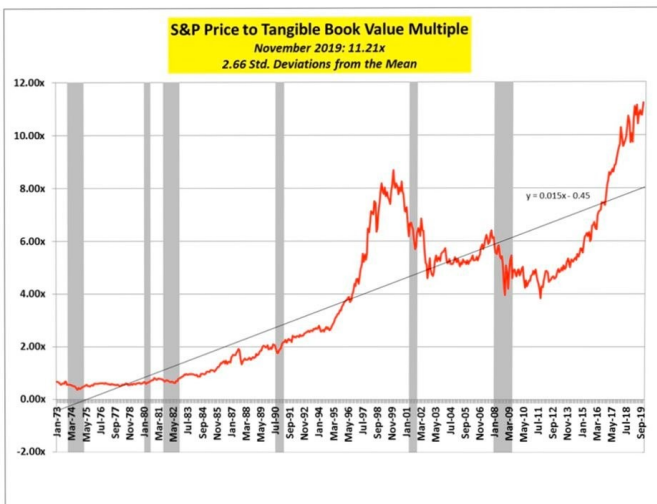
If things are not emotional and all prices are always perfect, how does one explain the the above scenario or two charts below? The first is the profit gap between the S&P 500 and historical profits. We've only seen this phenomenon once before, in the late 90's during the dot.com bubble. Here we are again valuation wise and many don't understand we're in a bubble. They'll get it very clearly when it pops, but then it's too late.

Chart 1: The widest profits gap in history



Source: BofA Global Research, Global Financial Data; US corporate profits from NIPA (before tax with IVA & CCAdj), S&P 500 EPS (as-reported until 1980, thereafter diluted operating).

Now let's look at a valuation metric I love, the price to tangible book value. Tangible book value is the hard assets only, not the intangibles. We like to buy things for less than book value and boy that is hard to find today. It's out there, but in just a few select places.



The peg we're referring to here isn't the thing on the end of a pirates leg, it's the measure of a stocks value. The PEG is derived by taking a stocks P/E Ratio, as discussed in our Q & A section this issue and dividing it by the growth rate of its earnings over a certain period. The PEG enhances the P/E ratio by adding in expected earnings into the calculation. The lower the PEG, the better indication that a stock is selling at a discount to true value, including earnings growth over time. Note the chart below shows us the PEG ratio has never been higher, ever. Don't let anyone tell you this is a cheap market because its one of the most expensive in history, by any valuation metric, period.



* Forward P/E divided by LTEG, which is 5-year forward consensus expected annual earnings growth. Monthly through 2005, then weekly. Source: I/B/E/S data by Refinitiv.

Once we've pegged the right ratios of a stocks value relative to its earnings, we look back and take a peek at the global macro picture. Where are we in the cycle and where are we in relation to historical trends. It ends up we're at the top tier in any metric available in terms of pricing. Below we look at the total stock market capitalization relative to GDP. Again, it's never been higher, ever. The stock market is 10 Trillion over the market of the overall GDP of the country. We're in new territory folks so tread lightly. I'd recommend snow tires and all wheel drive for this next economic season.

Total Market Cap and US GDP



Noteworthy News!!!

- Congratulations to Todd & Kim Marfyak on the purchase of their new home in Sunny Florida! 😊
- Congratulations to Brooks Markert on his new position with Aptar! 😊
- Our condolences to the Bittel family on the passing of Phil, a wonderful man, husband, brother, father, grandfather, uncle and friend.
- Our condolences on the passing of “Chief” Joe Sekorski, a wonderful man, husband, brother, father, grandfather, uncle and friend.

Question & Answer

Ask any financial question you have and we'll address it here.

Q: What is P/E Expansion?

Euphoria is good way to explain P/E Expansion. What this really boils down to is people being willing to pay more for the same thing simply because people feel better about things.

The P/E ratio is a simple measure of a stocks price compared to the earnings of the company. Let's take a real life example and see how to measure P/E as well as what happens when there is an expansion of P/E. We'll use Macy's as our example. Ticker symbol is M and they are currently earning \$3.10/share. Stock price is now around \$17.00 so here is the math.

Stock Price/ Earnings = P/E Ratio. $17/3.1 = 5.48$ is our P/E ratio. This means an investor is paying 5.48 dollars for one dollar of corporate earnings. We'll assume for this conversation that earnings are going to remain flat. One could argue they're going up or down and that's very much part of this process but to see how the P/E expansion works we must assume no changes to simplify the example.

If the ratio expands from 5.48 to 10.00 and everything else stays the same we will have a higher share price. Here is our new math

Price/Earnings = 10. $Price/3.10 = 10$. Price now is $3.10/10 = 31.00$.

P/E expanded from 5.48 times earnings to 10.00 time earnings so investor appetite was now willing to pay \$10.00 for \$1.00 of Macy's corporate earnings. This earnings expansion is wonderful if you bought it as 17 and it goes to 30 and this is exactly how value investing works. What's been going on with the market in general is that already high P/E ratios are being pushed to ridiculous. Here is the reality of our world lately using the averages. A year ago the S&P 500 was priced at 18x earnings. Now at the tail end of 2019 the S&P is now priced at 25x earnings. This is people feeling really good about things so they pay more. They see prices going up and everyone is happy. We don't share the enthusiasm, when prices go sky high without earnings growth we become cautious as it's unsustainable. We love buying solid assets at cheap prices. We're not momentum chasers or looking for the best new invention, we're just shopping for \$1.00's that we can buy for fifty cents or a quarter and let it ride back up to fair value. P/E expansion as of late is scary and unsustainable.

Tough Enough? (cont'd from page 1)

While at BAMC, he was the first soldier to participate in cutting-edge regenerative stem-cell research to regrow his fingers, and later received prosthetic ears. Shilo's recovery has involved more than 75 surgeries, which required his family to spend up to six hours a day on wound care. Shilo also struggled from PTSD. In 2010 he was medically retired from the Army. Shilo reflects on his time in the service and his injuries: "Everything in life is a gift. Sometimes it may not be the gift you want but you realize that your challenges are a new beginning."

Shilo is a family man who is committed to five children, and a devout Christian. Today, Shilo is a motivational speaker and Coalition National Spokesman, sharing his story with groups around the country, raising awareness for PTSD and serving as an inspiration to fellow soldiers.

Next is Rob Jones:

Special Assistant to the President

Rob Jones is a retired Marine combat engineer, serving between 2006 and 2011. He deployed once to Habbaniyah, Iraq in 2008, and once to Delaram/Sangin, Afghanistan. During his 2010 deployment to Afghanistan, he was hit by an improvised explosive device, resulting in double above knee amputations of both legs. He spent time in recovery at National Naval Medical Center, Walter Reed Army Medical Center, and the combined NNMCC/WRAMC hospital, Walter Reed National Military Medical Center. The first year of his recovery was documented in the short documentary film, "Survive. Recover. Live," winner of the Sgt William Genaust Award from the Marine Corps Heritage Foundation, and Best Short Documentary from the GI Film Festival. He was introduced to the sport of rowing in early 2011 and went on to win a bronze medal in the mixed double scull event in the 2012 Paralympics in London. He competed at the 2013 World Rowing Championships in Seoul, South Korea, and cycling across America to benefit charity.

Next time the youth are whining about something, anything they feel is bad or unfair, share these stories with them. These men are literally tough as nails. It would be very healthy for all kids to experience a few weeks of outdoor or nature training as they grow up.

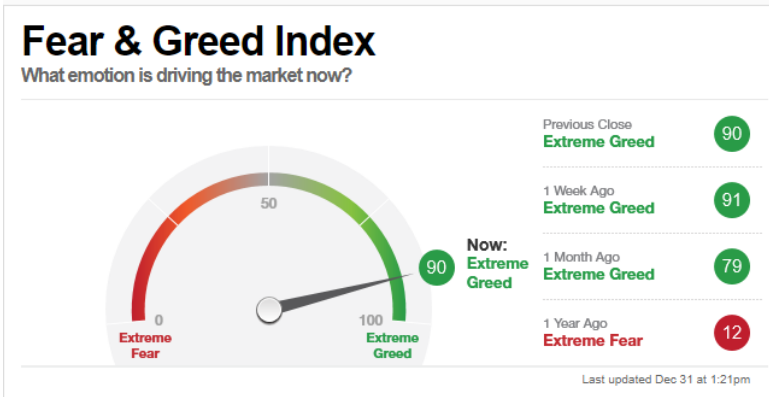
Money Quiz



This month's challenge is on German retirement savings! A shout out to the amazing engineering of Eurozone economic leader but how to the Germans save for their retirement? What % of Germans use the stock market as a tool for their investment future? ☺ Last month's quiz wasn't won, we'll recycle it. ☹ 12:16:19:5

Fear & Greed

This is investor sentiment and we use it as a contra indicator When people are fearful, we're looking to buy and when people are greedy, we're looking to sell or short. This Fear and Greed index below is how the average investor is feeling. Here is where it is for the last day of 2019!



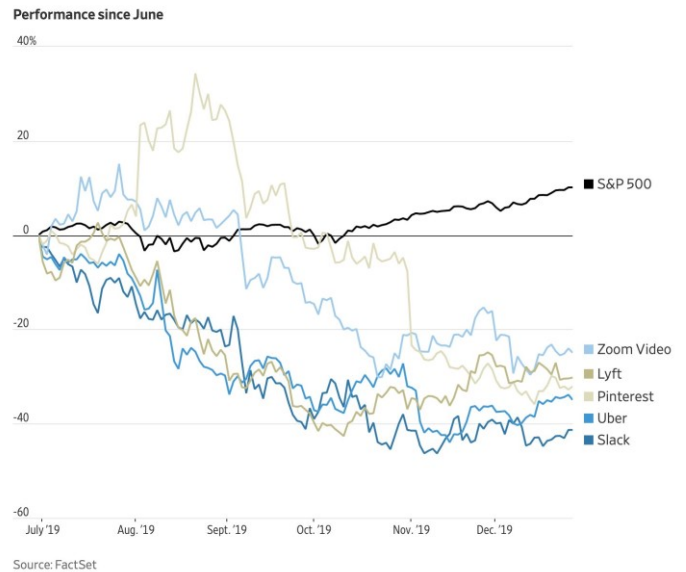
Elated may be the best way to describe people's feelings today and it's clearly in the extreme greed category. Let's couple this with something else we look at on the institutional side, the put/call index. This shows the positioning of people in the options trade. It too shows extremes, and when this extreme is a great indicator of a top or a bottom. We're at or near a top folks in the end of 2019! Don't be greedy here, follow the piggy principle.



IPO Interest Waning!

We've been watching IPO's go vertical once they hit the public markets in the past few years. As we've noted before, 80% of IPO's today are losing money each year and they're raising billions of dollars by a very enthusiastic public willing to pay dearly for big hopes and dreams. 2019 may be the turning point for the IPO frenzy.

This year we've seen some of the hottest IPO's come to public markets and struggle to impress with their performance. Many would argue their performance as a stock is in line with their performance financially and we'd agree with that 100%. The trouble with asking a stock to perform as its finances are performing is that over the past few years the public has been very spoiled. The fiscal performance of a company simply hasn't mattered, many of them losing billions yearly. If the company was hot and well loved by investors it would go up hundreds if not thousands of percent in just a few short years. This makes investing seem so easy and risk free, but those of us who have been around the block a few times and lived through 2007, 1999, even 1987 know much better.



This year we watched Wework implode and on the outskirts, investor sentiment isn't quite as euphoric as it's been over the past few years. These are some big named firms here that are sucking wind both financially and stock performance wise. I think we're in for a decade of reality where stock price actually reflects fiscal health and performance. It'll be a beautiful decade! ☺

Inspirational Quotes

- We pass through the world but once, Stephan Jay Gould
- The less you talk, the more you're listened to, Pauline Phillips
- One faces the future with one's past, Pearl. S. Buck
- Cherish your human connections, your relationships with friend and family, Joseph Brodsky
- If you're alive, there's a purpose for your life, Rick Warren
- Dream in a pragmatic way, Aldous Huxley
- We grow small trying to be great, E. Stanley Jones
- Forgive many things in others, nothing in yourself, Ausonius
- It is the set of your sails, not the direction of the wind that determines which way you will go, Jim Rohn



We can piece the puzzle together and make your money work for you!

If anyone you love or care about would benefit from receiving our newsletter, tell us who they are and they will be included on our mailing list. They'll certainly appreciate you thinking about them and having their best interests at heart!

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Kids Corner

Travel now or travel later? The big thing today is for kids to travel abroad for a semester and that's a nice life for sure. Study in some foreign country at a college or a hotel or an apartment and live a great life that is setup through the university while getting credits. Who wouldn't want to do that, my girls included?

When I was young such an opportunity was never afforded to me and I feel blessed for it. I've heard countless people say do it while you can, and you'll never be able to do it again so do it now while you're in college or while you're young.

I never felt that way at all. I've always felt that if I were smart and lived below our means, packed away a portion of our earnings and lived wisely, as I've aged, I'd be able to do anything I wanted, within reason. That theory has played out to be true and now that we've got a family of 4 with the girls turning into young adults it's more fun than ever to travel with them. It's not a lot of work like it was when they were young it's pure joy and they're also great help with many things now.

There is nothing wrong with studying abroad, although I wouldn't do it if it's on borrowed money. It's important to make sure the kids have a vision for their future and see a path to making that vision a reality. We've worked hard to help the kids become someone visionary and in control of their future. It's a joy to see it unfold as they work through life. 😊



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