5C CAPITAL MANAGEMENT, LLC

> *Whosoever desires constant success must change his conduct with the times.*
>
> *- Machiavelli*

Vol 4 — November 2019

Wall Street lore is filled with myriad of expressions. Strong equity markets tempered by increasingly divisive social and political maneuvering remind us that the stock market "climbs a wall of worry"; the less well-known counterpart is "sliding down the slope of hope". We seek to parse the endless flow of financial information jamming our heads and inboxes and provide useful commentary.

Economic and financial worries?

- The ongoing trade war with China: will it be settled, and if so, how and when? Will it push the global economy into a market-pummeling recession?
- The latest news from England: will Boris Johnson push through a no-deal Brexit or get pushed out of his job?
- The yield curve inverted during the quarter: what does this mean?
- The sudden volatility in overnight interest rates: what is the repo market anyway, and how can it go so haywire (10% rates, however short-lived) when we are continually told how much cash is lying around? Is this a larger warning signal or just a technical quirk?
- Troubles and aberrations on the European continent: what do negative interest rates mean for the Euro and, by extension, for the dollar and the world economy?
- Protests in Hong Kong: will they lead to Chinese retaliations that can endanger trade discussions (see above)?
- Global warming: do the President's reversal of environmental protections and the outbreak of major fires portend catastrophe, or can science find a way out?

Our Views

Our investment and financial planning is consistently applied, yet accommodates the unanticipated.

- During September, a drone attack appeared to endanger a considerable portion of Saudi Arabia's oil capacity. Oil prices spiked 12% higher but retraced sharply on news that long-term production would not be affected (although stocks appeared to discount the news in stride). The price jump on the first trading day after the attack reminds us that some forms of inflation don't creep into the economy but are foisted upon us. Potential conflict with Iran still looms; however we don't believe that strong defensive positioning is warranted.

Continues on page 2

Continued from page 1

- Interest-rate compression, inversion and volatility have led us to reduce the duration of our typical fixed income portfolio. We continue to focus on shorter-term, high-grade issues while seeking additional income opportunities through modest adjustments to interest rate and credit risk. We anticipate taking advantage of a steeper yield curve.

- It's important to emphasize that reacting to daily change is not necessarily as important as maintaining a long-term investment plan; one that is easily modified to exploit opportunities and moderate risk.

- We are overweighting value within our equity portfolio. The opportunity results from a combination of significantly higher dividend yields, attractive valuations, and a nearly decade-long underperformance. During the last five years, growth equities, led by technology companies outperformed value annually by over 500 basis points[1]. Interestingly, many factors including government scrutiny for privacy issues, may impede certain growth-driven technology companies profits in the near term.

- We recognize that Japan's easy-money policy has for decades failed to produce the desired inflation. However, we are not convinced that the Fed's accommodative efforts will meet the same fate. Investors should consider how an allocation to commodities may mitigate future inflationary effects.

Capital Market Returns Data

Stocks were mixed for the quarter, with large-cap outperforming small-cap and the United States outperforming most of the rest of the world. Rates fell sharply across the global yield curve amidst growth concerns, though they generally finished the quarter well off the lows. Other than gold, commodities were broadly weaker, pressured by economic concerns and low inflation expectations. The dollar strengthened versus major currencies. Global real estate has led most investment asset classes in 2019 and returned over 5% in the Third quarter. The following chart includes the best and worst quarterly results over the last decade. Referencing this type of data reminds us that risk and return are related.

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
3Q 2019	**STOCKS**				**BONDS**	
	1.16% ▲	-0.93% ▼	-4.25% ▼	5.72% ▲	2.27% ▲	2.83% ▲
Since Jan. 2001						
Avg. Quarter Return	2.0%	1.4%	2.8%	2.6%	1.2%	1.2%
Best Quarter	16.8%	25.9%	34.7%	32.3%	4.6%	4.6%
	2009 Q2	2009 Q2	2009 Q2	2009 Q3	2001 Q3	2008 Q4
Worst Quarter	-22.8%	-21.1%	-27.6%	-36.1%	-3.0%	-2.7%
	2008 Q4	2008 Q4	2008 Q4	2008 Q4	2016 Q4	2015 Q2

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

Global Economics and Politics

There's little doubt that the market is particularly focused on US-China trade negotiations. However, many other conflicts loom large: While the long-term view shouldn't change, the nearer-term outlook has gotten murkier. The powerful stock rally would suggest at least a modest rebalance toward bonds, but a 10-year yielding approximately 1.7% – 1.9%, 75 basis points less than it paid a handful of months ago, doesn't seem particularly enticing.

Europe's economy, led by Germany is sending worrisome signals and is on the brink of recession. IHS Markit reported on September 23rd that its German manufacturing index had declined to 41.4; indicating a contraction. However, we see other encouraging signs in Europe. A decade of underperformance relative to domestic equities have left valuations attractive. Our research indicates that continental stocks are close to outright "cheap" territory.

India's once-growing economy has been mired in a three-year pullback, although on September 20, the government announced fiscal stimulus in the form of a large corporate tax cut (effectively from 35% to 25%), prompting a one-day 5% gain in the Sensex index. Meanwhile, Japan is bracing for an increased consumption tax going into effect on October 1st. Japan wants the increase, from 8% to 10%, to help reduce its huge deficits. The increased tax has accelerated some consumer purchases, though less than a similar increase five years ago. Interestingly, the earlier increase contributed to Japan's recession[2]. That earlier increase ultimately took Japan into a recession. The new one may force the Bank of Japan to push rates even further below zero to stimulate inflation.

The confrontation between the two main powers remains most concerning. A protracted and growing trade war has the potential to throw the world economy into a full-blown recession.

The President's erratic communications on trade have forced businesses to reduce or delay investment plans. Soybean farmers have lost (at least temporarily) their main market. The President has proclaimed victory after victory in the tariff wars but has on a number of occasions had to quietly spend billions having to throw a lifeline to another wounded industry[3]. Agriculture has been the biggest and clearest victim, but automobiles and technology are also vulnerable, just to name two. Smaller but useful anecdotal informtion – foreign student MBA applications have recently declined[4].

It would be folly to guess how and when this fight will resolve itself. It's not unreasonable to speculate that President Trump will seek some kind of face-saving resolution in advance of the 2020 election, because his strongest case for re-election appears to be the economy. But it's impossible to predict whether he will be able to balance competing goals. Considering that that the House has started an impeachment inquiry, it's even more difficult to predict the outcome for the President. We believe our leadership should focus on a constructive (pun intended) effort to rebuild the nation's infrastructure? This doesn't appear to be a top agenda item, yet it's critical to the long-term economic competitiveness of the US.

Given these uncertainties, we maintain our view that clients should stick with a long-term investment plan that incorporates sufficient "cushion" to withstand a protracted reversal in the equity markets.

Interest Rates & the Repo market

It's important to remember some basic concepts about interest rates in a year of heightened volatility. Bankers make a living by buying and selling money in different forms. Commonly, they borrow funds (essentially purchasing) short-term and lend (sell) longer-term. Interest rates are the price of money. Like any commodity, money has supply and demand imbalances, which can drive the price to aberrant levels, usually for very short periods. Banks and hedge funds typically buy longer-term forms of money (such as bonds) with money they need to borrow short-term. They often borrow through the repurchase (repo) market, in which not only the Fed but also huge pools of private capital typically participate. Usually that money is readily available. On September 17th, the lack of liquidity caused a significant rate increase without warning.

The repurchase (repo) market is designed for banks and other short-term borrowers to buy securities in the open market, then use them as collateral to borrow the money to pay for them. Usually the borrowing firm repays the loan and reclaims its collateral the next day. Lenders, such as money-market funds and the individuals and corporations who own them, are usually happy to make the loans because they earn interest on excess collateral (usually worth several percent more than the amount they lend). Sometimes the banking system needs extra short-term funding. In these cases, the Fed can step in and provide additional repo liquidity. It's essential for the system – when firms cannot fund themselves overnight, they are considered unable to repay (in default). During the 2007/2008 financial crisis, Bear Stearns and Lehman were two of the more extreme examples of the liquidity crisis. The current repo market does not appear to have asset quality concerns; unlike the 2008 crisis that ensnared the banking system and required a coordinated bailout. The Fed's actions apparently related to a calendar quirk that absorbed cash usually available for short-term borrowing, with tax receipts and Treasury payments coming due at the same time that the Japanese markets were closed.

However, issues which appear relatively sedate may portend for future concern. Although interest rates are low, there may not be quite as much free cash "on the sidelines" as suggested. Another is the growth of "shadow banking"—alternative lenders, such as business development corporations, which provide capital to smaller and more speculative borrowers. Hidden leverage is yet another risk. Our research indictes that over the past decade, institutional investors have markedly increased their exposure to alternative income vehicles with substantial leverage. Many large institutional investors have over the past decade doubled or tripled their exposure to various alternative income vehicles which often use substantial leverage. Fed Chairman Powell has also voiced concerns to that effect.

Interest Rates & Volatility

We were surprised by 2019's bond rally, particularly during the third quarter, when US 10-year Treasuries briefly yielded as little as 1.45%. We overweighted short-term fixed-income assets, remaining liquid while generally earning more income than intermediate to long dated maturities. However, the enhanced cash flow came at the expense of principal appreciation during a declining interest rate environment. The inverted yield curve also pressured us to keep our fixed-income allocations shorter than normal. Inverted curves are fairly rare, but when they happen, they usually portend a recession, though the timing can vary. We see the inversion in rates as transitory and technically driven by global monetary policy and not long-term or foreshadowing a recession. Therefore, much of 2019's fixed income gains are exposed to steepening curve and reversion to historical norms.

Continues on page 5

Continued from page 4

During a two-week stretch in September, volatility in the domestic fixed income markets increased significantly. The 10-year yield spiked from 1.45% to 1.85%. This equates to a 3% drop in the note's value in two weeks. For example, if you purchased an instrument yielding less than 1.5% and it loses 3% of its value, you've just lost more than two years of income. Interestingly, the drop in rates earlier in the summer was accompanied by relatively light volume. Essentially, bond sellers just decided to stop selling. Despite the remarkable price activity, trading volumes in the 10-year range of the yield curve have increased much less (only 4.8% versus double digits) [5] than other parts of the curve.

Sample Domestic Yield Curve - October 2019

Instruments	3MO	6MO	9MO	1YR	2YR	3YR	5YR	10YR	20YR	30YR+
CDs										
Fixed Rate New-Issue Non-Callable	1.610	1.606	1.603	1.600	1.700	1.800	1.950	----	----	----
Fixed Rate New-Issue Callable	----	----	----	1.750	1.800	2.000	2.200	2.450	----	----
Stepped-Rate Coupon	----	----	----	----	----	1.750	----	----	----	----
BONDS										
U.S. Treasuries	1.556	1.557	1.590	1.667	1.690	1.702	1.771	1.943	2.272	2.424
U.S. Treasury Zeros	1.190	1.351	1.546	1.639	1.645	1.684	1.798	2.049	2.432	2.431
Government Agencies	1.459	1.577	1.630	1.717	1.750	1.806	2.102	2.804	2.823	3.057
Corporates (AAA)	----	----	----	1.505	1.593	1.771	2.027	2.142	----	3.536
Corporates (AA)	----	1.542	----	1.708	1.593	1.848	2.053	2.471	----	3.536
Corporates (A)	1.319	1.755	1.874	1.934	1.954	2.188	2.354	3.123	3.831	4.418
Municipals (AAA)	0.862	----	1.124	1.174	1.163	1.332	1.563	2.096	2.766	3.048
Municipals (AA)	0.862	0.995	1.124	1.219	1.669	1.495	1.830	2.475	3.143	3.204
Municipals (A)	0.862	1.153	1.124	1.367	1.669	1.556	1.830	2.475	3.143	3.311
*Tax Equiv. Muni AAA	1.326	----	1.729	1.806	1.789	2.049	2.405	3.225	4.255	4.689

Note the yield compression amongst all fixed income classes presented. The after-tax yield of short-term high-quality taxable paper compares favorably to tax exempt securities. Whereas investors seeking income struggle to avoid additional risk in order to achieve required returns, States and municipalities are busily taking advantage of low interest rates to refinance their obligations. Query if State and Local institutions benefitting from the low interest rate environment will save any part of their refi windfall for the proverbial rainy day?

Commodity Prices & Inflation

The Fed has made no secret of its desire to spark inflation, stimulate the economy and encourage corporate borrowing and investment. Recently, it has been relatively unsuccessful.

While certain financial assets have seen their values inflate (the money has to go somewhere), most commodities (other than gold) have not. The Bloomberg Commodity index has fallen nearly 10% from the end of 2017 through mid-September 2019 (update). However, growing populations and per-capita income will likely increase demand for energy, food products, metals, forest products and water. Investing in upstream (raw materials) resources provides exposure to this demand in its purest form[6]. Many commodities have experienced a protracted period of price weakness. Potential supply imbalances and accommodative global monetary policy favor price appreciation. We are transitioning our commodities exposure to a dividend paying natural resources fund, which includes positions in copper, rare earths minerals/ elements, petroleum and "clean" water.

The Challenge of Staying Invested

While equities have largely corrected and recovered over the past year, the broad indexes are only slightly higher than they were in early 2018, due to weakness during the fourth quarter. It's tempting to forget that quarter, given 2019's domestic equity rally and Fed's grudgingly accommodative policy. As discussed earlier, we support broad risk adjusted diversification through exposure to long-term market and economic growth.

Attempting to buy individual stocks or make tactical asset allocation changes at exactly the "right" time presents investors with substantial challenges. First and foremost, markets are fiercely competitive and adept at processing information. During 2018, a daily average of $462.8 billion in equity trading took place around the world[7]. The combined effect of all this buying and selling is that available information, from economic data to investor preferences and so on, is quickly incorporated into market prices. Trying to time the market based on an article from this morning's newspaper or a segment from financial television? It's likely that information is already reflected in prices by the time an investor can react to it.

Dimensional Funds recently studied the performance of actively managed US-based mutual funds and concluded that even professional investors have difficulty beating the market: over the last 20 years, 77% of equity funds and 92% of fixed income funds failed to survive and outperform their benchmarks after costs[8].

Complicating matters – for investors to have a shot at successfully timing the market, they must make the call to buy or sell stocks correctly not just once, but twice. Professor Robert Merton, a Nobel laureate, said it succinctly in a recent interview with Dimensional:

Continues on page 7

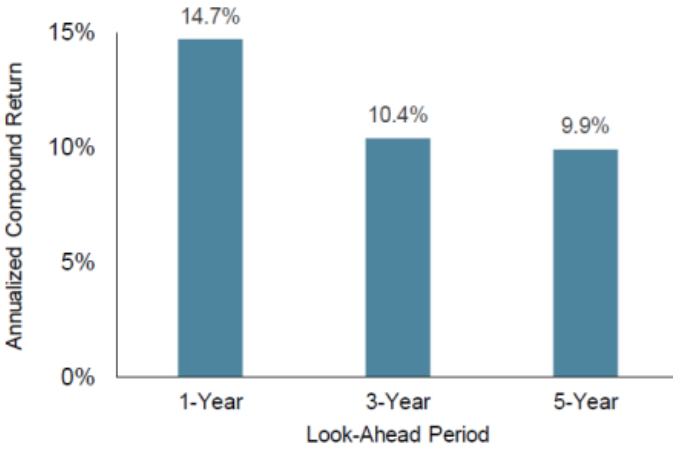
Continued from page 6

"Timing markets is the dream of everybody. Suppose I could verify that I'm a .700 hitter in calling market turns. That's pretty good; you'd hire me right away. But to be a good market timer, you've got to do it twice. What if the chances of me getting it right were independent each time? They're not. But if they were, that's 0.7 times 0.7. That's less than 50-50. So, market timing is horribly difficult to do."

Time and the Market

The S&P 500 Index has logged an strong decade. Should this result impact investors' allocations to equities? Exhibit 1 suggests that new market highs have not been a harbinger of negative returns to come. The S&P 500 went on to provide positive average annualized returns over one, three, and five years following new market highs.

Exhibit 1. Average Annualized Returns
After New Market Highs
S&P 500, January 1926–December 2018



In US dollars. Past performance is no guarantee of future results. New market highs are defined as months ending with the market above all previous levels for the sample period. Annualized compound returns are computed for the relevant time periods subsequent to new market highs and averaged across all new market high observations. There were 1,115 observation months in the sample. January 1990–December 2018: S&P 500 Total Returns Index. S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. January 1926–December 1989; S&P 500 Total Return Index, Stocks, Bonds, Bills and Inflation Yearbook™, Ibbotson Associates, Chicago. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. There is always a risk that an investor may lose money.

We maintain that outguessing markets is more difficult than many investors think. While favorable timing is theoretically possible, the issue remains divisive amongst investors regardless of experience. However, we firmly believe that investors don't need to time the markets to have a productive investment experience. Over time, capital markets have rewarded investors who have taken a long-term perspective and remained disciplined in the face of short-term noise. By focusing on the things they can control – such as asset allocation, diversification, managing expenses, and taxes; investors can better position themselves to take advantage of opportunities presented by capital markets.

As always we appreciate your business and look forward your questions and dialogue relating to this letter or any other issue you may have.

We hope for your continued success and a festive holiday season.

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[1] *The Russell 1000 Growth Index returned 13.2 % for the five years ended September 30, 2019, compared with 7.6% for Russell 1000 Value Index. (Source: Morningstar).*
[2] *The Economist, September 28, 2019.*
[3] *24th, 2019, citing calculations by Bloomberg BusinessWeek showing the cost of bailing out tariff-affected farmers has already exceeded the cost of the automobile subsidies during the global financial crisis.*
[4] *"Stanford's MBA applications drop 6% on US-China trade war," Financial Times, September 18, 2019.*
[5] *Source: SIFMA.org.*
[6] *See "Moving Upstream: The Case for Upstream Natural Resources," white paper by Flexshares.com.*
[7] *Source: Dimensional, using data from Bloomberg LP. Includes primary and secondary exchange trading volume globally for equities. ETFs and funds are excluded. Daily averages were computed by calculating the trading volume of each stock daily as the closing price multiplied by shares traded that day. All such trading volume is summed up and divided by 252 as an approximate number of annual trading days.*
[8] *Source : Morningstar. The sample includes funds at the beginning of the 20-year period ending December 31, 2018. For further details, see the Mutual Fund Landscape 2019.*

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There is a pattern in nature that portrays ongoing growth. Known as the Fibonacci sequence, it is seen most clearly in the intriguing spiral form of the Nautilus shell. From a mathematical standpoint, it is startlingly simple: each number in order is the sum of the two previous numbers: 0,1,1,2,3,5,8,13,21,34 and so on. Yet in terms of structure, it is sturdy, strong and reliable.

For 5C Capital Management, this unique combination of growth and stability is a powerful representation of our approach. The focus of our cumulative experience is to establish goals and implement strategies that support current financial stability while consistently building toward the long-term financial growth you aspire to for your own lifetime and for future generations, as well.

Much like the Nautilus is built on an unfolding and interwoven series of C shapes, so is the core of 5C Capital Management. Our clients rely on us to provide an exceptional level of:

- **COMMUNICATION** - We listen attentively, share ideas clearly, operate transparently and maintain connectivity.
- **COLLABORATION** - We work together with you and the professionals that comprise your advisory team to ensure that your concerns are addressed as they arise and your strategy adapts to changes in circumstance warranting such adjustment.
- **CRITICAL THINKING** – By incorporating independent fundamental analysis, we maintain the objectivity needed to provide a full spectrum of unbiased solutions. We plan for a range of potential scenarios; develop a structured, flexible strategy, and take timely action.
- **CREATIVITY** - Every client has a unique set of circumstances and goals. Our experience and common sense approach results in solutions that are customized for each client's circumstance.
- **COMMUNITY** - This cornerstone of our approach refers both to 5C's access to and use of a wide community of tax experts, attorneys, business consultants, and other specialists, as well as our dedication to understanding our clients' special commitments to community through philanthropy and support of cultural and educational initiatives and institutions.

We embrace our fiduciary obligation to clients and invite you to discover how 5C Capital Management, LLC is highly qualified to guide and advise you through this complex process.