CROSSCURRENTS Part II

Two quarters ago we noted that the two hurricanes in Houston and Florida, while tragic, would be GDP positive for the next few quarters. Last quarter we added that the tax package which should be GDP positive. Finally, we noted that the Federal Reserve is doing Quantitative Tightening (QT) and that QT would persist and eventually overtake the impacts of the hurricanes and the tax cut. Has that now happened?

The Fed has driven markets through liquidity injections since 2009. Excess liquidity finds itself spread across the risk spectrum. As the Fed bought the safest assets, those who sold those assets had to leapfrog to the next riskiest asset class as they were crowded out from staying in the asset class that they just sold. At the margin, as the Fed reverses their actions and sells the safest assets, those who buy the assets sell the next riskiest asset class to buy the safer class. One would expect pressure on stocks and bonds at the margin until the unwind slows.

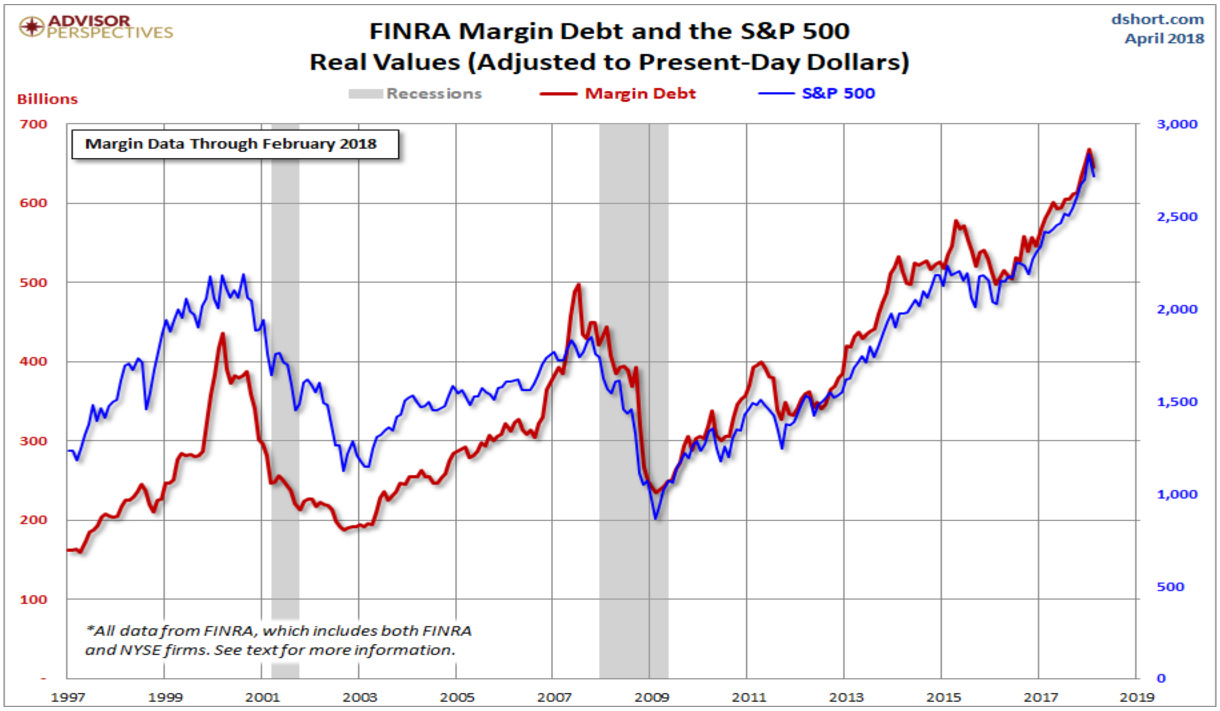
Perhaps there is some evidence of this. Some of the most speculative investments are the FANG (Facebook, Amazon, Netflix and Google) stocks and the crypto-currencies, including Bitcoin. When liquidity is sloshing around and speculative fever is running wild, these types of investments do great. However, when it reverses, they do poorly. How have they done?

The FANG stocks have led the market over the past few years rising over 150% and greatly outpacing the market. However, since March 12, they are down 11%. They have also broken below the 100 day moving average for the first time in two years. Note that in the February downdraft, they did not even break their 50 day moving average. So something may be different this time.

Bitcoin has been the poster child for speculation. It tripled in the fourth quarter last year. This year it has been reversing the fourth quarter's hyperbolic move. Interestingly, Bitcoin dropped in the February downdraft. It has now taken out the low it set on February 5 of $7,100 and is now nearly $6,600. We view the FANG stocks and Bitcoin as proxies for speculative fever. Perhaps the FANGs just confirmed that the party is over?

Margin debt is another indicator of speculative fever as investors borrow money to invest, thus magnifying gains and losses. Current margin debt levels greatly exceed those of the past speculative blow-offs in 2007 and 2000. These high margin levels accentuate the market gyrations of the past few months. As you can see, there is a record amount of margin debt to liquidate if the market continues to struggle.

Finally, one should note the different pattern in the market of late. Bear markets are characterized by lower lows and lower highs (they also include gut wrenching falls and amazing rallies). Also, when the market has fallen lately, it has been on high volume, while rallies have been low volumes events. These are classic symptoms of bear markets. Who knows whether they will continue, but these characteristics have not been around for a while.

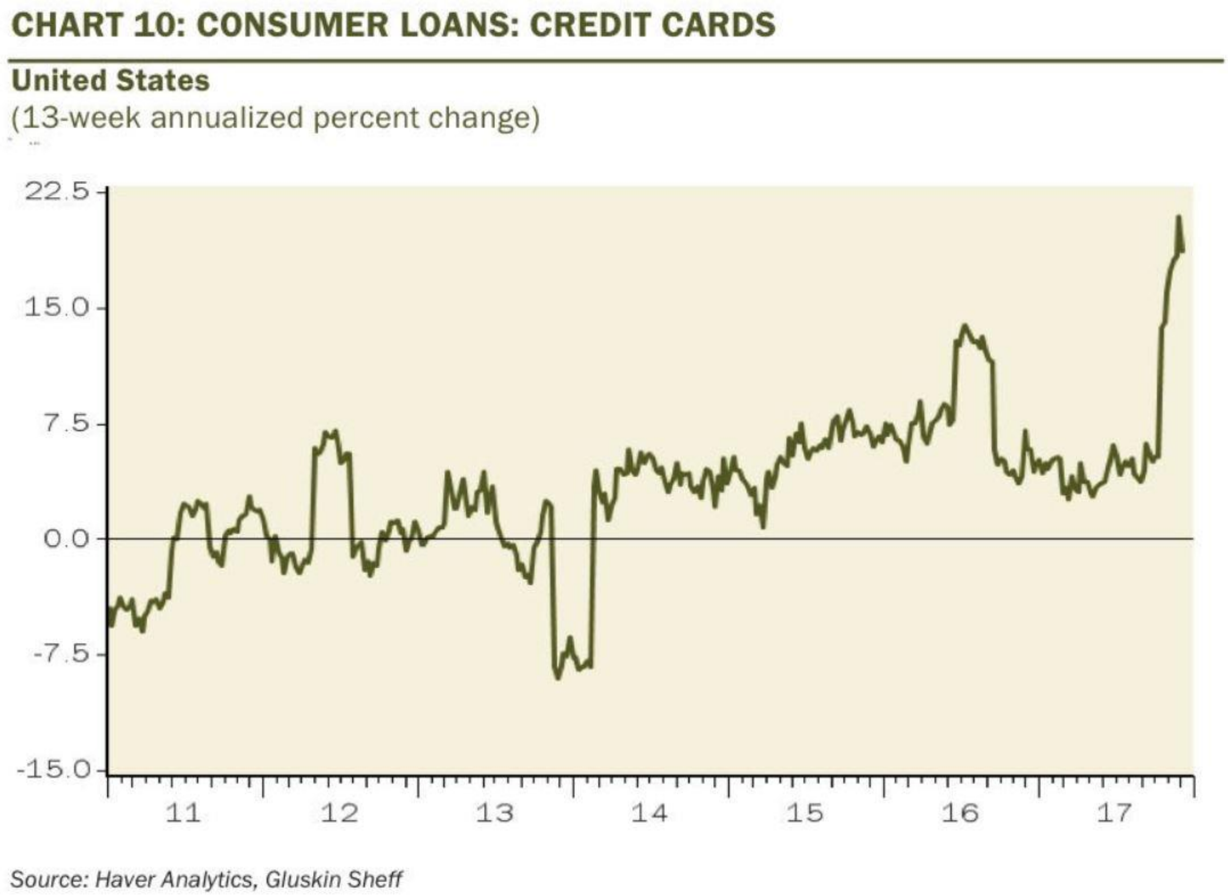


10 yr UST rates

Last quarter we looked at the 10 yr UST rates and noted that they may break out of at least a 24 year downtrend. Well it did break out. While the 10 yr is off of its high yield this year, the yield has stayed up, even with recent downdrafts in stocks. Usually stock drops produce a flight to safety and 10 yr UST yields drop significantly. Also, the talk of additional tariffs is inflationary. Tariffs raise the prices on the tariff goods. They also tend to stagnate demand, making them stagflationary. However, the jury is still out over how much of tariff talk is negotiation posturing or serious.

Hurricane Impact Update

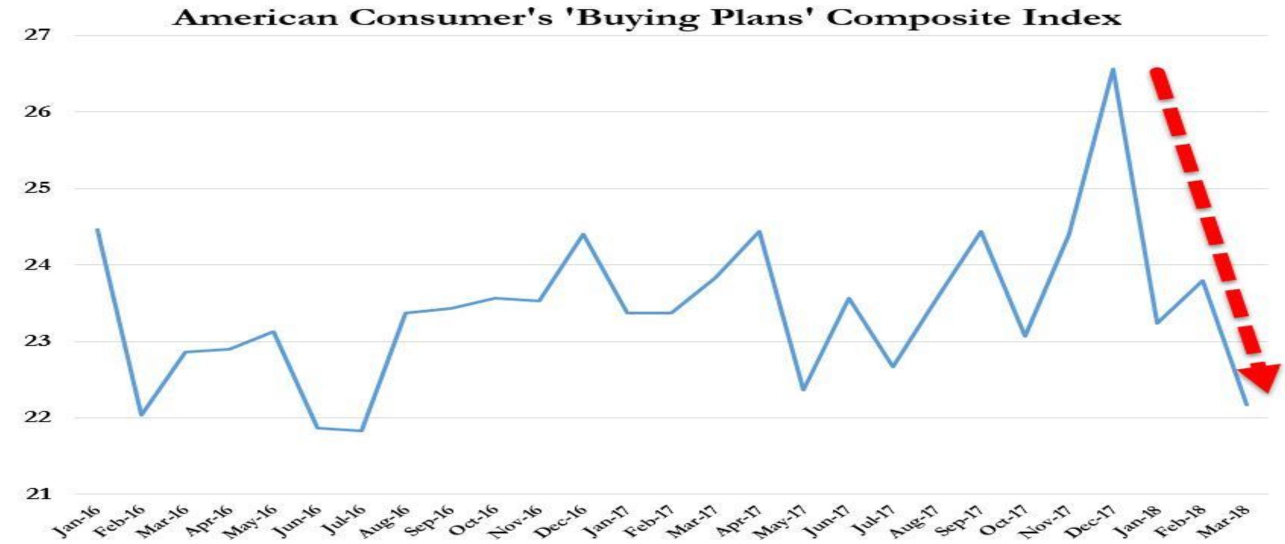
We believed that the hurricanes in Texas and Florida would cause a temporary spurt in GDP of 1-3 quarters. David Rosenberg, of Gluskin Sheff, posted a chart on credit card growth that showed a 20% 13-week annualized growth rate for Q4 2017. This is the impact that we were looking for. However, it is uncertain how long this will last.



The Conference Board Consumer surveys for “Plans to Buy” Homes, Autos and Appliances may have an answer. While all of these components saw increases in Q4, the all dropped off by the end of Q1. Perhaps the spurt has already ebbed?

Rosenberg asked what it means when there is “booming employment and massive tax cuts… and household buying plans take a deep dive.”

Rosenberg’s answer: “…the consumer is debt strapped and tapped out. Pent-up demand is a relic of the past.”



Quantitative Tightening

We want to reiterate that the Fed is currently reversing its years of Quantitative Easing. We call it Quantitative Tightening (QT). The Fed is reducing its balance sheet by $30 billion per month in Q2 and increasing QT by $10 billion per month each quarter so Q3 will be $40 billion a month and Q4, $50 billion. Hedge funds generally front ran the Fed's plans for QE and interest rates fell faster than just the Fed's purchases. We would expect that Hedge funds would again front run the Fed and interest rates should rise faster than just the Fed's sales.

Also the Fed's QT takes liquidity out of the market. Since the stock market was the primary beneficiary of the excess liquidity, it may also be the victim of the liquidity drain. We may be seeing the faint rumblings of that lately as volatility has returned to the stock market.

Fiscal deficits

We also wanted to remind readers that, in addition to QT, fiscal deficits also add bond supply as the Treasury finances the deficit. Below are projections by David Stockman, Reagan's budget director, showing that deficits are going higher after the just-passed tax bill and new budget.

Stockman additional funding requirements ($ billions)

Deficit FY '19	$700	
Tax Cut	280	
Budget additions	200	
Addl debt	100	
Total	$1,280	6.2% of projected GDP
QT	$600	
Grand Total	$1,880	9.1% of projected GDP

This begs the question of who purchases the new supply of debt, at what interest rate and do those funds come out of equities?

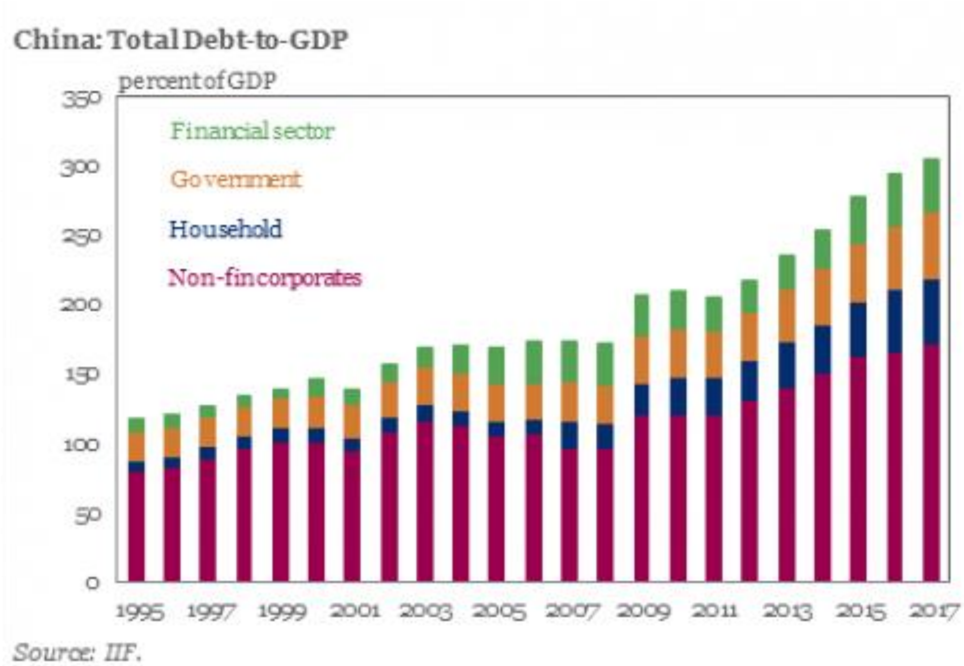
We believe that this liquidity draining is just beginning to impact the stock market. Since this is a multi-year headwind, we expect and are prepared to see increased volatility going forward.

China Tariffs

China and the US have been trading new tariffs lately. President Trump's style of active confrontation is alarming to the market and leading to headline volatility as investors are unsure of the outcome of such threats. It seems to us that much of this is negotiation posturing that usually happens in back rooms, but now is happening on the front page. Markets do not like uncertainty, so this new style is disconcerting.

China has overbuilt its manufacturing capacity in many industries and hollowed out many other countries' manufacturing base. This generally leads to dumping excess product around the globe which leads to tariffs.

We keep a keen eye on the developments to see if they get out of control. So far the impacts have been modest. However, given China's leverage, a loss of revenue is multiplied.



FUND INFORMATION

The fund's largest equity positions as of 3/31/18 were Travelers, Microsoft and Aon.

Despite high catastrophe losses from hurricanes and wildfires, shares of **Travelers** were up in Q1 2018. Travelers is a well-run provider of commercial insurance with industry-leading ROEs. Their scale will allow them to invest in cutting edge technology in 2018 (predictive modeling and artificial intelligence) in order to maintain their competitive advantage. They temporarily suspended share repurchases during the hurricanes this past fall, but recently resumed them, having confidence in their level of capital. Management believes that these natural disasters will provide the industry with pricing power into 2018, which has historically correlated with strong stock gains. Finally, US tax reform is expected to boost the company's 2018 EPS an additional 10%.

As **Microsoft's** cloud business becomes a larger portion of the company's revenues, growth continues to accelerate. In the most recent quarter, revenues reached double-digit growth of 10%. There should be several years of growth ahead as health care and financial services industries are just beginning to migrate to the cloud. As the cloud business reaches scale, margins will increase, causing earnings to grow at an even faster rate than sales. The multiple is rerating itself higher as Microsoft is increasingly seen as an important next-generation player. The shares were up nicely in Q1 2018.

Aon is seeing nice growth in their health exchange business as well as their data and analytic services business. Traditional commercial risk solutions business is seeing moderate growth, but their operating leverage insures that more of their growth flows through to the bottom line. Like Travelers, Aon could benefit the catastrophe losses in 2017 lead to stronger P&C pricing in 2018. The shares were up in Q1 2018.

LOOKING FORWARD

We try to produce the best risk-adjusted returns available. As risks have increased, we have increased our protection. If risks subside or are priced in, we will gladly reduce our protection. But until the market more fully reflects these risks, we will remain cautious.

Best regards,

Thomas H. Forester

CIO and Portfolio Manager

For more complete information on the Forester Funds, including charges and expenses, obtain a prospectus by calling 1-800-388-0365 or visiting www.ForesterValue.com. The prospectus should be read carefully before investing.