

Mispricing Risk

We can't seem to talk about this to get our point across well. Risk is mispriced today on many levels, some say every level. Risk pricing is supposed to be that a low risk is rewarded with a very low interest rate and a high risk is appropriately priced with a higher interest rate to compensate the investor for the additional risk (s)he is taking. In loan terms let's look at two consumers where the system is working properly today. Mark is looking to buy a home and has a great job, decent credit but not great, not a lot of money saved for a down payment and he is going to be charged 8% for his home mortgage. Kristie is in great financial shape, has a 770 credit score can put down 25% on the house, not as good of a job but a solid one, and she is being charged 4% for her mortgage. Both consumers are buying homes in the same town and that is how credit works in a sane world.

Note 10 years ago when banks were behaving badly the situation was very different. Virtually anyone could get a loan, you didn't need a down payment, a job, or even good credit. That fiasco of course was the precursor to the 2008 financial "crisis" as it is called. Comically we're not done with that and as it unfolded the government didn't really fix anything they just put a bandaid on it and we'll have the second episode of it come to a theater near us at some point soon.

Today the mortgage business has pretty much been cleaned up and now you need a job, a good credit score and other valid underwriting requirements to be able to get a mortgage. They still allow for very low down payments which is trouble long term but things are more sane today in the mortgage business. The craziness of 2005 – 2008 isn't gone it's simply shifted. We now allow and even encourage insane behavior from government on every level. The local governments are able to borrow money very cheaply and spend beyond their means. Many local governments spend more each year than they take in. Some do a fine job, in general small communities can keep it sane while larger ones are imploding and it's just a matter of time before these local communities have to file for bankruptcy or in some other way reorganize completely. Take Chicago as an example of a local government on

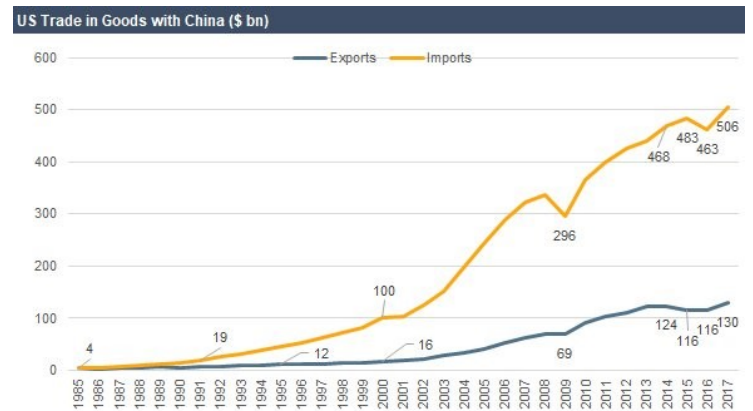
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Trade Wars?

A very big question mark lies in front of the recent decision to apply a tariff to imported steel to America. 25% on steel and 10% on aluminum. The concept of leveling the playing field with other countries is a very sound one. We have indeed made many bad deals for America as we've had political behavior running the show for far too many years now. This behavior has engaged in a plethora of deals that were good for politicians and horrible for America. We have looked back and done a little homework on how trade wars play out and it is quite interesting how the results come in. One side of the argument is that with these new levies it'll force foreign firms to build plants in America and bring our jobs back, I applaud that 100% as we do need our jobs back and foreign investment is indeed a beautiful thing here in America and there should be a lot more of it. China has that exact policy, if we are to sell our good to the Chinese we need a plant there but they do a whole lot more selling to us than buying from us. Not only do we need a plant there but we need to show them our technology, a policy I've always questioned. This graph does great job and putting that in perspective:



Source: United States Census Bureau, CreditSights. Note: Trade in goods only and exclude services. Data through Dec 2017. Figures are presented on a nominal basis, not seasonally adjusted unless otherwise specified.

Many point to China as our main source of steel and that is untrue, we import 70% of our steel from Canada and only 2% from China. Many firms today have slowed or stopped the Chinese imports on quality issues and shipping costs and delays. The concept is sound on one level but dangerous on another.

Let's step back in history to the Smoot-Halway Tariff Act which was imposed in 1930 in an effort to keep our domestic industry "safe". That act imposed tariffs on some 20,000 imported goods. It was far reaching and meant to

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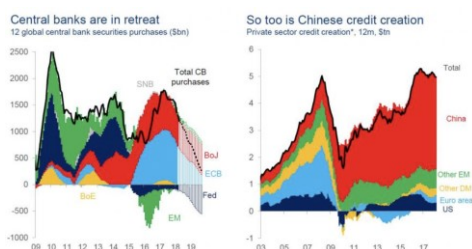
Risk Miscalculation (cont'd from page 1)

the brink. Hartford is another example where the city is in complete financial ruin and the mayor rather than being shamed out of town is instead running for Governor. Perhaps he should focus on fixing Hartford and not the next job? The states have the same disease, some are doing well and others are on the verge of closing their doors. They're printing money using the state credit card but that will come to an end. Southern states typically do a better job as to midwestern states. Connecticut sadly epitomizes fiscal mismanagement and will go down the road that New York, Illinois and California are on. Amazingly when we talk about mispricing risk, the clowns in Hartford can raise money at 4% despite their fiscal train wreck of a balance sheet and economic policy. This isn't far off from the sane states like FL, TX or TN where they too can raise money for the state at 4%, even high 3% range. The true risk pricing if it were working properly would justifiably charge 3-4% on bonds for fiscally sane states but the states like CT, CA, IL & NY should justifiably be charged double those rates as investors are taking on a lot more risk to lend money to fiscally mismanaged states.

From a country wide perspective we have the same issue on a grander scale. Here the charge blew from our friends at Bloomberg show the yields on various countries debt. Note how over the last 7 years the yields have gone down and down and down. This means bond prices have gone up and up and up. These southern block European countries are fiscally unsustainable and yet there are able to raise money at 1% and change? This epitomizes mispricing of risk and it's across the board.



When central banks print money endlessly for a decade it has the impact of making people do foolish things and misprice risk. For anyone to lend money to Portugal, Spain or Italy or Greece at super low rates we all know that ends badly. Germany is super solid and deserves the low rates they have earned, the story is just like our local towns and states. The punch bowl is now in retreat, the Citi chart below shows the removing of the drug, watch in the coming years as the risk become appropriately priced. ☺



Historical Note of Importance

The following is a very important note, I'll elaborate after you read it:

Investors have the following to look forward to at some time in the next twelve months: Bob Prechter of the Elliott Wave Hotline will give his much vaunted sell signal. On that day, the market will open down approximately 5 to 7% as Prechter probably has more clout today on both a domestic and international level than Joe Granville did back in the early 1980's when he was capable of moving the market 5%. Since there is only approximately \$17 Billion devoted to stock index arbitrage, the natural buyers in the futures pit will be quickly overwhelmed by at least a portion of the approximately \$60 billion of portfolio insurance that will be for sale. Remember, if all that \$60 Billion of insurance were to be hedged in the S&P 500 the open interest would have to increase by a multiple of 2.5 times the highest level previously attained. This is an unlikely prospect. As a result, stock index futures will remain at discounts that have never been seen since their introduction in 1982, keeping continued pressure on the NYSE. The severity of this one-day break should at least be equal to twice that of any prior break during the entire bull market. Considering that the market has a 6% decline from top to bottom in 45 minutes on January 23, 1987, a 12% intra-day break at some point in the future would not be unrealistic and would simply match that of the 1929 drop. If one examines the nascent stages of major bear markets following exponential bull market rises, (such as we are currently witnessing in the stock futures market) it seems that the initial selling wave generally lasts between 50 and 60 days from peak to trough, and results in a 40% decline in the market. Therefore, if our projection of over Dow 3000 is met by mid-January, 1988, then the initial 40% correction results in a Dow level of 1800 or 235 basis points in the S&P 500. Within three years and after many sharp bear market rallies, however, we project the DOW will fall below 1000. While this decline may seem dramatic, it is not inconsistent with breaks in other major bull markets.

From January 1 on in particular caveat emptor.

Paul Tutor Jones

P.S. Have a great day!

This is the note Paul Tutor Jones wrote to his investors in early 1987. The ability of someone to "see this coming" isn't magic at all it is simply paying attention to the little details that are under the covers of markets that few dig deep enough to understand.

It ended up that on October 19, 1987 the markets lost 23% of their value in a day so Paul Tutor Jones was conservative in his views of a 12% drop. This was the first instance of computer driven trading run amok and it will not be the last. We've been cautious on markets for some time as they continue to defy gravity but be patient and don't chase, capital preservation is the name of the game today, not chasing bubbles! ☺

Noteworthy News!!!

- Congratulations to the Kolakoski family on the birth of baby Elliotte Grace, grandbaby # 4! ☺
- Our condolences to the Vander Eyk/Iffland families on the passing of Kathleen, a wonderful woman, mother, sister, grandmother, aunt, person and friend.
- Congratulations to Garry Johnson on the sale of his business and recent retirement! ☺
- Congratulations to Mike Savino on his recent retirement! ☺

Question & Answer

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

Q: With the indexes making such big moves how come my positions are not moving as much as the indexes?

This is because many markets or indexes are capitalization weighted, meaning bigger stocks have a bigger impact on the index or the average or whatever is being measured. Here is a great snapshot to see it in real time:



This chart shows us the % index move for each security in the DOW. As you can see the top one here represents 449% of the movement of the index, far more than any other DOW component. We cannot name names on any specific securities but you can see how in this snapshot one stock has a 449% impact while another has a 34% impact. This is a very large range and it shows just how much one or two names can hold up an index or a tool used to measure a market.

Disclosure – this chart and information isn't a recommendation to buy or sell any security, nor is it performance reporting, it is educational in nature only to illustrate how one or few assets can drastically impact a sector or index.

Peaceful Easy Feeling (cont'd from page 1)

protect our industries, all of them. Farmers were happy and auto makers were elated. Shortly after that was imposed Canada retaliated as well as other trading partners to America with their own tariff policies on goods imported to their countries from America and the trading war was on. From 1929 to 1933 the trade war went on and in 1934 the tariffs were repealed. There is much debate over tariffs and whether or not they're a good thing. The jury is still out and what is happening today is nothing in comparison to what happened in the 1930's. We should be smart and look at history as a guide to what we should expect moving forward if we stroll down similar paths. The country went in the opposite direction of tariffs for the next 80 years as many felt the Smoot-Hawley act was a disaster and part of the reason the great depression was so bad, government acted to exacerbate the situation. They may have gone away from tariffs, but they simultaneously sold out the American family by bad deals.

Italy and France had a trade war many years ago and the French people clearly "won" that battle but at the time the French economy was far larger than Italy's. Italy started that war and regretted it, but even after they lost and pulled out their tariffs the French people kept theirs as a punitive move to the Italians. I'm sure there was a lot of arm and hand shaking by the Italians at this policy. The administration here today may be thinking this is how it'll work now as we're the superpower and we do a lot more importing than exporting. There are downsides to tariffs as well, the American auto industry was insulated from foreign competition for many years by tariffs and they failed to modernize, improve quality or reduce costs. That allowed the decades long decline in American auto where Japan and European carmakers cleaned our clocks. We seemed to have learned our lesson and America is now competitive again on most levels except reliability. Design and performance are on par with the foreign competitors. That slacking of an entire industry is not something we want to ever see again so to try and navigate the waters carefully here with these tariffs, if we pursue them we need to ensure our businesses stay competitive and preferably ahead of the global competitions.

America has made so many bad deals politically over the years it's understandable that people want pro American policies. I agree with that concept I'm just not sure tariffs are the way to do it. Often the losers of trade wars are consumers as it can have the impact of forcing prices up. It's not always the case but could be an unintended consequence of what happens post such policies.

The era of the Smoot-Hawley act was the era of the great depression and ironically much of today rhymes with the roaring 20's. We have an era of government spending and debts being amassed at levels never seen before. We're in a period of "roaring" markets and an economy that seems strong on the surface. If you're involved in any government paid for business you're busy, super busy. For many things remain tough and industries that have been recession proof are no longer. Medicine is feeling a lot of pain over the health care law that has doctors working a lot more hours doing administrative minutia and getting reimbursed less for said work. We'll see how it plays out, but a historic lesson is in place for those paying attention!

Money Quiz



This month's challenge is on education, what % of jobs in the USA require a college degree? Last month's quiz wasn't won, the 4 largest retail banks in America wrote off \$12.5 Billion in credit cards in 2017. WOW! Winner goes to Ruby Tuesday on us! 02/26/18: 8

We've Moved

There is a lot going on around here at Chadwick Financial Advisors. We've been busy all around not only serving you and navigating the macro economic landscape but we've relocated one of our offices. The Torrington office has been closed and relocated to Thomaston.

Our new address is 226 South Main Street Thomaston, CT 06787

Our phone remains the same, 860 489 8880. Fax 860 673 5177.

The building in Thomaston is very similar to the one in Torrington, a classy 1900's era home that is converted into an office. Also very similarly we are on the 1st floor and the building is on the corner of Center Street across from the firehouse. Our main entrance door is at the rear of the building so park either on Center Street or parking the lot behind the building and enter the building through the rear door across from the garages.

The Torrington office building is one I owned together with a dear friend of mine, John Ciesco, who owns the memorial business located at the same place. I sold my share of the building to John and he now occupies the entire first floor. We wish him well as he forges ahead with new faces.



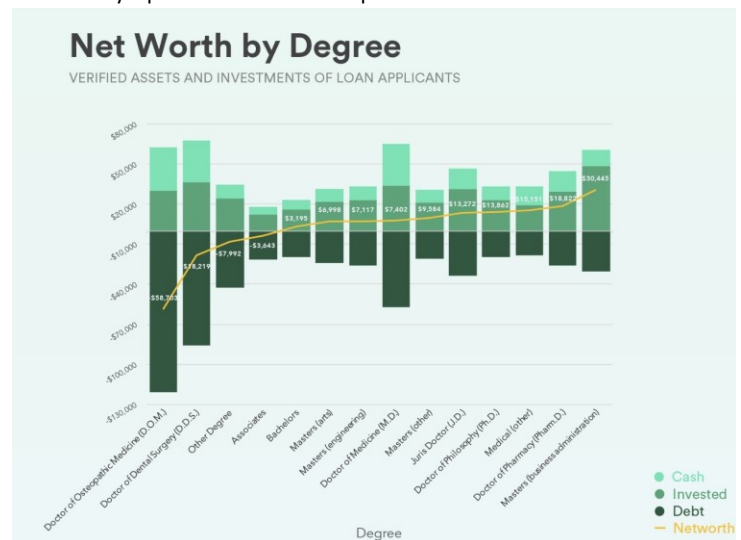
Open Position @ CFA

If you know anyone who is looking for a front office position please think about connecting us. The person we're looking for is someone who has great people skills, highly organized and detail orientated. They must be proficient with computers, Microsoft Office & CRM. We know there are plenty of great people locally who are looking for a job and it's just a matter of making the fit. We're looking for another person with high moral character to join our team!

Debt Debacle

We've been talking for a long time about the cost of higher education and it's clearly broken. Depending on what your child is pursuing it may or may not make sense to pursue a degree at a "high price" institution. Many jobs today are going unfilled as people don't look to the trades for jobs anymore. There is a lot of growth in jobs for people who are mechanically inclined and can do things like carpentry, electrical, hvac, masonry, etc. These jobs are often far better than desk jobs for those with many degrees if you have the talents and ambition to make them work.

If you're set on the college track that's great too, but an interested study has been done by Upfina.com has come up with the chart below.



This tracks the net worth by degree of many jobs and sees just how the students are making out after graduation. I'm blown away at how many high end jobs are not doing well because of the overall cost of getting the education. We're noting that if you get out of school with 150k in debt and do not have a pretty high end job to live life as well as knock out that debt it's a disaster in the making. The MBA folks seem to do best followed by the pharmacists and the philosophers. Attorneys of course do well they write the system for their benefit. The people struggling are the Osteopaths, the dentists and "other degrees". Think this through very carefully with your kids and grankids prior to embarking on the journey. 😊

Inspirational Quotes

- It's how you deal with failure that determines how you achieve success, David Feherty
- To climb steep hills requires slow pace at first, Shakespeare
- A candle loses nothing by lighting another candle, Erin Majors
- Our attitude towards others determines their attitude towards us, Earl Nightingale
- Nothing is a waste of time if you use the experience wisely, Auguste Rodin
- Great minds have purposes; others have wishes, Washington Irving
- All glory comes from daring to begin, William Shakespeare



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

Pay for it now or pay for it later. I just recently had a great conversation with a brilliant individual and the outcome of that discussion sparked this article. We talked about how society isn't behaving as it once has and commiserating on some issues people we both know are having with teenage or adult children.

The conclusion of this conversation was that with our kids we're going to pay now or pay later. The paying now would be with our time and energy and wisdom to give them the tools they need to become the best possible versions of themselves as possible. If we do that chances are they'll do well in life, have success and not be a burden on the family or society later on. In fact they may go on to do very well for themselves and help society greatly in the process.

On the flipside if we don't spend the time with the kids when they're young and formative we may find the opposite scenario. Maybe we'll have to pay top dollar for their education because they didn't do as well in school as they're capable of doing. Maybe we'll have to pay to help them in life financially if they cannot get their acts together and we enabled a peaceful easy childhood. Maybe they'll get into some trouble with the law and we'll need to help them out of that trouble if they indeed get into it. Maybe addiction will grip them and they'll struggle with it for a period of time. Anything can happen and even if we do the best job possible there is no guarantee of a great outcome. The concept of pay now with time or later with time and money with our kids and grandkids just hit me and it made a ton of sense. This is one of those things we want to pay forward so everyone benefits from it! ☺

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!

Name _____ Email _____

Address _____

City _____ State _____ Zip Code _____

Name _____ Email _____

Address _____

City _____ State _____ Zip Code _____

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