LEAKY BATHTUB

Much of the stock market gains over the past several years were due to easy money (quantitative easing) and extremely low interest rates. Some observers noted that it was like filling up a bathtub. The Fed bought debt and investors were forced to move out on the risk curve to invest the new cash they now had. That process is reversing itself and is starting to have global repercussions.

10 yr UST rates

We looked at the 10 yr UST rates earlier this year and noted that it broke out of a 24 year downtrend (the red line). The 10 yr UST ran into resistance at the highs from 2014 (the blue line). Last week the 10 yr UST broke through that resistance with authority. This added pressure to stocks which were down.

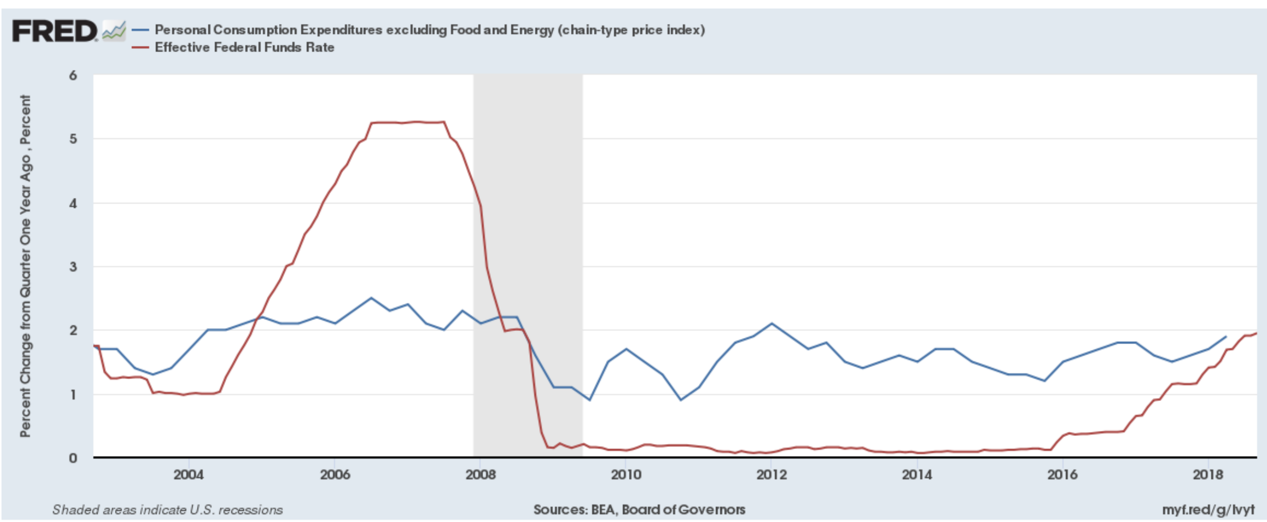
Interest rates are being driven by several factors including Quantitative Tightening (QT), rising Fed Funds rates, rising inflation, US fiscal deficits, foreign sales and expensive foreign hedging.

Quantitative Tightening

We have discussed Quantitative Tightening (QT) a few times now, where the Fed is reducing its huge balance sheet. It just increased its bond sales to $50 billion per month ($600 billion per year) in Q4. The money to pay for the purchases comes from the sale of other stocks and bonds, savings or foreign investment. This means that 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.

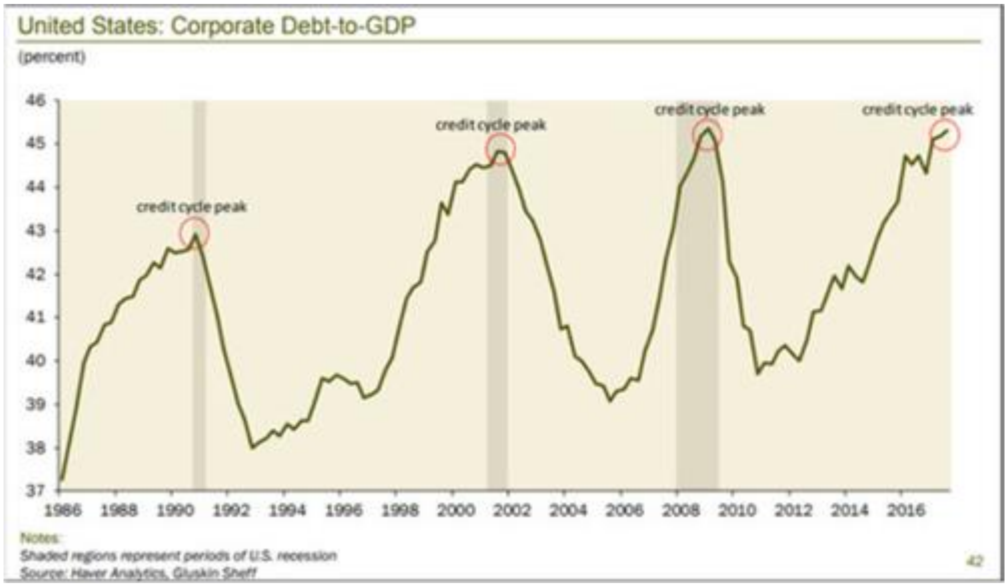
Fed Funds and inflation

The Fed has been raising short term rates since 2016. Almost two years later, Fed Funds have gone from nearly 0% to 2.25%. While this may not seem like much, the 0% rate was held for nearly seven years. Many projects and investments made sense when debt was "free," especially when inflation was running at 1-2% above that rate. The Fed was very accommodating for those 7 years. Significant debt was taken on. The Fed has been taking off its accommodation and is closer to neutral now.



From 2009 to Q2 2018, US non-financial corporate debt grew from $6.2 trillion to $9.4 trillion. At 0% interest rates, the debt is easy to carry. At even 2.25%, the interest cost is over $210 billion in additional interest per year. This eats away at earnings growth.

Corporate debt-to-GDP is now at past credit cycle peak levels. Alarmingly, this usually occurs at recession troughs when corporate borrowers draw down on bank and other credit lines. We are not in a recession and we have already reached those levels. While interest rates are still at low levels, as they increase, they are affecting a larger pile of debt and have a larger impact on income statements.



Fiscal deficits

We 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 tax cut bill and budget last year.

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?

Foreign sales

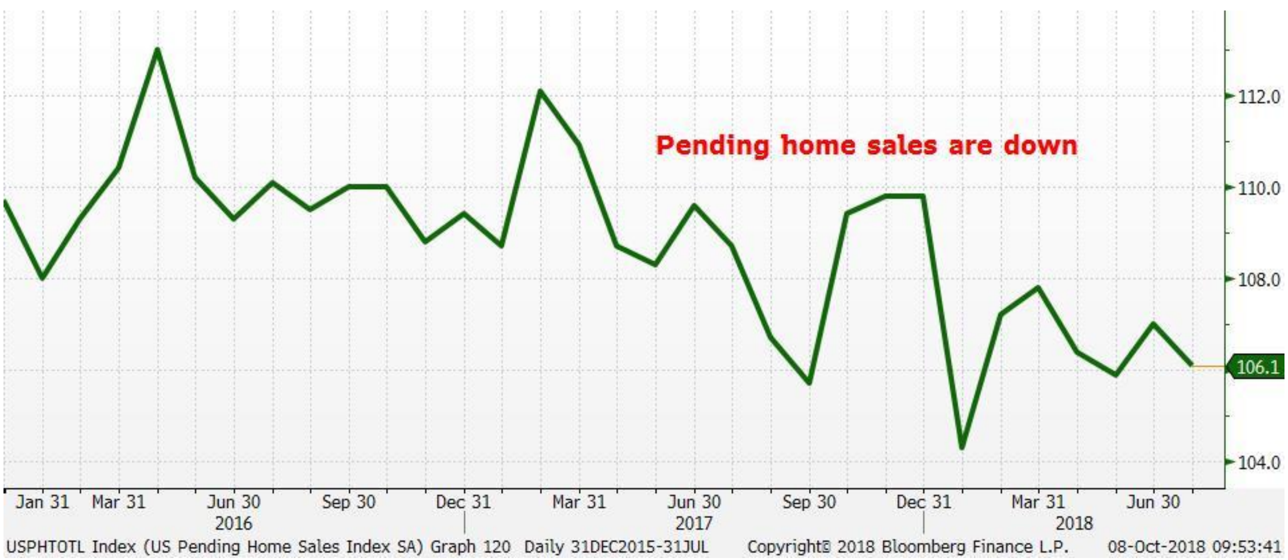
Foreign buyers may have limited appetite for US debt. Japan and China both own over $1 trillion in USTs. Outside of the Federal government and the Fed they are the largest owners of USTs. Both have been sellers ($100 billion plus) over the past few years. Russia sold around $80 billion this year.

Over the past few years, our UST yields looked attractive compared to negative yields in parts of Europe. While German 10 yr Bunds currently yield about 0.50%, currency hedging costs are now more that the spread to UST 10 yr at 3.22%. Europeans have been priced out of the market. Bill Gross, of past PIMCO fame, noted that “lack of foreign buying” probably leads to lower UST prices.

Bloomberg, in $ billions

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.

Pending homes sales have been falling since interest rates have risen. The perennially strong New York City market is seeing prices soften.

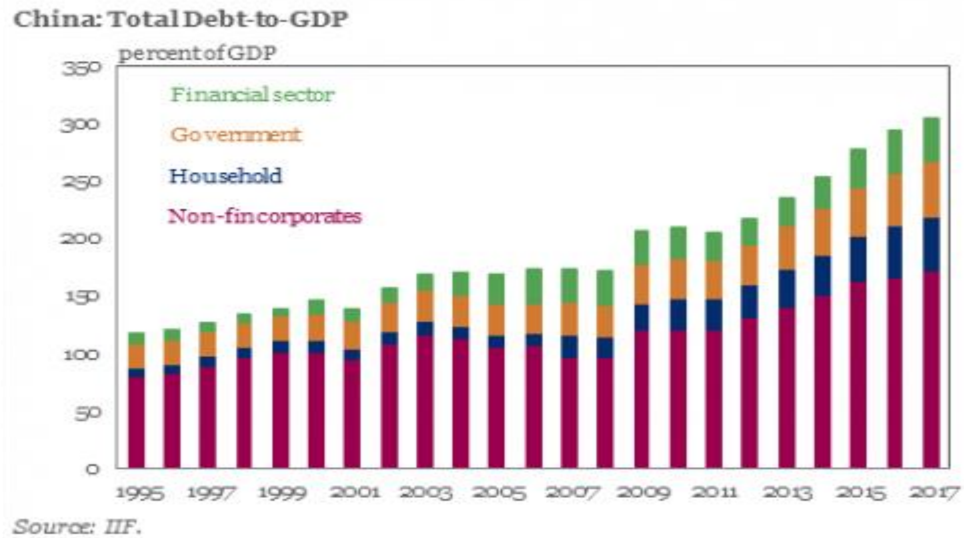


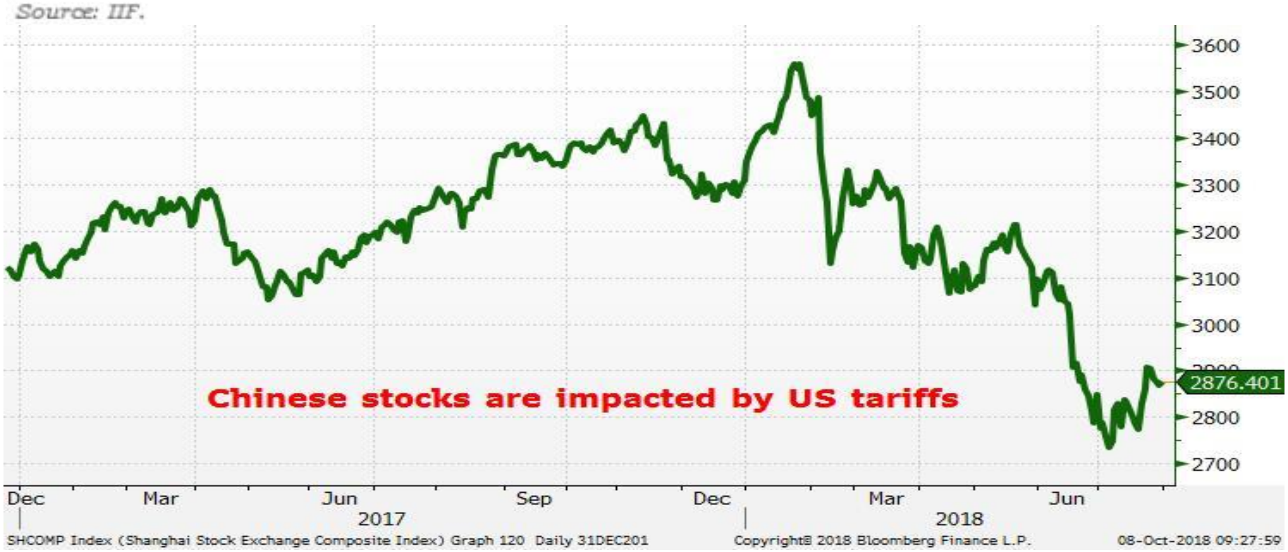
China Tariffs

China and the US have continued trading new tariffs. 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.

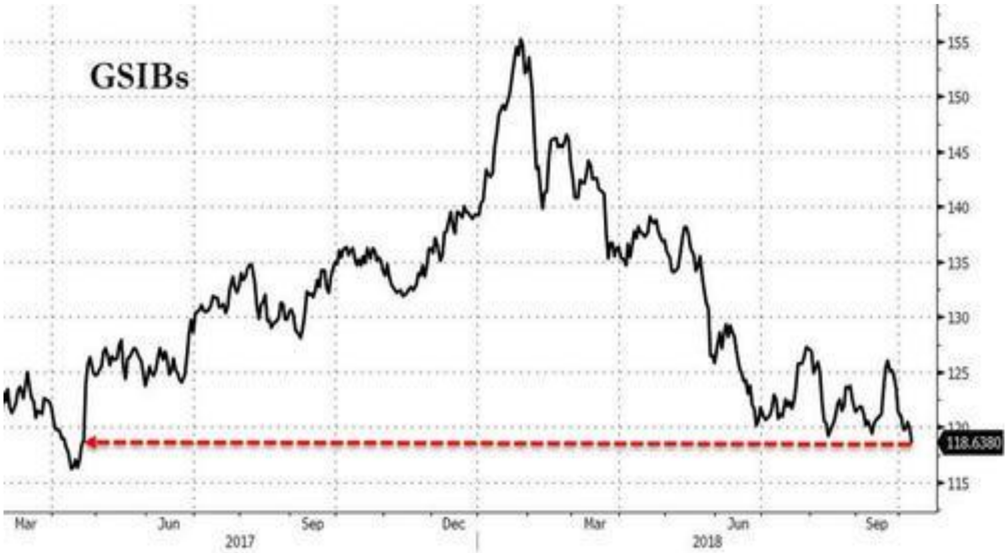
Chinese companies use a lot of leverage which multiplies the impact from even small losses of revenue. This can be seen in the stock prices of large Chinese stocks.





Global Banks

Global bank stocks have been roughed up. The largest banks are denominated as Global Systemically Important Banks, which as the name implies, can have significant impact on the global economy and financial system. The index of GSIBs has set new lows this year and are down over 20% from its highs.



FUND INFORMATION

The fund's largest equity positions as of 9/30/18 were Pfizer, Allstate and US Bancorp.

Pfizer is known for its high profile brands including Lyrica, Lipitor and Viagra. The company is reorganizing into three business categories: 1) science-based Innovative Medicines, 2) off-patent branded/generic Established Medicines, and 3) Consumer Healthcare. The Consumer Healthcare segment could be spun-off. Pfizer has faced revenue uncertainties over the years with some brands coming off patent. Those expirations are slowing, as are the revenue uncertainties. Pfizer expects to see a return to revenue growth in its Established Medicines in 2019. Key growth products are Prevnar, Ibrance and Xtandi. Pfizer also has a strong oncology pipeline which could boost upside.

Catastrophe losses at insurers, including **Allstate**, have been above consensus expectation this year. While cat losses lead to short term pain, it also usually leads to price increases which lead to long term gain. Last year, Allstate focused on improving its margins. This year it has been focused on keeping margins strong and growing policies in its personal auto and homeowners insurance businesses. The company has benefitted from home and auto price increases as that increases the policy and premium amounts.

US Bancorp is one of the higher quality banks in the country. During the financial crisis customers moved to US Bancorp in a flight to quality. The bank continues to grow its earning assets in a profitable but safe manner. It has focused on driving higher fee income through corporate payments and commercial products. It also tightly manages expenses to drive positive operating leverage.

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.