July 14, 2017

Home Ownership Rises

Dear Investor:

The Fed stayed on track this quarter by raising rates in June. This was widely expected by the market, and there was no significant reaction. We know that the Fed is watching all aspects of the economy, but inflation is playing a very big role right now. For the Fed to continue raising rates and begin reducing their balance sheet, they have to feel reasonably certain that inflation will continue to stay in a range where it will be close to their 2% intermediate target. In May of this year, wholesale inflation was at 2.4%. A year earlier, it had been at zero. The consumer price index (CPI), was well over 2% for several months earlier this year. It has recently slowed to just under 2% primarily due to the drop in energy prices. The Fed is keeping a very close eye on this, as it will help show them if the economy is handling the tightening moves. If it was to slow drastically, which I think is very unlikely, the Fed would have to put their plans on hold.

The winding down of the Fed balance sheet is a very important step on the path to restoring equilibrium to our financial system. I'm sure you remember well all the dollars the Fed created out of thin air to buy enormous amounts of government bonds and mortgages. This was done to offset the effects of the deflationary credit collapse we faced in the recent crisis. They have held on to all this paper and have been reinvesting the interest and rolling over the bonds when they mature. Detailed plans have been developed to start reversing this process. They intend to use a tapering strategy that will gradually diminish the percentage of the interest being reinvested. Perhaps in a year or so there will be no reinvestment of interest. The next step will be to use the same taper type strategy to reduce the bond holdings in a gradual way. The total process could take several years if everything goes well and the economy continues to hum along. This will have a tightening effect and will put some upward pressure on rates. It also provides insurance against another time in the future when such drastic measures may be used again.

The labor market has continued to improve very nicely. It is much stronger in every regard. New jobs have been averaging over 170,000 a month for the first half of this year. Unemployment is currently around 4.4%, and more people have continued to enter the work force. The U6 rate is also dropping which tracks underemployed workers who either want full time work or a better job more suitable to their skills. Wage inflation has still been modest, but some economists are saying this will increase as the labor market tightens further.

The housing market has continued to do very well. Marketwatch.com ran an article recently discussing the upturn in the home ownership rate. It appears to have bottomed and is now moving up toward healthier levels. New owner occupied households passed the number of new renter occupied households for the first time in over ten years. This is another sign that the economy is healthier and things are returning to normal. Many of the reasons that renter occupied households surged in the last

decade were a direct result of the credit collapse and high unemployment. New home sales are booming and are up over 15% from last year. They are currently running at an annual rate of around 600,000 units. Existing home sales are also very strong and property is selling very fast. People I know in real estate have told me that even in Syracuse, NY, houses often sell in one day and it's not unusual to hear of bidding wars for the same property. As good as all this sounds, it's actually creating a few problems along the way that could become serious. The strong demand and low supply of homes for sale is causing prices to rise at a stiff rate. They have been going up at annual rates of over 5% for many months now. This has a lot of economists concerned because obviously if the trend keeps up, housing affordability will decline and everything could slow back down again. The hoped for outcome is a suitable increase in supply that will slow down the price increases to a more sustainable level. This is definitely something we need to keep an eye on.

We have also been seeing very high readings on consumer sentiment this year, with a distinctive partisan flavor. Notably, expectations among Democrats have been much lower than expectations among Republicans. Mr. Richard Curtin, the director of the widely followed University of Michigan Index of Consumer Sentiment, has written of this sharp divide every month this year. He states that many Democrats believe that a deep depression is imminent, and many Republicans expect a new era of robust growth. These views are based on survey questions on future expectations. The sub index that measures current conditions show almost no differences as respondents said their own finances were good. I generally refrain from political comments as that's not the purpose of my letter, but I do hope the Democrats are wrong on this, as I would not be interested in a deep depression or even a small one after the credit collapse we just survived. The Index is relevant as consumer spending is 70% of our economy and when consumer sentiment fades, it can lead to people closing their wallets.

The stock market has continued to rise with the SP 500 up over 3% in the second quarter. The technology sector has been the top performer year to date rising over 17%. Based on the decent economy and the very strong earnings in the first quarter, expectations are for more of the same. The dollar has declined this year which should help the earnings of our big multinational corporations. While it is certainly true that the market is uncomfortably high by some measures, I hear almost no one predicting a recession anytime soon. There is no definite length to a bull market. Each market cycle is different and has its own characteristics. Stock prices are driven by earnings more than anything else and if companies can keep making steady profits, the market can continue to rise until the earnings growth stops. A lot of this will depend on how skillful the Fed is at balancing interest rates and inflation. International markets and emerging markets have also been doing well as there appears to be some improvement in the overseas economies. This backdrop of additional growth worldwide should help all of us to do better.

I hope your family is well and enjoying the summer. Please feel free to contact me anytime to discuss your portfolio.

Best Regards,

David E. Keim

Lyndon Office Park|7000 East Genesee St. Bldg D| Fayetteville, NY 13066-1139
315-701-5750|Fax 315-701-5751|dkeim@keimassetmanagement.com
www.keimassetmanagement.com
Securities and Advisory services offered through Commonwealth Financial Network, Member FINRA/SIPC, a Registered Investment Adviser.