April 9, 2018

No End in Sight

Dear Investor:

I brought up the issue of market corrections in my last two letters. This was meant to be a reminder that markets always go both ways, and we should expect periods when things will pull back. The extremely low volatility in 2017 was very unusual. The largest pullback we experienced during the year was in the range of 3% - 4%. This is one of the smallest price adjustments of any year on record from what I've read. As I discussed specifically in my letter of Oct 2017, this leads to complacency, and that was a word you heard frequently last year. Volatility is the normal way of the market, and it's what we have to live with as investors. It re-emerged in early February of this year as the market quickly dropped around 9% in a couple of weeks. There were several reasons for this. One was the very fast rise in interest rates in the beginning of the year. People were worried that perhaps wage inflation and general inflation in the economy were about to accelerate. This would then lead to faster rate increases by the Fed, which is a headwind for stock prices. Another is that stock prices were very high, uncomfortably high, after the big run up in January. Other reasons were technical in nature having to do with some of the products that have been created to bet against volatility. So, the recent correction was both sharp and short. Since then, things have bounced back, but we are struggling again as the issues surrounding the tariffs and trade are creating a lot of uncertainty.

Our economy is doing very well right now, but there are always things to be concerned about. At this moment, there are some changes in the consumer debt picture. Credit growth has slowed notably the last few months. While some of this may be seasonal with people paying off their Christmas bills, the Fed survey of banks senior loan officers shows that many banks have been tightening their credit terms for consumers for the last year. This is in response to rising delinquencies on both credit cards and auto loans. I'm glad the banks are responding as we don't want a repeat of 2008 where they were too lax. The savings rate has also gone up the last two months, so it looks like people are pulling back a bit right now. I view that as a good thing over the longer run. Another issue is the housing market. Housing starts had their best year since 2007, and existing homes are selling like hotcakes with bidding wars a common occurrence. The problem is price. The Case-Shiller 20 City Home Price Index has been rising at an average rate of 7% for the last 6 years. Since this is much faster than wages or inflation, you have to wonder when this is going to become a problem, particularly for first time buyers. Consumer confidence is the highest since Bill Clinton was President. My personal opinion, it's likely a tax cut sugar high and I expect it to moderate going forward from here.

One of my biggest concerns for the long term is the ever expanding budget deficit. There is **no end in sight**. We can see from recent legislation that our leaders from both parties are willing to borrow and spend money that we don't have in truly astonishing quantities. We are now looking at trillion dollar deficits as far as the eye can see. While this may produce a wealth effect in the short term, I believe it will produce a "poverty effect" in the long run. Borrowing ever greater and truly huge

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amounts of money to sustain our current lifestyle is very unwise. In future years it will result in lower productivity and lower lifestyles for all but the very rich at the top of the food chain. I believe this will lead to even greater income inequality than we have now. For the last couple of centuries, the American capitalist system has produced one of the most prosperous and abundant economies the world has ever seen. Certainly the system is far from perfect and has many flaws, but overall, we have had a very high standard of living. You have to wonder if we are determined to strangle the goose that lays the golden eggs.

While I fully realize that unlike an individual or family household, we have no intention of ever repaying our debt, or even trying to repay it, there will still be enormous costs to service the interest and to keep rolling it over. The "money" for this has to come from somewhere. Some of it will come from increased taxes and lower benefits from our entitlement programs. Some of the value will be caused to "disappear" by inflation, and some of it will likely be absorbed by the Fed in years ahead through several different methods. All of this will ultimately lead to a loss of power and real wealth as there is no free lunch. You hear political rhetoric all the time about how we need to protect the economic future of our children and grandchildren, but we are failing. It looks like they will be inheriting a weak and hollowed out economy someday, loaded down with interest payments and with very little strength to expand. If this sounds far-fetched, all you have to do is take a good look at how Japan has done the last 25 years. Their GDP growth rate has averaged 0.50% from 1980 – 2017. They are drowning in debt and it has not produced wealth, it has produced stagnation and a malaise where there is very limited opportunity to get ahead.

Going forward for the remainder of this year, I would expect that increased volatility will remain with us. As already discussed, the very calm waters of 2017 were highly unusual. There is a lot going on now in the political arena, and while I am optimistic on the trade situation, it could escalate and get out of control. To end on a positive note, if nothing major goes wrong, there is no reason not to expect companies to have very good earnings this year. Many companies are paying much lower taxes. Some of the big players have brought money back from overseas and will be putting it to work in various ways, including dividends and stock buybacks. The employment picture is very strong and looks like it will stay that way. The Fed has been very public that rate increases will remain on a modest uphill trajectory, if possible. With all that going for us, there's plenty of reason for some optimism. Please contact me anytime to discuss your portfolio.

Best Regards,

David E. Keim

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