October 13, 2017

Quantitative Tightening (QT)

Dear Investor:

The economy is continuing to move forward on a reasonably steady basis and may be showing some small signs of acceleration. The GDP growth rate came in at 3.1% in the second quarter which was good news. Federal Reserve forecasts for the third quarter are between 1.5% and 2.5%, a somewhat slower pace. Right now it looks like we may come in at over 2% growth this year, which is well above last year's final number of 1.6%.

A few details, retail sales have been steady at a moderate pace. They are currently up about 3% from last year. Some retailers are optimistic about the coming holiday season, expecting very good numbers. Auto sales are showing some signs of saturation. I've mentioned this before. There's a definite slowdown in sales of cars and trucks. It seems that the extra demand from the great recession has been filled. Unfortunately for many people down south, we know there are a lot of vehicles that need to be replaced as a result of the recent strong hurricanes. This may bring the numbers up for a few months. Consumer Confidence and Consumer Sentiment, which are two different indexes that survey consumer attitudes, are both at very high points. While they don't measure spending, the relationship is obvious. When people are optimistic about the future and feel pretty good about things, they aren't afraid to spend their money. Consumer credit has been expanding every month, but appears to be under control right now. I am concerned that the savings rate has dropped off and is now around 3.6%. Five years ago when the fear level was much higher, the savings rate was 7.6%. Lower savings rates have been shown to lead to slower growth in the future. Unemployment just hit 4.2%, which is the lowest since December of 2000. The recent storms will likely affect that number next month.

Probably the biggest thing on most investors' minds is the possibility of a correction. I want to remind us all that there are basically two emotions that drive investors – desire for gain and fear of loss. These two powerful forces are always in play. Due to our fear of loss, we need to be reminded that corrections, which are generally defined as pullbacks up to 10% of value, happen all the time. By all the time, I mean specifically that they are a frequent and normal part of investing. We cannot predict in any reliable way what may start one of these periods of correction. The last significant correction occurred in the first six weeks of 2016. We talked about it at the time. The market took a pounding for six weeks straight. When the dust settled, buyers moved in and by the end of March, prices were higher than before. That is not to say that prices will always recover that fast. Some studies I've read state that a more typical recovery period is around five months. I think the more relevant point right now is that it's been a long time since we had a pullback. This leads to complacency. If you listen to financial news, you hear this term mentioned frequently. It refers to the idea that the longer we go on with a rising market, we tend to relax and get comfortable. We get the false impression that the market is just going to keep

rising, and there will be no periods of loss. Clearly, that will not be the case. At some point, it might be a week, a month, or a year from now, people will find reasons to cash in some of their profits. This will lead others to do the same, and we will be in a downturn. We need to stay on top of our fear and realize things will still work out fine for long term investors who own quality companies.

Many of the smartest people in this business have a major concern right now, and that is the current strategy of the Federal Reserve. As you likely know, the Fed has begun their program to shrink their balance sheet, as expected. This has been called quantitative tightening, as it's the opposite of the quantitative easing we had for several years. I'm very much in favor of this as I've stated in the past, and I think most conservative people are. The history of money clearly demonstrates that it cannot be created out of thin air forever. In fact, I would go so far as to say it should not be created from thin air at all, but this is the world we live in today. When money ceases to be a store of value, it becomes worthless, and that creates enormous problems. The concern these people have is that shrinking the balance sheet and raising interest rates at the same time is an incredibly risky and perhaps dangerous course. If the overall effect of this is too much tightening, they could choke off the forward momentum in the economy. This could lead to numerous bad scenarios. We simply cannot afford to go backwards. The system is fragile due to our high levels of debt. We don't have large buffers that can absorb mistakes in policy. Many are questioning the wisdom of additional interest rate increases when the PCE inflation gauge that is preferred by the Fed is only up 1.4% in the last 12 months. This is a problem, and the recent release of Fed minutes shows that some of the governors are concerned by this. Many Fed officials believe that inflation will move higher in the near future based on the low unemployment rate and improving global economy. Others think it is smarter to wait until it is a little more certain and can be seen in the numbers.

There is additional uncertainty coming from the battle over tax reform. This is just getting underway and there's no way to know how it will turn out at this point. There could be big changes or what the administration ends up with could be small adjustments to the current tax code. I would personally like to see something that will actually help the middle class. Another related concern is the appointment of a new Fed chair person. Until we know who gets the job, it's difficult to assess the possible changes in policy and where that might lead us.

As always, contact me anytime to discuss your portfolio.

Best Regards,

David E. Keim

DEK/jg

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.