October 12, 2016

SLOW GROWTH

Dear Investor:

It's been a fairly quiet quarter without any big events that stand out. The economy has been moving along at a slow but steady pace. The coverage of the election and the travails of the candidates have been the top story line, as you would expect with a Presidential race heading to the finish line. There were unexpected stories concerning the serious corporate missteps of Wells Fargo's sales practices and Mylan with their Epi Pen pricing. It's interesting that in a moment of time Mylan could authorize and offer a generic version that costs 50% less. Kind of makes you wonder…

Second quarter GDP came in at a 1.4% rate of growth. This was well below expectations that were around 1.8% or higher. This makes two slow quarters in a row, as the final print for the first quarter was 1.1%. Consumer spending has been the strong point. Many more people are working and wages are slowly rising. The number of job openings reached over 5.4 million in August, down from an all-time high in July of 5.8 million. Jobless claims for new unemployment benefits have continued at absolute rock bottom lows. There has been a reasonable amount of business investment outside of energy and mining, but it's still soft. It will take a strong second half to reach last year's real growth of 2.6%. It doesn't seem very likely to happen. We will probably have another year with under 2% annual growth.

This slow growth is a definite concern. In the six years since the Great Recession, we have averaged just over a 2.1% annual real rate of growth. This is slow by historical standards. The last time the US economy grew over 3% was in 2005. There are many headwinds facing us, and it's far from certain that we can push past them to a higher growth rate. A higher growth rate could help us with our deficit and allow the Fed to bring interest rates into a more normal range. This would provide a cushion against our next downturn, which is inevitable.

The Fed also dominated the news, as they always do. At one point in the quarter, there was a strong feeling that they would raise rates again at their September meeting. Things seemed to be moving in that direction, but it fizzled as usual. However, things were different this time as three Fed governors dissented, meaning they wanted to raise now. They are Boston Fed President Eric Rosengren, Kansas City Fed President Esther George, and Cleveland Fed President Loretta Mester. While they have slightly different views on the matter, they all believe that the benefits of waiting no longer outweigh the risks.

David Rosenberg, the highly respected economist at Gluskin Sheff & Associates, Inc. says "There's a growing sense that central banks have hit the wall." What he means by that is continued super low interest rates may have little further ability to stimulate economic activity. There is no free lunch, and these low rates have risks. One of those risks is to our insurance companies and pension plans. I've talked about this with some of you at our meetings. Insurance companies and pension plans have made a lot of promises to a lot of people. To keep those promises, they have to be able to make a decent return on relatively safe investments. When the interest rate on ten year US Government bonds is well under 2% that becomes very hard to do. Insurance companies and pension plans are an important part of our basic financial infrastructure. Think of how many people you know that receive pension checks, just as an example.

Another risk that you hear about all the time is the creation of asset bubbles. This basically refers to a situation where the price of investment assets escalates above their realistic true value. At some point in time, these high values collapse, and we have a severe correction or a crash. The third significant risk is inflation. While inflation is low right now, there is a chance of it picking up and gaining traction as wages and spending increase. If this acceleration happens, the Fed may then have to raise rates more quickly. This has usually resulted in a recession, and is one of the major concerns of the Fed governors who voted to raise in September. They believe that raising now provides some insurance against this scenario.

Janet Yellen has strongly signaled a rate increase before the end of the year. The market is looking past the November Fed meeting due to the election, so there is momentum building once again for a rate increase this December. It will depend on the data that comes out the next few months. If there are no significant negative surprises, I do think we will have another small increase. I consider this good news. As the market is always looking ahead, we may have a modest correction in value between now and the end of the year. This may be uncomfortable in the short term, but it increases the odds of the bull market continuing to advance.

The election will be behind us soon, and we should have a better picture of what policies the new President will pursue. Perhaps this will help the market, as one of the major headwinds we face now will be removed.

Please feel free to contact me anytime to discuss your portfolio.

Best Regards,

David

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