January 9, 2019

Wild Ride

Dear Investor:

There's certainly been a lot of action since my last letter in October of 2018. We have been on a wild ride for sure, with the market moving up or down hundreds of points on many days. A much needed correction has finally come. I've talked about this in several of my recent letters to remind all of our good clients that corrections are a normal part of investing and should be expected. So, let's take a look at what happened this quarter.

While we didn't know it at the time, the Sept 20, 2018 price of 2930 turned out to be the all-time high for the SP500 and the high point of this current bull market thus far. On October 3rd, a comment by Fed chair Powell to an interview question with Judy Woodruff of PBS, set the stage for almost everything that has happened the last three months. At that time he stated that the economy no longer needs the extremely accommodative policies that pulled us out of the financial crisis. So far, so good, as I really do think everyone knows that by now. He then went on to say, "Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral." "We may go past neutral, but we're **a long way** from neutral at this point, probably." This may seem like a small thing, but it was huge to the market. The market did not like the term **long way** at all, and the simple interpretation was that the Fed possibly planned to raise rates much more than the market was currently expecting. This is a big deal and worries that the Fed was leading us into a recession began to dominate the market. The market dropped close to 7% in October and erased most of the gains for 2018. Some high flying tech stocks lost over 20% to 30%.

As we moved into November, things pretty much wobbled back and forth for most of the month. Besides Powell's comment, there were a lot of ongoing concerns about the trade war. This has been a drag all year and pessimism about progress on that front was also weighing things down. There was also a growing realization coming into the market that growth may be slowing. Not just overseas, but also in the US. In that context, the Fed's outlook for four rate increases in 2019 looked very much out of touch with reality. There was a lot of negative feeling in the market and by Thanksgiving, we had dropped even further. In the background were tweets by President Trump about how terrible Jay Powell was, and how he would like to fire him. This is not by any means the first time that a President has criticized the Fed Chair or tried to pressure that person into doing what they prefer. Several articles appeared with examples of this happening in past administrations in varying degrees. For the record, I personally think Mr. Powell is doing a good job with the hand he has been dealt. He is continuing to gradually bring us back from the brink of financial ruin. As I am fond of saying, "There is no Free Lunch".

After Thanksgiving, with gloom overhanging the markets, Mr. Powell gave a speech to the Economic Club of New York. In that speech he walked back his comment from October 3rd and stated that the current rates were “Just Below Neutral”. He also stated that the Fed was not on a preset policy and was not planning to just blindly push on with their previously announced rate increases regardless of the outlook. He stressed they would depend on incoming data. This is what the market was waiting to hear and it shot up around 2.5% and back into the black for the year.

As we moved into December things began to weaken again. As people further digested Powell’s comments, they realized they were better, but not really that different. Also, the idea that the world economies were slowing was gaining substantial traction and now seemed to be the base case scenario. For most of the year and even earlier in Q4, the odds of another rate increase in December had been a foregone conclusion and were over 90%. The outlook had changed dramatically and many were now questioning if there should be an increase in December at all. When the Fed announced on December 19th that they would proceed with a quarter point increase and foresaw two more hikes in 2019 (down from four originally), the market started dropping again and continued to sell off hitting a real low point on Christmas Eve. At that time we were well into correction territory of a 10% drop from the high in September and touching the 20% definition of a bear market in some sectors. The bottom line is the market finished with a loss for 2018.

Are things really that bad? The Fed’s current forecast for 2019 is 2.3% GDP growth, unemployment dropping a little further to 3.5%, and inflation remaining in the range of 2%. That’s not a recession. We’ve arrived at the bottom end of the range of neutral rates. We may already be at the neutral rate. They plan to be very patient going forward, making only gradual changes based on the incoming data. This all makes sense to me. I believe the Fed is well aware of the economic conditions and is currently on the right path. I think we have many reasons for a positive outlook on 2019.

Perhaps you’ve seen the show “Deadliest Catch” on TV. On the show, these huge fishing boats with captain and crew go out into dangerous waters to fish for crab that they can sell at a handsome profit. This is very hard and risky work and is obviously not for the faint of heart. As they are often out for weeks at a time, they encounter all kinds of weather. When storms come up it’s not unusual for waves to surge up to 30 feet or more. There are also hurricane force winds to deal with. The captains have to continually maneuver their boats to head into the waves so they don’t get hit broadside and capsize. In fact, one boat and crew were recently lost at sea in a bad storm. But, the rewards can be quite substantial when they finally come back in with boats full of crabs. So what’s my point? The last three months may have felt like being on one of those boats. We have surely faced strong winds and waves. It’s been very volatile, somewhat dangerous, and a bit scary for all of us. Right now it looks like the storm may be over and things are settling down again. If the economy grows at the forecast 2.3% this year, I think things will turn out alright as stock prices have come way down and haven’t been this good for several years.

Best Regards,

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