April 1, 2017

Greetings,

The market has essentially gone sideways over the past 6 weeks. Considering the torrid start that the market has had this year the recent sideways move is not a surprise. There was a smidge of a pull back over the last couple of weeks. That was not a surprise, although I expected more. While the year is still young, so far, nothing is turning out as expected. Not with the stock market, the bond market and the politicians who are attempting in vein to govern this country. Just three months into the year, the broad market has a return pretty close to what the talking heads guessed the market would return for the entire year. Can you now see why it is an exercise in futility to even attempt to predict short term market returns? With the anticipation of President Trump's bold pro-growth agenda, the bond market was finally supposed to crack. The Federal Reserve did raise short term interest rates two weeks ago and is expected to raise them two more times this year. However, the long term rates didn't budge other than for a few days as the 10 year Treasury bond has a historically low yield of 2.4%. Please keep in mind that at the market low (famously referred to as the "Haines bottom", Haines being the late CNBC host, Mark Haines who was my favorite person by far on CNBC) on March 9, 2009, the yield on the 10 year Treasury bond was 2.9%. Finally, speaking of cracks, the Presidents bold pro-growth agenda is now in jeopardy after the vote to repeal and (emphasis on "and") replace the Affordable Care Act (sometimes referred to as Obamacare) was defeated by members of the Presidents own party. Specifically, it was defeated by the Freedom Caucus, formerly known as the "Tea Party". I am not stating that tax reform, infrastructure spending and construction of "the wall" (which Mexico is supposed to pay for) are dead on arrival. I do believe that from the day after the election until the big vote to repeal and replace the ACA/Obamacare failed, the stock market has reacted as if everything the President wanted to enact was a sure thing. Now that reality is setting in, calmer heads are realizing that tax reform could happen, as opposed to will happen. Some people who thought that it was a sure thing are now just beginning to realize that passing comprehensive tax reform will be more complicated than the vote to repeal and replace the ACA/Obamacare.

Optimists are chirping now that the big vote on the health care package failed, the Republicans are more motivated than ever to pass tax reform. As I am typing this letter, someone on CNBC just commented on all the pressure there is for the Republicans to "step to the plate" to pass tax reform. As a big baseball fan for 45 years, I can assure you that just because there is pressure at the plate to get the game winning hit doesn't mean that the batter will come through. These Republicans can be motivated all they want, but if the Freedom Caucus doesn't join in (they have approximately 40 members, although 2 have recently defected) then tax reform most likely will not happen. For those who don't remember (it has been 31 years) how the big tax reform act of 1986 came about, President Reagan accomplished the task at hand with bi-partisan support. Realistically, that was (and in my view) and still is the best way to accomplish it. Then Senator Bill Bradley (D-New Jersey and my favorite Senator ever) was instrumental in writing that law along with the Speaker of the House of Representatives Tip O'Neil of Massachusetts. When Paul Ryan (the current Speaker of the House) stated that he wanted to think big and do something bold, he must have forgotten his history and that TRA 86 was a bi-partisan piece of legislation. He is most likely learning (the hard way) that it is extremely difficult to pass major legislation without a single vote from the other side. I also gather that President Trump is learning that draining the swamp (among the many campaign promises that he made) will be much more difficult than anticipated.

The fundamentals of the economy are modestly improving, at least in my view. The modest improvement in the economy does not justify the short term market returns. I should point out that since so many of our holdings didn't do well last year (as far as price appreciation) despite strong fundamentals and being reasonably priced, their short term returns are justified. The market is forward looking. The earliest that tax reform will occur is the early fall although that is looking like a real long shot. The more likely scenario if it does happen is late in the year. Even if tax reform does happen, the positive effects on the economy won't be realized until well into next year. I hate to be a wet blanket but I simply can't be comfortable with strong market returns now that are based on what politicians might do later on in the year. Even if pro-growth legislation occurs, in my view waiting 15-18 months to see positive results seems like a long time.

While I have a long term perspective, I feel compelled to hold a larger than normal cash balance until I either see a market pull back (or a correction) or an improvement in economic fundamentals. Earnings season is around the corner. If I see what I like as far as earnings as well as forward guidance, I will look forward to putting some of the cash to work. The worst case scenario by holding a larger than normal cash balance, is we make a little less money in the short term. That is assuming the market continues to go straight up.

If you have any questions or anything that you need to discuss, please either call or email me.