

January 1, 2017

Greetings,

So much has happened so quickly. The last thing that I want to be is a wet blanket and rain on anyone's parade. I like the expression "Don't shoot until you see the whites of their eyes". The market has been doing a lot of shooting lately. Many people forget that when the markets are both hot as well as cold, that company fundamentals ultimately are responsible for long term returns. Market sentiment is what moves the markets in the short term. This also applies to sectors and individual stocks. It is imperative to remember that market sentiment can turn on a dime. I haven't heard of a single CEO coming out and raise his or her earnings guidance post-election. If anything, there are some concerns about a potential trade war with China. I personally doubt that it will happen, but it could. Several CEOs of large industrial companies have expressed caution about 2017. The CEO of Caterpillar was one of these people, yet CAT's stock price has seen a huge run up post-election as its stock price was up 36% in 2016, which made it the best performer in the DOW. U.S. Steel is another example of the "animal spirits" that has recently taken hold of people. I am very familiar with this company since I owned it twice. I did very well with it the first time, not so great the second time. This company's stock price was up 314% last year even though operationally the company lost money. This in my opinion is the ultimate in speculation. Heck, I have speculated on stocks before, more than once and on occasion it has worked out well. More often than not, in my taxable accounts they turn out to be tax losses. As much as I would love to make 314% in one year, I won't do it by speculating with a company that has horrific fundamentals. I have made 350% on my personal Disney position over the past 15 years (that includes 2 bear markets) although Disney had a zero return last year and hurt my recent performance. This was despite the fact that Disney is consistently producing blockbuster movies and is printing money at its theme parks. When I see such a furious market rally being led by such low- quality stocks, some with terrible fundamentals, based on some legislation (as well as reducing and eliminating some regulations) that might happen, I find that a concern. Some of the talking heads have stated that the market may have taken some of 2017's gains from the end of 2016. Under the heading "Even a broken clock is right twice a day", while I detest making short term predictions, in this case I agree with the talking heads.

The recession in corporate earnings is over. Last quarter, earnings rose for the first time in six quarters. They didn't rise by that much, low single digits but something is better than nothing. With an economy that is supposed to improve this year, so will corporate profits. There is one potential problem and that is King Dollar. Pre-election, the dollar was strong relative to other currencies. Post-election, the dollar has been on an absolute tear. While this move should help the domestic economy by keeping inflation in check, it could hurt corporate profits because the prices of competing products abroad will be cheaper due to the local currency being cheaper. In addition, when products sold abroad are translated into more expensive dollars, the result is a decrease in revenue.

A year ago, I wrote in my investment letter that the bull market in bonds was over. The Federal Reserve increased short- term interest rates in December 2015 and indicated that four increases were

likely to happen in 2016. Well, not so fast. The FED only increased rates once last year as economic growth stalled (until recently, that is), the bond market rallied in the first half of 2016 as the yield on the 10- year Treasury bond fell to just 1.38% in July. At the last Fed meeting just 2 weeks ago, Janet Yellen indicated that three rate increases are likely this year. If the economy continues to improve and long-term rates continue to move higher, then I wouldn't be surprised to see three, perhaps even four short-term rate increases for this year. The 10- year Treasury yield is now up to 2.45%, up from just 1.8% at the time of the election, so it certainly appears that the bull market in bonds is now over. But then again, a year ago at this time it also looked like the bull market in bonds was over. I use the term appears because the bond market reacted in the month of November (the worst month for bonds in general in three years and for Municipal bonds in eight years) as if the President- elect will get just about all the legislation that he wants. Post-election, both the stock and bond markets are reacting as if some laws already in existence will be repealed. Realistically, that isn't the way that things work on Capitol Hill. With just a four vote majority in the Senate, the Republicans will need some bi-partisan support for the majority of new legislation and repeals of current legislation. I deliberately mention "repeals" because much of the animal spirits now are because of the chatter of repealing Obamacare, significant changes in the Dodd- Frank financial law as well as significant deregulation in many other areas such as the environment and labor laws. Not to be a wet blanket for those with these animal spirits but Obamacare barely passed with 60 (filibuster proof) Democrats in the Senate. If memory serves me right, Ted Kennedy did pass away shortly before the vote, with Ted Kennedy's replacement Paul Kirk voting yes. Even with a filibuster proof 60 votes, President Obama had to convince Senator Ben Nelson of Florida to cast a vote in favor of passage by promising to build a hospital in Florida, otherwise it still might not have passed. My point is (with now just a four vote majority in the Senate) that legislation could be more difficult to pass than both the stock and bond markets are realizing. While I expect bond yields over time to continue to rise, if the economy stalls next year and or legislation is slow to pass, the bond market could rally and the death of the bull market in bonds could be pushed back, as it was last year. Janet Yellen has also indicated she wants to be 100% certain that the economic progress is for real and sustainable before raising short- term rates multiple times. The last thing that she wants to do is to be partly responsible for halting the economic recovery. Her term as Fed chairwoman is up in January 2018. The next Fed President will almost certainly be more hawkish than she is. My guess is that Yellen would prefer to let her successor be the aggressive one as far as raising rates, as opposed to her.

Another reason for the rise in animal spirits (that term is used in the financial media often now) and much of the stock market enthusiasm is the prospects of tax cuts, both on the personal and corporate end. This is the opportunity for which Republicans have been anxiously waiting. While I practice accounting as little as possible now, I am still a CPA with 30+ years of experience so I can offer some intelligent observations on what could happen. I much prefer to wait on a more in- depth opinion (at least with this letter) until legislation is passed. If you want a more thorough view now, please either email or call me and I will gladly share some more detailed views with you. For now, I will state that I have read the highlights of the Trump and Ryan plans. From what I was able to gather, for the personal taxes, it appears to be more like tax reform than deep tax cuts. The Trump plan- which was already changed once, is short on details so it is difficult to evaluate until the final result is revealed and put up for a Congressional vote. For the past several years, I have viewed Paul Ryan on CNBC countless times talk about the importance of corporate tax reform. He is now the speaker of the House of Representatives and previously was the head of the influential Ways and Means Committee. At the

time, he was saying he wanted to eliminate the “loopholes” while lowering the tax rates so that it would be revenue- neutral. Not a bad idea on the surface. I believe his goal was a top tax rate of 20%. The ultimate goal was to simplify the tax code and to have our domestic companies more competitive globally as a result of a lower top tax rate. Now, there is no chatter about closing any loopholes. This is a concern of mine. For full disclosure, I haven’t read every word of the Ryan plan so maybe there is something there in the fine print about closing the loopholes. My point is that closing the loopholes in the tax code no longer seems to be a priority. There is some talk about the personal tax changes being revenue- neutral because the Ryan plan eliminates many personal deductions. One thing that almost certainly will happen is a one-time tax to repatriate the cash being held overseas. This should help the stock market going forward. Both sides of the aisle seem to agree on the need to repatriate the cash and the tax revenue will probably be used to fund new infrastructure spending which is also something that both sides seem to want.