

January 1, 2019

Greetings,

Happy New Year! This past month was the worst December for the market since 1931. If someone would have told me a year ago that in 2018 the economy would grow at a rate of 3% (the best in over 12 years), the unemployment rate would be the lowest in 50 years, there would be an expansion in the work force, steady solid job creation and earnings growth in excess of 20%, I would have anticipated great things from the market. Instead we had a difficult year with severe PE multiple contraction. PE multiple contraction means in plain English that company valuations collapsed, by 22% this past year to be precise. The market is now reasonably priced based on historical valuations, some might call it cheap. Our holdings certainly are. 2018 was a perfect example of why it is impossible to predict what stock prices will do over a one year period. They simply don't react in a logical manner over such a short period of time. The causes for the market downturn were the computerized selling based on algorithms, massive hedge fund redemptions (up 30-40% from a year ago) and the China trade tensions. The hedge funds also had to do much selling to meet the dreaded margin calls. The Presidents constant tweets urging the Federal Reserve to stop raising interest rates have also unsettled the markets. The headlines are worse than the reality. The reason being is that the economy is still strong, as are corporate profits.

Speaking of the Federal Reserve, there has been plenty of commotion about the FED lately. Anyone who is looking to blame the FED for the stock market's woes is barking up the wrong tree. Jerome Powell, the chairman of the FED is doing a fine job. Most, not everyone agrees with me. Those that don't in my view simply don't understand the purpose of the Federal Reserve. It is not the job of the FED to coddle the markets and set policy to support stock market prices. Its job is to keep inflation low and to maximize full employment. With the inflation rate just below the FED's target rate of 2% (1.9%) and the unemployment rate at 3.7%, a critic would have a difficult case to make that the FED is doing a bad job.

Another problem is the total misunderstanding (by the President among others) about FED policy. So many people have said "why not just keep rates where they are since there is no inflation"? Joe Kernan, a very smart host on CNBC's squawk box in the early morning just asked that same question on the air recently. The question surprised me coming from him. The answer is that with a strong economy at full employment, if the FED left rates alone, then there could be an inflation problem down the road. More importantly, the FED has to stay ahead of inflation because if they do wait until it occurs and then they raise rates (as the President would prefer), then you will have an inflationary spiral going out of control and then the FED will be too late. The President has been repeatedly calling on the FED to stop raising rates. Considering that he has said how much he knows about the markets, President Trump should know the ramifications of keeping rates too low in a strong economy. As a candidate, the President was critical of the FED for keeping rates too low for too long. Real interest rates (The Federal funds rate less inflation) is barely above zero so short term rates are still low. The yield on the 10 year Treasury bond is 2.69% so long term rates are also low. There is some concern that the FED is on auto pilot and will

continue to raise rates and over shoot, either slowing down the economy too much or causing a recession which has happened in the past. This is not a valid concern since the Fed has stated that it is not on auto pilot, is data dependent (unlike other Federal Reserve boards in the past) and has already said that they will slow things down this year as far as raising rates. Steve Liesmann also of CNBC (and a smart man) recently said “the stock market wants 4% GDP growth and zero interest rates”. He also said “You can’t have that” and I agree. President Nixon back in the early 1970’s ordered the head of the Federal Reserve not to raise rates and like an idiot, he listened. An inflationary spiral was the result which later led to short term rates in excess of 10% and 10% unemployment. That was called the misery index. Believe it or not, I remember those times and it was not pleasant. It took Paul Volker (remember him?) years in the early 1980’s to whip inflation. For those who want low interest rates in a strong economy, be careful what you ask for.

While Jerome Powell is arguably doing a fine job, I will state he is not doing an outstanding job. His predecessor, Janet Yellen did an outstanding job. The President decided despite the great job that she did to bring in his own man. Some people call that the CEO mentality. The problem with Powell are not his actions but his words and the way he comes across. Watching him in his press conferences is like watching the old character Sergeant Friday from the TV show Dragnet. Do you remember the phrase “Just the facts mam”? It shouldn’t be important to be judged so heavily on how you communicate but in this case, it is. He simply doesn’t communicate well with the financial media and the markets. There are times in which people feel that after Powell says something he almost wishes that he could take it back. His predecessor Janet Yellen had a calming almost soothing style about her that the markets adored. It also helped that Yellen made it clear that she was the markets best friend and while that seemed great at the time, in retrospect it could have been a mistake. Jerome Powell has made it clear that while he is aware of what is going on with the markets and he does care, it is time for the stock market to do well on its own without the Fed’s help. Let’s just say the stock market has given him a big thumbs down.

In my view the trade tensions with China have had much more of a negative effect on the markets than the Fed’s policy. The trade tensions simply aren’t talked about as much because the Fed is an easier target. I thought incorrectly that after President Trump and the Chinese leaders met at the big G20 meeting on December 1, that the markets would have a huge rally. That rally lasted a few hours. The President set a March 1 deadline for there to be an agreement, otherwise the Tariffs in place will go up plus there will be more Chinese imports subject to tariffs. This is a show me market. Even though there are negotiations taking place (supposedly going well) and both sides want a deal, the market doesn’t believe that a deal will be made by March 1. Part of the problem is that Robert Lighthizer (US trade representative) and Peter Navarro (his chief assistant) are leading the negotiations. They are both idealogs in regard to China. I have seen Navarro interviewed on CNBC numerous times and he looks at China as the Soviet Union was looked at during the cold war in the 1970’s and 80’s. He even wrote a book titled “China death by a thousand cuts”. These men don’t just want a trade deal, they want to change the way that China runs its economy and I don’t believe that is a realistic expectation. I acknowledge that China has done many bad things and is not practicing fair trade. That being the case, if you want to accomplish the task at hand, it makes more sense to have Steve Mnuchin (the Treasury Secretary) and Larry Kudlow (the President’s chief economy advisor) lead the negotiations. I have read that going forward Mnuchin will have more of a role. I believe that if this were just about trade, that

Mnuchin and Kudlow could cut a deal by March 1, or at worst have a framework for a deal which would calm the markets and prevent the President from increasing the Tariffs. With China's economy slowing significantly, I am sure that they are anxious to end this dispute and sign a deal.

For now, the economy is still looking strong although the rate of growth is slowing. Just over a year ago, the President predicted as a result of the tax cuts, economic growth would explode. The President expected growth rates of a minimum of 3% annually, more likely 4% or higher. This happened last year as growth came in at the low end at 3%. Growth rates going forward will not be anywhere near 4%, most likely growth won't even be at 3% for the coming year as economic forecasts are expected to be in the 2 to 2 ½% range. The reason being those trade tensions, the possibility of an escalation of the trade war and the tariffs. Anyway that you slice it or dice it, these tariffs have had an adverse effect on business. I have spent more time than usual the past few months listening to and reading the transcripts of the earnings conference calls. So many CEO's have been talking about the economic uncertainty being caused by the trade tensions and the tariffs. Fred Smith, the longtime CEO of Federal Express (and one of the best in the country) was especially appalled on the recent conference call at the trade tensions in addition to the political instability in this country and Europe. Mr. Smith was one of the big proponents (and beneficiaries) of the tax cuts. I have noticed that while reading earnings transcripts, there was virtually no talks about interest rates and the FED policy. With all the money that was being saved on taxes, corporate America was supposed to invest much of the savings into capital expenditures which would filter back into the economy, increasing the rate of growth. This has not happened, at least not to the degree that it was supposed to. Instead much of the tax savings has been spent on stock buybacks, which at this point in time has not been a wise decision. Some of the tax savings has been used to increase the company's cash.

You might be asking- "What would happen if a deal is made by March 1"? That would not only be a good question but also a heck of an accomplishment. Given how beaten up the stock market is, at best there could be a market "melt up", at worst a huge market rally. Someone on CNBC did say back in September that the S&P 500 would rally by 10% if a deal was cut. I disagreed at the time since the market was at record levels. At these levels (assuming a flat market until March 1) I can easily see a 10-15% market move over a matter of months. Just a guess, not a prediction. As far as the economy, I just don't see the same type of reaction. One of the reasons is that the stock market so far has been more adversely affected than the economy by these trade tensions. I can see an improvement, the degree depending on how good the deal is. The better the deal, the more the economy should benefit. With the global economy slowing significantly as well as the lack of trust and confidence in the dysfunctional government by corporate America, I just don't expect the "boom" that the administration and their supporters see.

Please by all means either send me an email or call me if you have anything that you want to discuss or have any questions.