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2016 4th Quarter Portfolio Commentary

By

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To everything, turn, turn turn.

There is a season, turn, turn, turn.

And a time for every purpose under Heaven.

--Pete Seeger

And we're off, to greatness. We have nothing to worry about, just sit back put our feet up and await the tax and regulation reductions that will free up our animal spirits and bring these United States to unfettered prosperity, again. Except, well maybe, that we can never return to those "good 'ole days"; that our world today is vastly different than that of the victors of World War II; that technology and innovation will constantly destroy old jobs and create new ones (see Joseph Schumpeter and Creative Destruction); that trade barriers only bring about inefficiencies in production and lower standards of living (see David Ricardo and Comparative Advantage); that we must constantly reinvent ourselves and learn new skills to be relevant, or starve; that the wider the disparity of wealth among mankind, the greater the alienation and eventual bloodshed; that mercantilism is not a good thing; that the Laffer Curve (lower taxes on those with higher income will stimulate spending and increase overall tax revenues) has been proven a fallacy (ask David Stockman, Ronald Reagan's Budget Director); that tariffs raise the cost of goods for a citizenry and bring about a downward spiral of retaliation and economic stagnation; that we must commit hard cash, not just debt, to upgrade our infrastructure if we want a first class country; that the United States, like Britain in the last century, may naturally lose its dominance in world affairs as other nations improve and advance. I need not go on, as I wish to make my notes brief. However, I suggest that if we don't diagnosis the problem accurately, we will not implement the right solution. The wrong remedies will turn our hard won economic recovery from the debacle of 2008 and the gains in our investments downwards. Mistakes will hurt, bigtime.

I've been studying China and her history since my first visit to that vast country in 2005. China formerly dominated the world, but lost this dominance commencing around the early 1,400's. Why? I submit that one of the major reasons was the voices within the country that grew evermore fearful of the "outsiders" who were migrating, trading and traveling into China. Unexpected events, like the burning of Beijing, due to lightening, and the death of the Emperor in warfare with the Mongols, were taken as signs of displeasure by the gods, and the country turned further inward. Learning a foreign language or trading with outsiders become illegal, as the country closed down. Only recently, beginning around 1986, has China opened itself up to The West again and hasn't turned back since. A great book to read for some background is ***1421- The Year China Discovered America*** by Gavin Menzies.

Isn't that a kick: the US and Europe (the West), driven by fear, are building barriers, closing borders and turning inward, while China and The East opens and expends outward: 1421 all over again, but this time for The West and not The East.

Our investments had a great year even before the elections. In what started out as a year of trepidation, our investments came back strongly as the year progressed. Our average returns for all accounts, "conservative", "aggressive", moderate", "balanced" etc. was 12.4%. Our median return was 13.6%. Our individual stock investments grew at rates double those of our mutual fund holdings. As I wrote in my third quarter report, our faith in individual stock selection versus passive investing has been restored. Allow me to site a few examples: Portfolio One grew at 9.0% overall. Its individual stock investments (excluding its dividends) advanced at an 11.3% clip, while its equity mutual funds (including reinvested dividends) appreciated at only 5.9%. Portfolio Two grew at an overall rate of 22.2%, its individual stocks (excluding dividends) advanced by 23.9% and its equity mutual funds (including dividends) grew at 11.3%. Portfolio Three grew at an overall rate of 21.3%, its individual stocks by 21.7% and its equity mutual funds by .002%. Meanwhile, the Dow Jones Industrial Average advanced by 13.42%, the S&P 500 by 9.54%, the NASDAQ by 7.50% and the Russell 2000 by 19.48%.

During this year, small capitalized stocks far outperformed large caps and caught up with their lag of the past eighteen months. Fixed income holdings lagged on a relative basis. The Russell 2000 Index rose by 19.48% in comparison to the Vanguard Total Bond Market Index's (VBMFX) 2.49%. It has been said that the thirty-five year bond bull market ended in July. With Mr. Trump in office, infrastructure stimulus on the horizon, unemployment under 5% and clear signals that our Federal Reserve will raise interest rates, bonds clearly have more of a downward bias than upwards. We've been keeping our duration in bonds short for several years now. We'll be surprised if anyone makes any money in holding even these. We do not recommend any fixed income investment with a long maturity and haven't owned any for years.

Going forward, it is my hope that Mr. Trump and his administration will not turn our economy downwards in their pursuit of unorthodoxy and desire to "shake things up". He clearly does not want to fail in his presidency and may well adopt economic policy that moves our economy forward. However, I will watch carefully for missteps against the concerns I listed in my first paragraph and shift our investment posture accordingly. We will also hold a careful watch on those indicators that flash "down-turn" ahead. I've mentioned them frequently over the years in my letters. These include: accelerating inflation; slowing payroll growth; rising unemployment claims; an inverted yield curve; slowing leading economic indicators; and those that follow:

Economic outlook remains favorable and we anticipate GDP growth of around 2.5% in 2017. Housing is still favorable, as new home inventory is historically low, employment is increasing and mortgage rates, while rising, are still historically low. Additionally, lower corporate and individual tax rates, the repatriation of overseas profits and a massive infrastructure initiative may prove simulative. Nevertheless, we must remain cognizant of the fact that our US GDP exceeds $18 trillion and our annual deficit presently is about $588 billion. These present two potential constraints: only a massive infrastructure initiative will seriously impact our $18 trillion GDP and our national debt is already huge, $19.8 trillion as of December 29th. Unless we pay for these projects with income taxes, which are targeted to be reduced, we must either borrow the funds or turn the projects over to the private sector. In light of our current national debt and deficit, and the mood in Congress to keep the purse strings tight, borrowing is unlikely. Thus a massive infrastructure initiative is unlikely. On the other hand, we could refinance our current long-term debt with 100 year US bonds. This would free-up cash to spend on new projects without increasing our annual payment, like a house refiance. I'm guessing that the current administration will choose to joint venture these projects with political cronies from the private sector. So, we'll pay more tolls and user fees instead of income taxes in the future. Is there a difference? Well, yeah, we citizens will no longer own our country.

You gotta love it: we'll drop the income taxes on those among us with the most wealth and doing so will free up billions of dollars that will be used for infrastructure projects. Our highways, tunnels, walls, bridges, national parks will be owned now by the wealthiest among us and we peons of these great United States will turn over our dollars forever more to the wealthiest among us in order to use the facilities. On top of this, we will eliminate the "death tax", or the estate tax as it has been historically known. In doing so, these infrastructure projects will be owned forever by the families and heirs of our wealthiest. Let us hope that they are kind. But, don't despair: we'll have jobs in these United States! But, I digress.

Moving back on point: we look forward to a guarded favorable economic outlook for 2017.

Monetary policy should prove no surprise for us. Our Federal Reserve will continue to increase interest rates towards normalcy. Their long-term target is 3%. While we may not get their within the year, we should find ourselves moving closer towards that goal as our economy fully recovers from the 2008 debacle. Slow steady, measured increases sit well with us. Aggressive interest rate increases, necessary due to excessive stimulus, will be a cause for alarm.

Valuation in our equity prices remains reasonable in our view. Despite our major equity indexes reaching all-time highs (today, January 25, 2017 the DJIA, S&P 500, Russell 2000 and the NASDAQ will close at all-time highs), we see the strong possibility of the S&P 500 trading in the mid-2300 range during 2017. Earnings should reach the $130 range. Here the Price/Earnings ratio will be about 17.7. This is not excessive. Nevertheless, the inability of this index to reach these earnings projections would turn sustainable advance on its ear.

Sentiment is presently close to euphoria, in my opinion. I do think that once the bloom of the recent election is off the rose, our markets may settle down a bit and fall from their recent highs. A "correction" would be a healthy dynamic of this market. Where our equity markets go afterwards will be driven by the economic and regulatory polices enacted by our government.

I did not mention the strong US dollar in my essay yet. Well, we know that the stronger the dollar, the lower our exports. This is not good for domestic productivity. The higher US interest rates, the stronger our US dollar. Throw "border taxes" into the mix and we have a higher cost of goods. Higher cost of goods along with a slowdown in domestic productivity and we have the whiff of recession. The Trump team must be savvy enough to avoid this.

So, we enter 2017 with a cautious optimism. We are not in the mood for buying presently, especially after the run up in stock prices since November 8th, and are more disposed to hold our investments, collect our dividends and wait for another buying opportunity to add our cash into the market. There will be a correction in equity prices one day this year. It's only of matter of what will trigger it. When it arrives, we will not panic, take it in course, and maintain our favorable long-term outlook until events dictate otherwise. I note that most recent run up in stock prices, like we experienced since November 8th, occur periodically. They take us by surprise and are missed by those out of the market when they occur. Such moves, brief and quick, will give to the investor most of your gains over any given time period. Such dynamics underscore the importance of remaining invested, even during periods of uncertainty.

We hope that you are pleased with the 2016 returns on your portfolios. We are.

As always, thank you for you continued business and confidence. Of course, give us a call should you have any questions or changes in your portfolio that you would like us to make.

Food for thought

I'm a business man and I don't like my high tax bracket. The first action I would take to lower this would be to give my employees, who helped earn this taxable income, a raise. This would reduce my taxable income and stimulate our economy by placing additional money in the form of more disposable income into the hands of my employees in circulation. The next step would be to adopt a profit-sharing (not a 401K plan) so that my employees would share in the profits that we all earned. This would reduce my taxable income further and benefit our country by helping my employees prepare for a financially comfortable retirement. Then, I would purchase all new equipment I might need or expand my facilities. This, via depreciation, would reduce my taxable income further. I could go further by initiating a training program to upgrading the skills of my employees if I needed additional expenses to drive down my taxable income. All of these actions would reduce my taxable income without having our government lower our tax rate.

I suggest that all of the political posturing about how we in these United States must lower our corporate tax rates to remain competitive with the rest of the world, is just that, posturing. We already have the tools to manage our tax rate.

I do know that a high tax rate will encourage me to find deductible expenses, as identified above. A lower rate will not. So, can anyone reading this explain to me why lowering our corporate or personal tax rate will stimulate our economy? All such an action will do will concentrate the wealth of our nation into the hands of fewer and fewer and increase the disparity of wealth in our nation and our world.

We add to this disparity when we eliminate the “death tax”. Taxes allow money to recirculate into a nations’ economy, its bloodstream, and just like with our body’s circulation, when you cut it off, you die.

Our nation is moving further and further along a path of curtailing real liberty from the masses. A nation cannot remain vibrant or healthy over the long run when it moves in such a direction. This widening disparity, more than anything else, may be the linchpin that destabilizes our economy. We must all be cognizant of this. Lowering taxes on the wealthiest among us at a time when our nations’ financial needs are great (think infrastructure) is the wrong medicine.

Feeding the Multitudes or The Miracle of the Loaves

I was raised a Catholic by a man who went to church every day of his life. So, you may say that I am infused with the teachings of The Roman Catholic Church and the Gospel. I’ve also explored throughout my life other religions and spiritual practices too. I’ve learned many lessons through listening and putting into practice that which I’ve heard. I’ve heard many versions of the various miracles of Jesus Christ. However, one stands out among the many. This was the sermon of the Miracle of the Loaves given to me by a younger priest in a parish in Saddle River, New Jersey. This opened my mind to an entirely new understanding this scripture. I presume that you all know this miracle. If not, then you may wish to pick up a copy of your Bible and turn to John 6:1-14. Note this may be the only miracle that is included in all four gospels. It’s also in Matthew 14:15, Mark 6:30 and Luke 9:10. This in itself says much about the value this should hold to the reader and to the faithful. The Gospel of John features a different twist. His Gospel includes a small lad, “which hath five barley loaves and two small fishes. None of the other three Gospels feature the lad.

So what was the message here? When I hear this story I think of the old men running the event who are stuck in their old ways of viewing the world, unable to fathom a solution of feeding the masses surrounding them. The lad represents new life, one that has not been tarnished by old ways of thinking and doing. His food, his optimism, his willingness to share, opened up the world of possibilities to everyone on the hillside that day. And this was the miracle, not the literal feeding of the five thousand.

Opening doors, willingness to engage with others for the betterment of all is what will move our world forward. A "zero-sum", us against them mentality will not. Negotiations cannot be me against you, but must be how we optimize both of our needs and wants. The miracle we need in our lives today is that our current leaders in Washington are blessed with the mind of Christ in their view of the world. We are all in this together and there is plenty for all of us. Either we all win, or none of us do.

The Wall

Mr. Trumps' Wall on our border with Mexico will cost between $25-40 billion. Additionally, we will have to pay about $13.5 billion annually to maintain and to staff the border guards. Couldn't the money be better spent elsewhere? Maybe like on water pipes for the people of Flint, Michigan. Any smart business person would access an endeavor and its returns on investments before initiating a project. What will be the returns on investment on this project? We don't have unlimited resources to misplace on "bridges to nowhere". By listening to Republican Representative Will Hurd, of the 23rd District in Texas, which includes 800 miles of border with Mexico, I learn that this project is "the least effective way to secure the border". Additional research reveals that 253,000 in firearms travel down to Mexico from the United States each year and that 93% of opium into the US comes through the Mexican border. Additionally human traffic (that's sexual exploitation) adds to the flow of "goods" over this border. On a relative scale, worker immigration traffic is small. It's also fallen significantly over the past eight years. The problem appears to rest in the huge cash haul from the drug trade and this will only find another way into our country if a Trump Wall is erected to stop the flow of goods over the border. The "bad guys" will still find a way to get into the US and trade in their illicit goods. The problem is the drugs and the enormous US demand for them. We have an epidemic in our country in this drug trade and it reaches deep into our communities throughout the nation. Wouldn't legalizing these drugs solve the problem? Doing so would drive down the costs to virtually nothing and remove all incentive get our kids "hooked" on them. We would be better able manage the distribution of the controlled substance and the recovery of those addicted to the opiates too. Economic principles solve the problem. Cut away the artificial restriction to supply and the excessive profit motive disappears. How many billions annually would this save and how many lives?