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Third Quarter Investment Commentary

By

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"Do you not know, my son, with how little wisdom the world is governed?"

-Count Axel Oxenstierna of Sweden (1583-1654)

"The true conservative seeks to protect the system of private property and free enterprise by correcting such injustices and inequalities as arise from it…I am that kind of conservative because I am that kind of liberal."

-Franklin Delano Roosevelt

"Both the Great Depression and the Great Recession were preceded by periods characterized by global imbalances in trade and finance and by maldistribution of wealth……A similar combination of global rebalancing and a more equitable distribution of the gains from economic growth will be required, if America and the world are to move beyond the bubble-economy pattern of asset bubbles followed by collapses and rising inequality of income and wealth."

"A new American system, if it is successful, can increase the productivity of the US economy in the generation ahead. But productivity-driven economic growth by itself is not enough. The gains from growth must be widely shared among the citizens of the American people."

-Michael Land, Land of Promise, An Economic History of the United States

“Public utility is more truly the object of public banks than private profit”

-Alexander Hamilton

“According to my calculations, the White House methodology yields the absurd conclusion that eliminating the corporate tax altogether would boost annual household wages by up to $20,000….Well-designed business tax-reform would include permanent expensing , elimination of the corporate interest deduction, a more robust and competitive international system, and fully paid-for reductions in the corporate rate. Such changes could help boost wages modestly over time. But the current plan falls short on all of these counts- and it is workers who will ultimately bear the cost of the White House’s wild claims.”

-Jason Furman, Professor at the Harvard Kennedy School

“Despite the clamor, the market isn’t pricing in a tax cut. Failure to pass one wouldn’t sink stocks….This year, S&P 500 earnings should show a double-digit percentage increase for the first time since 2011, to about $131 per share. And next year’s 11% expected gain to $145 doesn’t include any fillip from tax cuts.”

-Vito J. Racanelli, <u>Barron’s</u>

“Over the long term, I see continued good economic growth and low inflation. Maybe we are in a period analogous to the late 1880’s, after the railroads came into this country. It was a long prosperous period with corrections along the way, good economic gains, and very low inflation. And the disruption occurring in so many industries that are driven by technology maybe [puts us] at the beginning of one of those very long periods of prosperity.”

-Jeff Vinik, former manager of the Fidelity Magellan Fund

“Instead of helping the victims of these disasters through responsible aid paired with lasting reform, Congress has rushed to its favorite so-called solution: billions of dollars in new spending with little accountability or meaningful oversight.”

-Senator Mike Lee (R) of Utah

“The federal government’s budget is on the road to hell. There is no polite way to describe way the world’s largest economy has placed itself on a trajectory that looks like a third-world debt crisis.”

-Douglas Holtz-Eakin, former CBO Director

“And if Republicans pass their smorgasbord of tax cuts, the mushrooming deficit will push the savings-investment imbalance in exactly the wrong direction.”

-Eduardo Porter, Economic Scene, <u>The New York Times</u>

Are you better off than you were ten years ago, or five years ago? How are you do'in, financially? From my perspective, with what I know of your financial matters, pretty well. Apparently our nation is doing rather well too according to The Census Bureau. American households are enjoying the strongest sustained income growth this century (although this century is only seventeen years old) after a long stretch of stagnation marked by the financial crisis, recovery and slow recovery, according to the WSJ. Median household income in 2016 was $59,149, up 4.1%, a new record high. The last peak was reached in 1999. Our economic expansion, now in its ninth year (the third longest on record), continues. Manufacturing activity recently reached a 13-year high, despite the impact of three severe hurricanes. We have all of this without any monkeying around with our tax code.

Income equality has widened, however, as the top 20% of the income distribution took in 51.5% of the total income. Such disparity, historically, had led to major social disruption and must be addressed to avoid another, in my opinion. Henry Ford sought to address this matter by paying his employees higher wages than his competition so that they could buy his cars. Marriner Eccles, chair of the Federal Reserve during FDR's term, noted that the imbalance of income distribution in the 1920's led to the Great Depression. "Had there been a better distribution of income from the national product, in other words, had there been less savings by business and the higher-income groups and more income in the lower groups, we should have had far greater stability in our economy", he noted in his assessment of what went wrong. "Had the $6 billion, for instance, that were loaned to corporations and wealthy individuals…been distributed to the public as lower prices or higher wages and with less profits to the corporations and the well-to-do, it would have prevented or greatly moderated the economic collapse that began at the end of 1929", he went on. Bernard Bernanke and Janet Yellen, our two most recent Fed chairs, fortunately understood this and worked feverously to provide liquidity to our economy during our most recent financial crisis and in doing so kept the ship afloat. Fed chairs throughout the globe have followed suit and the result is that we are climbing out of the financial disaster that brought us to the precipice in 2008. The Census Bureau report indicates that the result to date has been successful.

When we needed fiscal stimulus (tax cuts) in 2008-09 our idiots in Congress didn't give them. The Federal Reserve was left alone to save our economy with monetary policy. Now when we don't need tax stimulus, Congress puts them forth. Timing is everything and this timing is way off the mark.

I offer the aforementioned to underscore my fear that our present government, in all its "wisdom", will upset the applecart and in doing so precipitate an economic and stock market downturn. In addition to talk about trade restrictions necessary to "make America great again", our Republicans will be appointing a new Federal Reserve Chair shortly and are bound and determined to pass "tax reform". Any of these, done wrong, or with little wisdom, could change the economic landscape sufficiently to upset the economic expansion. A "rule based" Fed Chair, such as is candidate John Taylor, may not have the flexibility to make decisions outside of the parameters of his rules even when events dictate otherwise. Tax reform built on ideology, political expediency and weak thought will be a disaster. Our Congress, in its members need to pander for votes, doesn't have the capacity for strategic thought.

The last time our Congress passed comprehensive tax reform was 1986. Our nation has performed rather well since then without any new tax reform. It will continue to do so without any new tax reform now. Our Dow Jones Industrial Index stood at 1896 on December 31, 1986. Today it is 23,377. Our median average household income was approximately $24,900 in 1986. Today it's $59,149, a record high! All of this talk about how we need tax reform now to grow our economy is nonsense. Those who will sacrifice our nations' economic health to score a few political points should be driven from representative office.

The 1986 tax reform initially hurt our economy, as taxpayers had to adjust to its terms. The real estate market suffered significantly as the reform eliminated pass-through losses from limited partnerships. Real estate values fell by over 30% shortly thereafter and the equity in these partnerships was wiped out. Many limited partnerships became worthless. I submit that these significant losses contributed to the 1987 stock market crash. Taxpayers, back then, eventually grew accustomed to the new rules, worked around them to profit and have been doing so ever since, but the adjustment took a toll on our economy for a period.

We will undergo another adjustment period with any new significant tax legislation. I prefer grid-lock in Washington and no "reform". I prefer slow and steady economic expansion rather than any stimulus for faster growth. Fast growth seems to always lead to eventual downturns. Slow growth allows for adjustments in all of the participating levers and therefore sustains prolonged growth. Our present slow growing economic expansion approaches our longest in history. It has been sustained for 109 months.

Let's take a brief look at the lay of the land and consider whether the proposals of our Republican Congress address the major financial imbalances before us. Our federal debt currently sits at $20,453,368,882,109. That's TRILLION. Our current annual federal deficit stands at $693,000,000,000. That's BILLION. Corporate profits recently posted their biggest jump in five years. The top 10% of US household income averages $170,536 and the average US household income at $59,149 is the highest on record. We have infrastructure needs of over $456 BILLION a year for the next ten years. We have disaster relief needs (from hurricanes and fires) of $200 million a day, (all on top of our regular operating expenses). We have these wise-ackers in Congress proposing for tax reductions that will add $2.4 TRILLION to our national debt over the next ten years.

Wouldn't the money funneled out by "tax reform" be better spent on infrastructure needs? Such would increase productivity, create good high paying jobs and provide sustainable economic stimulus for a long, long time. Wouldn't money going to a tax cut be better spent in reducing our ever increasing national debt? My sons, my sons, do you know with how little wisdom you govern our country?

While I fret about potential apple cart turnovers, I also remain focused on present indicators that indicate how close we may be to such an event. Today, these still tell us that we have clear sailing ahead with no recession on the horizon, at least for the short term.

These are:

Accelerating inflation: The average rate of inflation over the past decade has been 2.1%. Presently the year-over-year rate of inflation as measured by CPI is 1.9%. The six-month annualized rate of inflation is .6%. We do not have accelerating inflation at this time.

Payroll Growth: Payroll growth has improved significantly from the debts of the crisis, but is not accelerating aggressively. Payroll gains have averages 176,000 per month this year compared to 187,000 for the same period last year. Labor force participation stands at 62.9% similar to last years'. Unemployment is 4.4% and the under-employment rate is 8.6%. The under-employment rate before the downturn was 8.6%. So, while we are approaching rates that the Federal Reserve defines as "full employment", we have not exceeded previous levels and income growth, due to a variety of reasons, has not accelerated aggressively. Creative destruction, technological efficiencies, global trade and robotics, among other things seem to be keeping a lid on acceleration of wage growth.

Rising Unemployment Gains: New claims averaged 234,000 weekly (the lowest level since 1973) before the disruptions caused by hurricanes. They increased slightly to 277,750 in the latest week, but should fall again once the disruptions caused by weather conditions subside. Low new claims are a positive for continued economic expansion.

Inverted Yield Curve: This indicator is still positive with long-term rates exceeding those of short-term loans. The 30-year USD Treasury bonds currently yield 2.86%, while the 3-month bills yield 1.04%. Until we see short term rates accelerating to approach those of the long-term, we see economic growth continuing.

Leading Economic Indicators: August provided the 12th consecutive increase in The Conference Board's Leading Economic Index (LEI). On a year-over-year basis, this index has increased by 4.4% (the most since June 2015). The Coincident Economic Index (CEI) remains positive too, with a 1.0% rise over the past six months.

The National Association of Home Builders/Wells Fargo Housing Market Index (HMI), at 64 is down for September due to hurricanes, but remains well above 50, the threshold of a positive reading. New home permits presently stand at a 1.30 million annual rate, their best level since February 2008.

The American Trucking Association (ATA) Truck Tonnage Index was up 7.4% year-over-year in September. Cargo volumes at the Port of Los Angeles (one of the two busiest ports in the nation) were up 8.9% year-over-year. The second busiest port, Long Beach, CA, experienced increases of 8.9%. Both are experiencing record-breaking activity for the third quarter: A clear sign of continued economic expansion.

To conclude, despite all of the noise and opinions exchanged amongst experts, mavens, politicians, panderers and charlatans, we distill the noise down to our empirical indicators for clarity and we see green ahead.

This year has been good to us again, as our portfolios have increased by an average of 10.9% through September 30th. Our more equity weighted portfolios have increased by an average of 13.2%, while our bond weighted portfolios moved up by an average of 6.1%. Our individual portfolios moved across the gambit according to objective and holdings, with our best appreciating by 50.15%.

Please review your individual progress reports enclosed with this letter and be sure to call should you wish to discuss anything within or want to make time to visit us in person to review your investments and financial needs.

We continue to thank you for your business and confidence and look forward to the months ahead.

Revenue and debt as a share of GDP at the time of previous and proposed tax cuts:

	1981	**2001**	**2017**
Revenue	**19.1%**	**18.8%**	**17.3%**
Debt	**25.25%**	**31.4%**	**76.7%**

From

'The U.S. Can No Longer Afford Deficit-Increasing Tax Cuts'

by Jason Furman in the Wall Street Journal, October 2, 2017.

Source CBO