

April 16, 2018

“I want to quickly acknowledge that in any upcoming day, week or even year, stocks will be riskier – far riskier – than short-term U.S. bonds. As an investor’s investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates.”

Excerpt from Warren Buffett’s 2017
Shareholder letter for Berkshire Hathaway

Shoot! Am I late?

After sitting out 2017, stock market volatility returned with its dancing shoes on for the 1st quarter of 2018. The U.S. stock market, as measured by the S&P 500 stock market index, lunged forward 7.2% into January 26, quickly backpedaled 10% into the February 8th close and then swung within that range through the end of March. While there were plenty of headlines to point to as reasons for the return of volatility (higher interest rates, trade wars, North Korea, Syria, etc.), if I just turned off the news for a moment I would say the simple answer is that we were due. And, as a portfolio manager seeking new investment opportunities, I would add, “Hello volatility, my old friend, where the heck have you have been?”

1st Quarter 2018 Index returns:

S&P 500	(-0.76%)
Dow Jones Industrials	(-2.3%)
EAFA (Europe and Japan)	(-1.18%)
U.S. Aggregate Bond	(-1.46%)

As you can see from numbers in the table above, the net impact on the major financial indexes in the 1st quarter from all the gyrations in the stock market was a relatively mild pullback from the close of 2017.

Monetary policy vs. fiscal policy.

There is a battle going on between our two major economic policy tools. In this corner, the Federal Reserve (the Fed) is in the process of “normalizing” monetary policy from the Great Recession crisis response levels by raising the fed funds interest rate and shrinking its balance sheet. Effectively, the direction of these policies is a more restrictive monetary environment.

In March, the Fed hiked its fed funds rate for the sixth time from the 0% - 0.25% range it established in 2008. It began hiking the fed funds rate in December 2015, ¼ of 1% at a time. It now stands at a range of 1.5% - 1.75%. Based on the notes from its meeting, the Fed currently anticipates raising the fed funds rate twice more this year and anticipates reaching a target rate of 2.9% by the end of 2019. On the balance sheet side, in an effort to suppress long-term interest rates, the Fed purchased over \$4 trillion of U.S. Treasury bonds and mortgage backed securities through the three stages of its quantitative easing program. The Fed began shrinking its balance sheet in the 4th quarter of 2017 (primarily by not purchasing new bonds with the proceeds from bonds that had matured) and plans to reduce it by \$420 billion in 2018.

In the far corner, the U.S. government is attempting to stimulate the economy through lower taxes and higher spending. Effectively, since both policies are financed by additional borrowing, the direction of these policies, at least in the short-term, is an expansive fiscal environment.

At the end of 2017, in an effort to create a more attractive business environment and to promote more jobs and spending and overall faster economic growth, the government permanently reformed and reduced corporate tax rates and temporarily reformed and reduced personal tax rates starting in the 2018 tax year. The current borrowing estimate for 2018 to cover the lower tax receipts is \$200 billion (and approximately \$1.3 trillion more over the following 9 years). In the first quarter, the government also passed a budget increase of \$150 billion for 2018 (and another \$150 billion for 2019) to increase levels of defense and other discretionary spending items.

Each of the monetary and fiscal policies referenced above are material to our economy on a standalone basis. On a combined basis, however, with the monetary policies heading in the opposite direction of the fiscal policies, I see the overall economic impact of them in 2018 as close to neutral. Looking for impact beyond this year, I will defer to the business cycle.

The business cycle.

We are close to the 9th anniversary of our current economic expansion. While the pace of growth has been relatively moderate, and certainly not everyone has participated to the same degree, the duration of the expansion is impressive. If you had asked me in 2009 if our economy was going to recover to and expand beyond our last economic peak in a straight line, I would have been skeptical. Debt was at the heart of the financial collapse in 2008, and I was not sure that confidence in the financial system would recover as quickly as it did. At some level, in order to avoid a deflationary depression, the Fed was committed to doing whatever it took to regain that confidence. Now, with debt levels at all-time highs (government, corporate, consumer, margin, student, global, etc.), the Fed is raising interest rates and removing liquidity. Those are the seeds of the end of this expansion. As I noted in my last letter, I believe our current expansion has been extended by global growth. Perhaps our recent fiscal stimulus will also help extend the cycle even further, though, as I noted above, when you add in monetary tightening its effects will likely be muted. Peak certainly hopes the U.S. expansion will surpass the 10-year record set from 1991 into 2001, but we also believe it is prudent to be well positioned for the next downturn. As Warren Buffett emphasizes in the quote that opened this letter, time horizon is a critical factor in managing risk.

* * * * *

We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or family member that could use our assistance.

John McCorvie, CFA