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2017 End of Year Report

I hope that this, my seventh semi-annual report, finds all of you well and happy. I am a bit late in rendering this year-end report. I thank you for your patience. I did <u>not</u> write my usual "Half-Time Report" last summer because I just didn't think that there was enough new and interesting information to give to you and I didn't want to take the risk of wasting your time. I hope this report does not disappoint.

"I'm in favor of progress; it's change I don't like." *Mark Twain*

There is more information available to be processed by humans today than at any point in history. It is estimated that, by the year 2020 – just a few short years away - the amount of information available to be processed by humans will double every *36 hours.* There are more people alive today – over 7 billion – that can process this information and, with computers and smartphones, they now have the ability to share and transmit this information to millions of other people, literally, at the speed of light. The inevitable result of all of this is a rate of change in many areas of life that is much faster than that which we are used to having to contend. It can be stressful and confusing.

Due to this explosion of available information, it is sometimes difficult to separate the wheat from the chaff. This seems especially true in the financial world. Some things are inherently complex with no real shortcuts for explanation. I will do my best to share the information I have with as much clarity and brevity as I can muster.

Demographics

There are several themes that have pervaded my previous six reports. One of those themes is the reality that the U.S. and most of the world's major developed economies have <u>aging</u> populations. The growth in <u>developed</u> economies like the U.S., Japan and the European Union is driven by the consumer. In the U.S. economy, for example, consumers spend 70% of all of the money that is spent. Business and government spending account for the other 30%.

Regardless of which developed economy or culture is in question, it remains true that by the time most people retire, they have made most of the major purchases that they will make in their lifetime. When most people retire, their income and overall spending goes down and, as people move into their 80's and beyond, they spend even less money on the basics, like food and clothing.

The Baby Boom Generation (of which I am a member) began to move through our peak earning and spending years beginning in 1991. Every year through 2007, more and more of us moved into our peak earning and spending years and, as a result, our economy experienced a long and unprecedented period of economic growth and prosperity. We began to retire on January 1, 2008. Since that time, an average of 10,000 of us continue to retire *every day*. Half of us have retired over the past 10 years, the other half will do so over the next 10 years.

As we Baby Boomers moved through our peak earning and spending years, our country experienced a very long period of unprecedented growth and prosperity. *Is it that hard to imagine that once we began to retire on January 1, 2008, we would have the opposite effect?* For the past 10 years, economic growth has been frustratingly low. Between 1945 and 2007, Gross Domestic Product (GDP) averaged about 3.50% per year. Since 2008, GDP has averaged about 2% per year. During the past 10 years, short and long term interest rates were much lower than the previous 10 years (1998 to 2008) – which should have, according to theory, provided for robust growth over the last 10 years. Income tax rates over the past 10 years were approximately the same as the previous 10 years (1998 to 2008). If tax rates had gone up, this would have detracted from growth – but rates remained about the same.

As I have mentioned in my previous reports, it is estimated that the demographics of our country will not change for the better for another 3 to 4 years. So, for the next 3 to 4 years, I do not see anything that would cause our economy to grow much faster than it has been growing for the past few years.

In both 2014 and 2015, GDP averaged 2.40% (69% of the historical average). In 2016, GDP dropped to 1.60% (46% of the historical average). In 2017, GDP averaged 2.60% (74% of the historical average). Not horrible, not great. Just more of the modest, yet consistent, growth that we have been experiencing for the past 10 years.

Tax Cuts

As I mentioned in my 2016 End of Year Report, there are certain things that no President or Congress can do anything about – specifically, they can't stop people from growing older and retiring. Hopefully, the recent tax cuts will help the economy some, but there is no guarantee that people will spend their tax savings – they may choose instead to save them or use them to pay down debt. We'll see.

Many corporations are using the new tax savings to buy back their own stock – instead of investing in the future growth of their business. I first mentioned stock buybacks in my June 2015 "Half-Time Report". (It would be valuable to reread that section of the report – pages 6 & 7). In 2014, stock buybacks hit a new record. That record was eclipsed in 2015. Buybacks shrank some in 2016 and hit new records in 2017. Between 2007 and 2016, it has been estimated that companies in the Standard and Poor's 500 Index spent 54% of their profits on stock buybacks.

As I mentioned in my June 2015 report, by repurchasing shares of their own stock and reducing the supply of shares owned by the public, buybacks inflate an important measure of corporate profitability: Earnings per share. It's a financial engineering trick. Companies can appear more profitable even if their sales and profits are not growing. In fact, sales and profits can be shrinking, but if enough shares are repurchased, earnings per share can go up! It has been estimated that slightly more than 40% of earnings per share growth between 2009 and mid-2017 is from share repurchases. What will companies do with the rest of their tax savings? We'll see.

Infrastructure Spending

As I mentioned in my 2016 Year End Report, it is possible that we might see an infrastructure spending bill. Deteriorating infrastructure in the U.S. is a problem that will only get worse and more expensive as time goes by. I also mentioned, however, that while such a bill would certainly help GDP, it would probably not create the increases in GDP that have been advertised. If such a bill were to pass in the next six months, it would probably be late in 2019 or 2020 before the first dollars on infrastructure would be spent.

As I mentioned in my report, working contrary to the growth that would undoubtedly result from infrastructure spending are two very large forces that will be pulling in the exact opposite direction. By 2020, there will be roughly 7,300,000 more retirees than we had at the beginning of this year - the demographic problem will continue. The other thing I mentioned was what the media has labeled "automation" – people losing jobs because of computer programs. (Please see pages 6 and 7 of the 2016 End of Year Report). I believe that the growth created from infrastructure spending would only be modestly greater than the opposite impacts of our aging population and jobs being lost – or not being created – to computer algorithms.

Jobs and Wage Growth

2017 was the *fourth consecutive year* where the average number of new monthly jobs being created went down. We need an average of 200,000 new jobs every month just to accommodate people who are graduating from high school and college who are looking for their first full-time job. That's 6,575 new jobs a day that are needed. In 2014, the monthly average was 246,010 or 8,088 new jobs a day. In 2015, the monthly average was 220,825 or 7,260 new jobs a day. In 2016, the monthly average was 182,500 or 6,000 new jobs a day (that's less than the 6,575 needed for the graduates mentioned above).

In 2017, the monthly average dropped again to 171,003 or 5,622 new jobs a day. Please remember that, at the same time, 10,000 Baby Boomers retire every day. So, every day, 10,000 people retire, their income and spending goes down and they have made most of their major life purchases. At the same time, only 5,622 people per day find full-time work and their income goes up. Not a recipe for vibrant, dynamic growth.

On December 31, 2007, there were 121,090,000 people in this country who had full time jobs. 10 years later, on December 31, 2017, the number of people working full time had increased to only 125,970,000. That's a net increase of only 4,886,000 people engaged in full time work over a 10 year period. That's an average annual increase of 488,600 net new full time jobs or a monthly average increase of 40,717 net new jobs over a 10 year period. Not good at all.

During that same 10 year period, however, our population has grown from 301,580,000 people to 325,719,000, an increase of 24,139,000 people….but only 4,886,000 net new full time workers has been added.

In early February, the unemployment rate was reported along with the January 2018 "year over year" wage growth. Both reports kindled the fear of rapidly rising inflation and, therefore, rapidly rising interest rates.

In my opinion, the unemployment rate is a very nebulous and not very useful number. It includes three groups of people. People who had a full time job which they lost, people who are graduating from high school and college who have never had a full time job, but who are included because they are looking for work for the first time and people who had a full time job many years ago who are looking for work for the first time in many years – college educations are expensive and many people who stayed at home to raise the kids go back to work to help pay for that cost. So, the way the unemployment rate is computed, you could have a growing economy where the average number of monthly new jobs being created is going up (unlike now) and the unemployment rate could still actually go up!

Because the unemployment rate is reported more frequently than any other labor-related number, it stands to reason that most people deem it to be very important. So, in February, the headlines were dramatic – the unemployment rate dropped to 4.1%, the lowest it has been in 18 years! (The year 2000 - when the economy was booming). Surely, the thinking went, we are having or about to have a labor shortage!

Because labor comprises two-thirds of the cost of all goods and services produced in this country, if there was a labor shortage and the price of labor did go up, employers would have to raise their prices (that's inflation) to offset the increase in the wages they would be forced to pay and surely the Fed would begin to rapidly increase short term interest rates and people who make long term loans (like mortgages) would ask for far greater rates of interest to compensate them for the deleterious impact that rapidly rising inflation would have on the fixed income stream that they would be receiving in the future! On top of that, in their minds, investors feared the January 2018 "year over year" wage increase of 2.6% meant that workers have a lot more money to spend, which could also cause more inflation!

Here's the problem with the January 2018 "year over year" wage gains: This number compares the average wages being paid to workers in January of 2017 (only) to what new workers are being paid in January of 2018 – they skipped 11 months in 2017! When you look at all 12 months of 2017, in many months, average wages went down relative to the month before. If you look at all 12 months of 2017 and adjust for inflation, wages grew by a not-so-significant .40% ! That is not an inflationary number. Additionally, when you look at the very small increase in full time jobs over the past 10 years relative to population growth over the same period, I just don't think that we're having or about to have a labor shortage, which means that the inflationary fears are without merit. Now, there may be a shortage of trained workers – but you simply hire and train them. If they don't initially have the requisite skills, you don't have to pay them as much. On top of all of this, I think that the evidence shows that there are many part-time workers out there who would love to have a full-time job!

Stock and Bond Markets Take a Big Drop in February

Because of the reports on the unemployment rate and January wage gains and the resulting fear of rapidly rising inflation and (therefore) interest rates, both the stock and bond markets took a big tumble. On top of that, for some reason, there is a perception with many investors that the economy is booming. If that were true, that would also be inflationary, which would cause interest rates to go up in a significant fashion.

With GDP for all of 2017 at only 2.60% or 74% of the historical average, it's hard for me to imagine how this perception could exist. Perhaps investors are comparing GDP to only 2016 – up from 1.60% in 2016 to 2.60% in 2017 – a 62.5% increase in a year - or maybe they just don't know the historical averages. Another possibility is that they just want to believe that better times are just around the corner – although our demographics don't favor that for another three or four years.

At the end of the day, this is the third time since May of 2013 that investors just knew that significant increases in economic growth and wages were right around the corner and certainly would cause a significant increase in inflation and therefore interest rates. In the first two instances, within about six months, they realized that the long-awaited economic growth and inflation that they were expecting to happen – didn't – and bond prices went back up and long term interest rates came back down. Because interest rates didn't go up, people continued to invest more money in the stock market because they couldn't earn very much interest on their C.D.'s and bonds and the stock market was going up and they didn't want to miss out on any more of those good returns.

Stock Prices

As many of you know, I started in this industry in 1984. Since that time, stock prices as measured by something called Price/Earnings Ratios (P/E ratios) – specifically, the average P/E ratio for the 500 companies in the Standard and Poor's 500 Index (S&P 500) - reached their highest level in history in the 1999 – 2000 time frame, when the economy was booming and we had a bubble in the stock market. In January of 2018, the average P/E ratio for the S&P 500 Index was at its second highest level since 1984. The economy is not booming and while stocks, in my opinion, are not in bubble territory, they are expensive.

So Why Did the Stock Market Do So Well in 2017?

As you know, two significant things occurred in 2016. First of all, the economy slowed to a GDP rate of 1.60% or 46% of the historical average. In November of 2016, we had the general election. Going into the election, it appeared to most observers that we would most likely end up with a Republican Congress and a Democratic President. As we all know, a funny thing happened on the way to the opera. We ended up with a Republican Congress and President! This is when investor beliefs about what this combination portends for the future began to take hold.

In my 2016 End of Year Report, towards the very end, I talked about how investor beliefs can, over the short term, significantly impact the prices paid for various investments. In the report, I specifically referenced how investor beliefs could, in the short term, have a negative impact on bond prices. This also holds true for stock prices. The truth is, every human has beliefs – you have them and I have them. To make my point, my beliefs may have zero basis in reality. My beliefs may be completely contradicted by all of the facts. With most humans, however, they will act on what they believe, whether it is true or not.

So, there is a significant portion of the investing public who hold an ironclad belief: With a Republican Congress and President, it is inevitable that the economy will improve. No ifs ands or buts…..it is going to happen. Now, the historical data don't support that contention, but that does not matter…..humans act on what they believe, whether it's true or not. So even before Mr. Trump was inaugurated, the stock indexes began a dramatic rise upward. If you follow the thinking, the rise in stock prices makes sense. With the belief that the economy was destined to improve, when that happens, consumer and business spending would go up. Because we buy things from companies, corporate sales and profits would go up as a result and, ultimately, it is rising corporate profits that cause stock prices to go up. So, the thinking goes, because all of this is inevitable and the stock market will go up as a result, I'm going to buy my stocks before they go up and, of course, if enough investors buy stocks, guess what happens to stock prices? They go up! It becomes a self-fulfilling prophecy.

Now there's a second group of investors that I've mentioned in my various reports that really helped the stock market to go up in 2017. It's the group of people who like to invest their money where they hear about or read about where <u>other</u> people are making money with their money (think about real estate in the 2000's and stocks in the 1990's). It's not a small group of people.

By June of 2017, if memory serves me correctly, the S&P 500 Index was up about 10% - in the first six months! This is when the second group of investors began to move money into the market. The market was "hot" and they didn't want to miss out on any more of the great returns that they had missed in the first six months of the year. And it wasn't just available cash on hand that they invested. It was also money that they borrowed using their existing stock investments as collateral for the loans – the "margin" debt that I mentioned in my 2014 End of Year Report. In 2013, the amount of borrowed money that was used to buy stocks increased from $330.356 billion to $444.931 billion, an increase of 34.68%. In that same time frame, the S&P 500 Index increased by 29.60%. From December of 2016 to November of 2017, the amount of margin debt increased from $489.523 billion to $580.945 billion (an all-time record), an increase of 18.68%. In that same time frame, the S&P 500 index increased by about 22%. See the connection? Whether it's cash on hand or borrowed money, the flow of money into the stock market caused the stock markets to go even <u>higher</u>.

It is noteworthy that, in the first instance, stock prices went up based on what investors <u>believed</u> would happen. In the second instance, stocks went up because people didn't want to miss out on any more good returns. Neither instance has very much to do with what was <u>actually</u> happening with the economy. Making all of this all the more likely is that interest rates are still very close to their all-time lows. By virtue of the fact that investors can't get very good returns on "safe" investments like certificates of deposits or bonds, it made it more likely that investors would take more risk with their money by moving into stocks to get higher returns.

Back to What Happened to Stocks and Bonds in February

There is a third group of people that I haven't discussed – let's call them (for lack of a better term) "the smart money". They know that the reasons why the stock market did so well in 2017 didn't have a whole lot to do with the underlying economic fundamentals. They made about 22% in their S&P 500 index funds. They know that if it weren't for the "human factor" – stock prices going up based on beliefs of what people thought would happen followed by a healthy dose of good old-fashioned greed - if stock prices were based firmly and fairly on realistic economic fundamentals, they probably should have made 7% or so last year on their index funds. That extra 15% that they earned was a <u>gift</u> – and they don't want to give it back. They know that stocks are expensive and higher than they should be if you look at the economic fundamentals. They know that if investors could earn 4-5% on a 5 year certificate of deposit, or 6-7% on a high quality bond, money would move <u>out</u> of the stock market to get the safer, higher returns, causing both the stock and bond markets to go down.

So, when the unemployment rate and January 2018 "year over year" wage increase reports came out in February- combined with the perception of a booming economy – and the fears about significant increases in inflation and interest rates were rekindled: They headed for the exits. Many sold their stocks to preserve their gains. I expect their behavior to remain the same as long as stocks prices remain this high.

Ultimately, what causes both short and long term interest rates to go up in a rapid and significant fashion is very simple – significant increases in the rate of inflation. Inflation has been at or below 2% for the past 10 years. The historical average between 1945 and 2007 was about 4%. Inflation goes up when the economy is growing rapidly and labor shortages cause significant wage increases, which employers pass on to consumers in the form of higher prices – if they can.

In today's world where there is so much competition both domestically and abroad, producers (employers) aren't always able to raise prices, so they seek to reduce labor costs – either through improving worker productivity (figuring out ways to have workers produce more in the same 40 hours) or finding ways to have fewer people on their payroll – initially by creating machines to replace people on the assembly line – now, in our service economy (90% of all jobs), replacing people with computer algorithms - think people doing their banking on line – who needs tellers?

What's Next?

When I look at the economic horizon, I don't see any storm clouds. I believe that for the next 3 to 4 years (until the demographics change for the better) we will continue to see more of this very modest, slow but consistent growth that we have seen since the end of the Great Recession. The banking and financial system are in very solid shape. Over the past 10 years, many middle class families have focused on increasing savings and paying down debt, which would make the impact of any future economic downturns less severe.

We are now in the third longest economic expansion since World War II. At some point, this slow-growing economy is likely to slow down. As I mentioned in my 2016 End of Year Report, when that happens, the Fed will use their primary tool of lowering interest rates at the banks to try to speed the economy up. But you can't lower them very far from the current Federal Funds rate of 1.5-1.75%. So, I continue to believe that the Fed will continue to gradually raise rates over time. Not because they believe that the economy is growing too fast – they don't. If they raise rates too quickly, that would have the unintended consequence of slowing the economy down – which runs contrary to what they have been trying to do for 10 years. Rather, they will continue to slowly raise rates – so that they can lower them when the next downturn occurs – whenever that is.

In my last report I also mentioned that I believe that long term rates – which are not directly controlled by the Fed, will move up and down within a fairly narrow channel over the next three to four years until the demographics change for the better and, as a result, meaningful growth for the economy and possible increases in the rate of inflation become a real possibility.

As far as the stock market is concerned, what will happen this year is anyone's guess. If we don't have any unexpected negative events, I expect to see lots of volatility in both the stock and bond markets until this uncertainty over inflation and rising interest rates goes away. After that, with no unexpected negative events, it's always possible that the stock market could have a good or very good year – no one knows for sure.

On the other hand, if we do have an unexpected negative event – think fear – with stock prices being as high as they are and with the amount of margin debt that exists, it is possible that the stock market could take a significant drop. The last time we had an event that caused enough fear to cause a 20% or greater decline in the stock indexes (a "bear" market) was September 15, 2008 when Lehmann Brothers collapsed, causing the financial crisis. That's almost 10 years ago. Between 1929 and 2007, we had 10 such bear markets. That's an average of every 7.8 years. So, we are past the statistical averages, and it is tempting to say "we're about due", but you simply can't use averages to make predictions – it could be 5 more years before we have such an event. No one can make those predictions with any amount of consistency or accuracy.

Having said all of that, when you take into account that it's been almost 10 years since we've had a recession or a bear market, when you consider that stock prices are very expensive and have, to a great degree "disconnected" from the underlying economic fundamentals, I think it makes sense for investors to really be aware of how much investment risk they are taking. Any truly significant declines in stock prices could be a good buying opportunity if your exposure to stocks is not too high when such a decline occurs. The one thing that will never change is that people will become afraid and many will sell their stocks when prices are down.

We need to be prepared to take advantage of any significant drops that occur in the stock market in the future. I will keep you posted.

Thank you for the privilege of your time. Thank you for your business and your trust. We will work very hard to continue to earn all three.

Yours most sincerely,

Scott W. Eglseder

Note: Unless otherwise indicated, Bloomberg is the source of the information contained in this report. All indices are unmanaged and investors cannot actually invest directly into an index. Unlike investments, indices do not incur management fees, charges or expenses. Past performance does not guarantee future results.