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2016 End of Year Report

I hope that this, my sixth semi-annual report, finds all of you well and happy. I am a bit late in rendering my usual year-end report. I thank you for your patience.

I will spend the bulk of this report discussing – barring the unforeseen and unexpected things which cannot be predicted – the things that I think we are likely to see as a result of something that has been at the forefront of the minds of most people with whom I have spoken:

The Election

I am not just referring to our new President, but also the makeup of the legislative branch of the Federal Government, particularly the Senate.

Let me start out by saying that there are certain things that no Congress and no President can do anything about, because there are certain things that are completely outside of their control. I have spoken with each of you and have written many times about the fact that the United States has an aging population. You may also recall that it is not just the U.S. which has an aging population, but also most of the major developed economies in the world – e.g., most of Europe and Japan. This seemingly innocuous statement has significant economic implications.

In the United States, consumers spend 70% of all the money that is spent in this economy. This is true for most developed economies in the world. Business and government spending account for the other 30%. We live in a consumer-driven economy. The only way for our economy to grow is if total consumer spending increases as time goes by. As you know from my previous reports, since January 1, 2008, an average of 10,000 Baby Boomers retire every day. While there will always be exceptions to the rule, by the time most people retire, they will have made most of the major purchases that they will make in their lifetime. After they retire, every five to ten years retirees will purchase a new (or good used) car. When most people retire, their overall income and spending goes down. Then, as people move into their 80's, many of the things that the rest of us purchase on a very regular basis, like food and clothing and car-related expenses, they tend to buy less and less of these items as well. By contrast, however, in 2016, the average number of new jobs created every day dropped for the third consecutive year to 6,000 (182,500 per month). To accommodate first-time job seekers graduating from high school and college, we need 6,575 new jobs per day (200,000 per month).

So every day, on average, 10,000 people retire. They will have made most of their major lifetime purchases, their overall income and spending will go down, and as they move into their 80's, as mentioned above, they will buy less and less of the things that the rest of us purchase on a very regular basis, like food and clothing and gasoline. At the same time, only 6,000 people per day find work and their income goes up. So every day, there are 4,000 more people whose income and spending go down relative to those whose income and spending are going up. There has not been a single year since the financial crisis where the number of new monthly jobs created has exceeded the approximate number of 304,000 people retiring every month (please see the June 2016 Half-Time Report). There have been only two years since the crisis where the 200,000 new monthly jobs needed to accommodate people graduating from high school and college has been met: 2014 and 2015.

As I have mentioned in previous reports, this is not a recipe for vibrant, dynamic economic growth and we are not experiencing vibrant dynamic growth. In fact, Gross Domestic Product (GDP) dropped from 2.40% in both 2014 and 2015 to a paltry 1.60% in 2016. 1.60% is only 45.7% of the average historical growth rate of 3.50% that we experienced between 1945 and 2007. When you stop to consider that there are roughly 7,300,000 more retirees today than there were two years ago, I don't find any of this terribly surprising.

At the end of the day, there is one thing that no President and no Congress can do anything about: They can't stop people from growing older and retiring.

With all of this as a backdrop, I would like to talk about the election and, of particular importance, the makeup of the Senate. Before I do, I have noticed that over the past six years, voters have become very frustrated by the fact that not much has happened (legislatively) inside of the Beltway. In a pure democracy, each citizen would cast her or his vote for all bills and only those bills that passed by a majority would become law – the majority rules. We, however, live in a Democratic Republic. While different from a pure Democracy, the Democratic principle remains basically the same: Through representative government, the majority rules. With our system, the only way that legislation can become law – the only way for us to move forward and get things done - is if we (a majority of our representatives) agree on a way forward. If we can't, the Constitution prevents anything from happening.

When you stop and examine how polarized the electorate is on the many important issues facing our nation, I would argue that the Constitution is operating precisely as the Founding Fathers intended. Because we have not been able to agree as a majority on the way forward with many of these issues, this wonderful document prevents anything from happening. The Democratic principle of majority rules is preserved.

Back to the Senate: The Republican Party has 52 seats in the Senate – a simple majority. The rules of the Senate are complex and a bit esoteric. I am no expert, but I will do my best to explain my understanding of how it works. While a bill can pass the Senate with a simple majority of 51 votes (if the vote is 50 -50, the Vice President casts the deciding vote), the Senate rules include a filibuster rule that requires 60 votes to proceed to an actual vote when some senators want to continue to debate the bill for a prolonged period of time (filibuster). So, if 41 Senators are staunchly opposed to a bill, it cannot proceed to the floor for an actual vote. So if a bill is controversial, with the Senate filibuster rule in place, for all intents and purposes it really takes 60 votes to get it to the floor for passage. The Republican Party has 52 seats in the Senate and not every Senator will vote along party lines each and every time. For all of the frustration voters have felt over the past six years, I think it is generally true that people don't like change a whole lot and they certainly don't like rapid change. The new makeup of the Senate pretty much guarantees that the only way for big change to take place is if the majority of us can agree on the way forward.

With this in mind, since the election, I have been telling clients that the only way for there to be major changes to existing legislation or for significant large new legislation to become law, any such bill would need to enjoy strong bipartisan support – especially in the Senate.

During the general election, President Trump discussed two potential pieces of legislation: Legislation that would "repeal and replace" the Affordable Care Act and legislation that would allow for significant spending on infrastructure. Let's examine both.

During elections, rhetoric is abundant and emotions run high. When you look past the rhetoric and the resulting emotions which surround "repealing and replacing" the Affordable Care Act and when you analyze what the proposed changes are – more importantly, what the majority of the Republican Party is not talking about changing – a different picture begins to emerge. Back in 2010 when the Affordable Care Act became law, the three key "selling points" to both Democratic and Republican voters were as follows: 1) Pre-existing conditions would now be covered under new health insurance plans. You could now switch your health insurance and be guaranteed full coverage. Many people were "stuck" in their old job because if they went to a new company the new insurance there would not cover existing illnesses.

2) Caps on what insurance companies would pay out for health claims over your lifetime were eliminated. Historically, most health insurance companies would pay out a maximum of one million dollars in claims during the lifetime of the insured. It was fairly rare for a person to reach the cap, but if you did, you could go bankrupt. 3) Your children can now stay on your health insurance plan until they are 26 years of age.

Guess which three things the majority of the Republican Party is <u>not</u> talking about replacing? Why, the three key "selling points" mentioned above! They are not on the table. I assure you that these three items are as important to Republican constituents as they are to Democratic constituents. Whether or not the Affordable Care Act is actually repealed and replaced is yet to be determined, but keeping the three major benefits to all voters makes it more possible. Because it is controversial, it would most likely need 60 votes in the Senate, which would be indicative of strong bipartisan support.

I think that a large infrastructure spending bill is very likely and I believe it would enjoy strong bipartisan report. There are two governmental bodies that can have the most effect on the economy: The Federal Reserve and the Congress. The Federal Reserve (the "Fed") is responsible for <u>monetary</u> policy. The Congress is responsible for fiscal policy (taxes and spending). When we had the crisis 8 years ago, the Federal Reserve threw <u>everything</u> they had at the problem. As you know from my previous reports, the Fed doesn't have very many tools in their tool box. They certainly don't have any fine surgical instruments. The data and evidence clearly demonstrate that the record monetary stimulus provided by the Fed prevented a horrible set of economic conditions from becoming absolutely catastrophic. While they were able to get the "heartbeat" of the economy going again, the record monetary stimulus that they have provided over the past 8 years hasn't done a whole lot to make the patient better. Since the record stimulus was applied 8 years ago, the economy has averaged only 2.10% growth over that time frame, which is only 60% of the historical average of 3.50%. Please remember that growth <u>slowed</u> from 2.60% in 2015 to 1.60% in 2016.

Since the crisis, however, the Congress has been roundly criticized by <u>both</u> Republican and Democratic economists for not doing more on the fiscal side (spending) to grow the economy. When we had the crisis 8 years ago, roads and bridges across the country were in need of repair. Deferred maintenance doesn't get better all by itself and it doesn't get less expensive as time goes by, it gets more expensive. Economists from both sides of the aisle argued that because we didn't have the money set aside to repair the infrastructure, that it would make sense to borrow the money to make the repairs while interest rates were at historical lows. While this new spending wouldn't change the economic impact of our demographics (our aging population), it would certainly provide a needed boost to the economy on something that really needed to be done. And despite all of this, the Congress did nothing.

Eight years and four Congresses later, the infrastructure problem has gotten far worse and more expensive to fix. And, you know, we voters are kind of picky: We don't like potholes very much. We don't like driving underneath overpasses and seeing rusting rebar where the concrete has fallen away and perhaps injured or killed a driver who was unlucky enough to be in the wrong place when it fell and we certainly don't like to hear about bridges falling into the water while cars are still on them!

So, I do believe that an infrastructure spending bill is very likely and will happen relatively quickly and I believe it will enjoy strong bipartisan support. Roads and bridges don't crumble and fall apart based on whether you are in a red county or a blue county. Now, quick for you and me and quick for the Federal government are probably very different time frames. My guess is – if it happens at all – is that we will probably see an infrastructure spending bill on the President's desk in 3 to 6 months. Once the bill becomes law, then you have a period of maybe 6 to 12 months of administrative and managerial hurdles, e.g., what will be the bidding process for contracts and then the process of reviewing and awarding contracts. So, on the short end, it would be at least 9 months before the first dollar is spent. On the long end, it could be as much as 18 months or longer. At the very minimum, we are probably looking at 2018 before the first dollar is spent and well into 2018 or possible even 2019 before the economic impact of that spending begins to be realized.

During the general election, the Trump administration said that the infrastructure spending bill would take GDP from roughly 2% up to at least 4%, possibly even 4.5 or 5.0%. The mathematics seem very unlikely to me. What is being discussed is an infrastructure spending package of $1 Trillion dollars over three years or roughly $333 billion per year – a lot of money. However, when you take $333 billion dollars and divide it by the total of consumer, business and government spending of roughly $19 trillion per year, you come up with a total increase in spending of 1.75%. A 1.75% increase in spending will <u>not</u> result in a 1.75% increase in GDP, but let's pretend that it would. Our current GDP is 1.6%. Add 1.75% to that and you come up with 3.35% GDP, which isn't 4%, 4.5% or 5% GDP. I think that a 1.75% increase in spending would result in a much lower increase in GDP and once again, we would probably not feel the impact on GDP until late 2018 or early 2019.

As a citizen, I think that the infrastructure spending is necessary. As an analyst, I do believe that it will absolutely help the economy to grow. At the same time that I believe the infrastructure spending will help to move the economy forward, there are two very large forces that will be pulling in the exact <u>opposite</u> direction. As I mentioned before, if the spending does occur, we will probably not feel much of an impact until early 2019.

In 2019, because of our unfavorable demographics, we will have roughly 7,300,000 more retirees than we do today.

So we have the ongoing issue of unfavorable demographics running contrary to growth for the next four to five years before they change for the better. The other thing that will be pulling in the opposite direction of growth isn't as obvious, but is very insidious. During the primaries and the general election, there was a lot of discussion about jobs being lost overseas. These job losses are both real and significant – but far from new. As bad as these job losses have been, however, the data clearly suggest that over time the number of jobs that have been lost to what the media is now calling "automation" – computer programs – is far <u>greater</u>.

I became consciously aware of job losses due to computer programs around five years ago. I go to two or three business conferences every year. I usually will rent a car when I go. Around five years ago, I would pick up the phone and speak to a human who was receiving a paycheck to make my car reservation. Around five years ago, companies found that it would cost them a lot less money if the reservation process was automated by a computer program. So you had to go online – no humans. When I became "aware" of the job losses due to computer programs, I realized that computer programs had been taking away a lot of jobs typically done by humans. The first thing that came to mind was "what happened to all of the travel agencies?". There are very few left. It's all done online.

What seems so significant to me is that now the amount of time <u>between</u> the computer programs that are taking away jobs is getting shorter and shorter. A few weeks ago, I rented a car. I made my reservation online – no humans. When I got to the airport, I went to the rental counter to do the paperwork (with a human, I thought) and was greeted by one human who was standing in front of five electronic kiosks that had been programmed to walk through all of the questions and answers that the counter agent would typically ask me. It took only one human answering the questions of five people regarding how to use the five machines versus five humans helping five customers. Over time, there will be a much lower cost for the car rental companies.

A few more examples:

Sometime in December, I was watching the evening news and saw a report where Amazon was going into yet another business – they are going to build 2,000 grocery stores over the next two years across the U.S. Their key selling point is that you will not have to wait in any checkout lines. As you walk in the store, you go through a turnstile. As you walk through you wave your smart phone over the turnstile. This turns on an application ("app") in your phone. Each item you pull off of the shelf has an electronic device that communicates with the "app" in your smart phone and adds it to the tally in you smart phone's electronic "shopping cart". If you put an item back on the shelf, it will be subtracted from your electronic shopping cart.

When you finish getting all of your items, you simply walk out of the store and the bill is paid through your amazon.com account. No checkout line – no cashiers. Up until the week of February the 20th, I had been telling everyone that as soon as Amazon does this, that everyone else will follow suit – Safeway, Acme, Giant Food, WalMart, Target, etc. The week of the 20th, a client told me that Sam's club was already doing the same thing. Now don't be confused here – this is not the self check-out system that is already in many grocery stores and Lowe's and WalMart. There you have to stop at a station, scan all of your items and, if you have a problem, there is one human there for 4 or 5 scanning stations to assist you if you need help. With this new technology, there is no scanning or check out stations. You literally pull the items off of the shelf and walk straight out of the store! No humans. How many cashiers will lose their jobs?

Banking: I still like to go to the bank. Depositing checks in person somehow makes me feel richer. I will view my bank accounts online. When I want to transfer money, however, I still pick up the phone and ask for someone at the bank to do it for me. Call me old-fashioned. Increasingly, more and more people are doing online and mobile banking. You can actually deposit checks to your bank account using your smart phone. No humans involved. I know quite a few people – this is not a criticism - who haven't been to a bank for years! In the past several years, I noticed that two of the four bank branches in St. Michaels have closed. In Easton, I have seen three or four branches close during the same time frame. As more and more people use online and mobile banking, more and more branches will close down. How many tellers have lost their jobs? How many will lose them in the future? It is inevitable. There are many other examples. There will be more. The difference seems to be is that the amount of time that elapses between these computer programs that cost jobs seems to be getting closer together.

So, while I do think an infrastructure spending bill is very likely and will help the economy to grow, we have both the demographics and the automation pulling very hard in the opposite direction of growth. If I had to guess – and I hope I'm wrong – we may see infrastructure spending add 1% to current GDP, but once again, we will really not begin to see the impact until well into 2018 or early 2019.

Here's the bottom line: I think that we will continue to be in a very low growth environment – due primarily to the demographics and to a lesser degree the automation – for the next four or five years until the demographics change. I believe that this low growth will be helped only modestly by an infrastructure spending bill. The other thing that will impact investments and the things that I recommend to you are interest rates. It is my observation that most advisors and most investors believe that interest rates are going to go up – many believe significantly so.

As you know from our meetings and my semi-annual reports, there are two different sets of interest rates. There are short term interest rates at the banks and the credit unions which are set and directly controlled by the Federal Reserve.

Separately, there are long term interest rates – think mortgage rates and longer term bond interest rates – the Fed does not set nor do they directly control those rates. The individuals and companies that make these loans set those rates. For example, if you had a rental property that you wanted to sell, you could chose to "take back a mortgage" on all or part of the property. Does Janet Yellen, the Chair of the Federal Reserve tell you the interest rate that you must charge? Absolutely not. You decide the interest rate that you are going to charge the purchaser of your property – not the Fed.

Historically, there is only one thing that will cause the Fed to raise short term rates in a <u>significant</u> fashion and only one thing that will cause mortgage lenders to charge <u>significantly</u> more interest on new loans. In both cases it is the same thing. Here it is: The economy is growing too fast and both the Fed and long term lenders believe that higher inflation will result. For example, let's say we're four years in the future and you have a second rental property that you wanted to sell and somehow we were magically transported back to the growth rates of the 1990's: 4-5% GDP. Your concern is that the incredible growth would cause inflation to climb by 2%. Let's say on that first property that you sold four years ago that you decided to charge 4% fixed for 30 years – a fixed monthly payment to you for 30 years – what's your biggest enemy on a fixed income? Inflation. So, if you think that this new explosive growth is going to add 2% to the inflation rate relative to the inflation rate from four years ago when you made the first loan, on this new loan, you will probably charge 6% instead of 4% to compensate you for the higher rate of inflation. See how that works?

Alternatively, the Fed has a dual mandate: Maximum employment within the context of price stability. If the economy is growing too quickly and the Fed believes that inflation will rise above certain targets that they have set, they will, in very short order and in rapid succession, raise short term rates. Here's the theory upon which they operate: Raising rates at the bank, while good for savers – is bad for borrowers. As interest rates move up, the cost of personal and business loans go up. Therefore less money will be borrowed and less money will be spent. As less money is spent, demand for goods and services will go down and eventually employers will not need as many employees to meet the falling demand and so they will fire people to preserve their profits. If the Fed thinks that the economy is growing too quickly and they believe that unacceptable levels of inflation will result, their goal is to put people out of work. Why? In the U.S., two-thirds of the cost of all goods and services produced is one thing – labor. If labor becomes short in supply, the price of labor can go up. Because it is two thirds of all costs, if labor costs go up, this would cause most companies to raise the price of their goods and services. Rising prices is inflation.

When the economy slows down, the primary historical tool they use to speed up the economy is just the opposite – they lower interest rates, significantly and in relatively short order. Here's the theory: While lower interest rates are bad for savers, they are good for borrowers.

The cost of personal and business loans go down. In theory, more personal and business loans will be made. As more money is borrowed, more money will be spent. As more money is spent, the demand for goods and services will go up. Eventually, employers will not be able to meet the increased demand with their current workforce, so they will be forced to hire more people. This will create more spendable income which will then be spent and the economy gets better. So the Fed's goal of lowering rates is to create new jobs. Over the past 8 years – and I have mentioned this is my previous reports - I believe that the theory of lowering interest rates to stimulate borrowing and spending has had a very limited impact on making our economy with its aging population grow faster. What's my proof? After 8 years of record low interest rates, the U.S. economy has had average annual growth of only 2.1% - only 60% of its historical average of 3.5%. Why such limited success? As I've mentioned in previous reports – people who are retired have made most of their major purchases and they don't want to borrow money after they have retired.

At the end of the day, I do not believe that the Fed will raise short term rates very far or very fast and I do not believe that long term rates will go up in a significant fashion for one very simple reason. It's simple: The economy is <u>not</u> growing too quickly and there is nothing on the horizon that is going to make it grow that much faster for the next four or five years until the demographics begin to improve.

I do believe, however, that we will see short term interest rates go up very slowly over a very long time frame. Also for a very simple reason: In December of 2015, for the first time in 10 years, the Fed raised interest rates ¼ of 1%. In 2016, they had their usual eight meetings and they waited until the eighth meeting in December of 2016 to raise rates another ¼ of 1%. We have had a very long eight year economic expansion – very slow growth, but an eight year expansion. At some point, we will have an economic downturn. When we have the downturn, the primary tool for the Fed to stimulate growth will be for them to <u>lower</u> interest rates. Well, you can't lower them very far from the current level of ½ of 1% can you? So, I believe that the Fed will raise rates for one very specific purpose: So that they can lower them when we have the next economic downturn. They have been trying desperately for eight years to get the economy growing again. If they raise rates too far or too fast, that would have the impact of slowing the economy down – that's the opposite of what they are trying to do.

Finally, long term interest rates: I believe that we will see long term interest rates moving up and down within a fairly narrow channel over the next four or five years until the demographics change and, as a result, when I believe that meaningful growth becomes a reality. Again, it is my observation that most people believe that interest rates – both short and long term rates – are going to steadily move up.

All humans have beliefs and we all act on them. Since 2013, we have had two periods where investors just knew that interest rates were going to go up. The first time was in May of 2013 and the second time was the last six months of 2016. As a result of their beliefs, many investors sold many bonds, causing bond prices to go down and long term interest rates to go up. In each case, about six months later, when the data showed – or, more accurately, did not show the growth and inflation that investors were expecting – bond prices went back up and long term interest rates went back down. I think that we will continue to see long term interest rates yo-yo up and down within a fairly narrow band over the next four or five years for precisely the same reasons. Expectations of growth and inflation for the future that seem more rooted in what has happened in the past versus a thorough analysis of the present and the likely, will continue to cause temporary short term rises in long term interest rates, which will then give way to bond prices going back up and interest rates going back down, as the reality of low growth and low inflation over the next four or five years continue to rule the ultimate direction of long term interest rates.

In conclusion, I believe that for the next four or five years, we will continue to be in a low growth environment which would only be modestly improved by an infrastructure spending bill. I believe that short term interest rates will continue to go up very slowly over a long period of time and that long term interest rates will move up and down like a yo-yo in a fairly narrow channel.

In the interim, I do expect to see the unexpected events and circumstances that have always occurred in the past with probably a fair amount of volatility in both the stock and bond markets. Moving forward, as I mentioned in the June 2016 Half-Time Report – which I invite you to read again – we need to be prepared to take advantage of any significant drops that may occur in the stock market in the future. I will keep you posted.

Thank you for your business and your trust. We will work very hard to continue to earn both.

Yours most sincerely,

Scott W. Eglseder

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