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Second Quarter Market Commentary 2018

2017 was a strong year for the equity markets, with very little market volatility. In fact, for the whole year, the stock market never experienced a correction of greater than -4%. The start of 2018 has been quite different. All three major benchmarks as well as the real estate index, have experienced double digit declines, while the NASDAQ composite has had two double digit declines this year. While some profit taking was to be expected after a long run up in prices, the Volatility Index (VIX) spiked after fears of a trade war arose in late January. In this commentary, we will address what we believe was the reason for the selloff, including rising interest rates, rising budget deficits, and a potential trade war via tariffs. We will expand deeper on the tariff issue since we have received a lot of questions regarding tariffs.

The Effects of Tax Cuts, Budget Deficits, and Interest Rates

The recently enacted tax cuts for corporations helped fuel the rally in stocks last year, and will increase earnings at U.S. companies. Long term they are also positive, in that the tax cuts will also encourage more investments in the America. This is due to companies making business decisions less dependent on tax considerations as necessitated by the old system of gaming which country has the lowest foreign tax rates as the site for investment. However, we view the subsequent increase in federal spending as a negative. Originally the proposal was to cut corporate tax rates, and let the (hopefully) growing economy make up for the shortfall in revenues caused by the lower tax rates. In June 2017, the Congressional Budget Office (CBO) was projecting that discretionary spending in Fiscal 2018 would be $1.222 trillion. Discretionary spending does not include entitlements like social security, Medicare, interest on debt payments or Medicaid. In March of 2018, the CBO now projects discretionary spending will reach $1.309 trillion. That is a gain in spending of 7.1% in only nine months, while revenues could decline simultaneously due to lower tax rates.

Bonds vs. Dividends

Interest rates have increased sharply over the last six months in percentage terms. Higher interest rates increase business cost, and therefore depress earnings, which in turn reduces stock valuations. Also, higher interest rates encourage investors to place more money into local banks rather than the stock market. For much of the last nine years stocks had little competition from bonds because interest rates were so low. Going forward, we believe more investment dollars may be siphoned into bonds, especially if interest rates continue to rise as the Federal Reserve projects. The 2017 year-end dividend rates, based upon year-end prices, were at 1.9% on the S&P 500, according to Standard & Poor's. The 10 year Treasury note ended 2017 with a 2.7% interest rate, and remains at that level, despite the short term interest rate hike mentioned above. Moreover, the value of existing bonds will also decline in a rising rate environment (investors who hold their bonds until maturity will get all their money back plus interest, investors who have to sell early could take losses) as investors buy newer bonds at higher coupon rates. While this will be painful in the short term, we view long term higher rates to stay in the 3-4% range (still low on a historical level) as a positive as investors will then be able to buy higher cash flow yielding investments. We do not believe U.S. interest rates will rise as much as in past cycles. The reason for this is that worldwide interest rates are still quite low, and we are in a global market. In fact, the biggest competitor to the dollar is the Euro. The ten year Euro rate currently stands at only 1%, and the ten year German bonds at 0.6%. Furthermore, given large deficits, the

Federal Reserve will feel pressure to keep rates low in order to fund increasing debt levels. Long term, dividend paying stocks should still perform much better than bonds because the dividends and earnings of the underlying companies grow, but in the near term some investors will move some money to buy higher yielding bonds.

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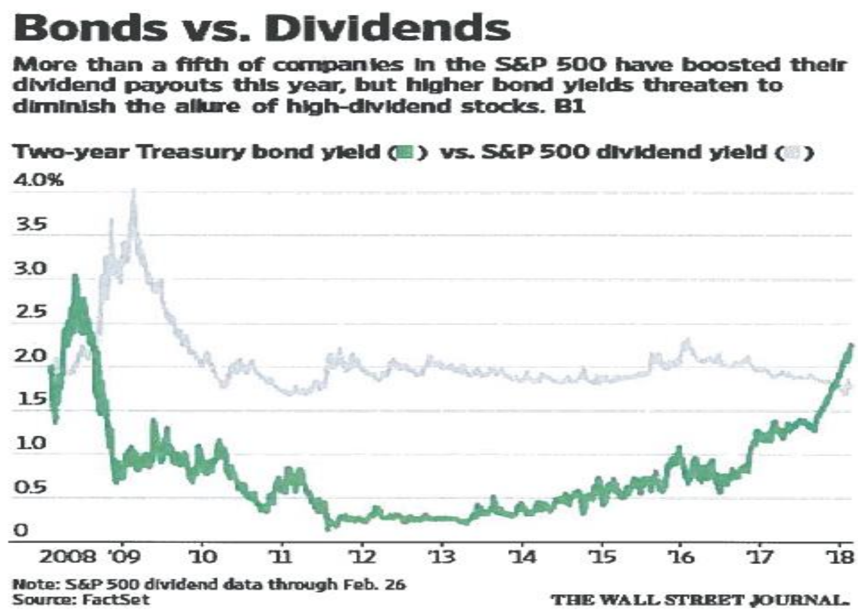


The next large issue facing the market has been the threat of a trade war and tariffs.

Intellectual Arguments <u>Against</u> Tariffs

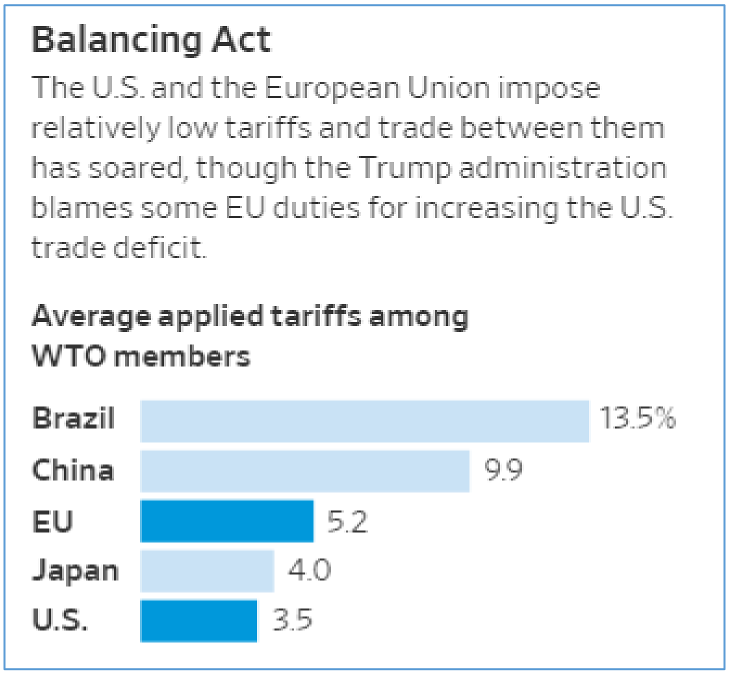
A tariff is a tax placed on an imported good that is designed to benefit a domestic producer of that good at the expense of the foreign producer. Tariffs were common place for most of human history until relatively recently as new ideas about trade began to emerge. The English economist, David Ricardo, came up with the theory of specialization and free trade in the year 1817. The theory states that if two countries capable of producing two commodities engage in the free market, then each country will increase its overall consumption by exporting the good for which it has a comparative advantage while importing the other good. This has become the theory that most business schools and colleges now teach, and is why free trade is so popular and has become the central argument for striving for free trade. Tariffs would be the opposite of free trade.

Another argument against tariffs is that it will force prices higher and hurt consumers. Higher prices will also hurt American manufacturers who use imported components which will in turn hurt their profits and sales. The fear is that the jobs lost due to loss of sales from industries using imported components is more than the jobs saved by the industry receiving the benefits of the tariffs. Moreover, when one country places tariffs on a country, history has shown that trading partners respond in kind, leading to lower exports and economic activity for both countries involved as a trade war between the countries develops.

Lastly, U.S. companies and Wall Street do not like tariffs because it raises cost and hurts their profits. U.S. companies want to hire employees anywhere in the world at the cheapest price and then sell their products domestically. The market has sold off because employing more U.S. labor to get around the tariffs will increase cost and hurt profits in the short term. Large multi-national U.S. based companies and Wall Street firms have argued strongly against tariffs.

Intellectual Arguments For Tariffs

We are already in a trade war and losing badly. According to the U.S. Census Bureau, America had an $811.2 billion merchandise trade deficit with the rest of the world, and a $242 billion dollar surplus in services (which includes foreign students studying in the U.S., travel, financial services, and technology royalty payments). The total trade deficit was $568 billion dollars, of which almost $375 billion was with China, not including Chinese theft of intellectual property.



Current trade is not free trade as most nations have higher tariffs on U.S. products than we place on their products. In addition, many countries also subsidize their industries (China subsidizes steel, and Japan, Europe and the USA subsidize farming). Elon Musk tweeted that he faces 25% car duties in China vs 2.5% for Chinese companies to import cars to the USA. This has forced Tesla to build a China factory, when his U.S. factory could have met the demand in China through exports. A Wall Street Journal editorial written on March 23rd states even free traders and internationalists agree China's predatory trade practices - which include forcing U.S. business to transfer valuable technology to Chinese firms and restricting access to Chinese markets - are undermining both its partners and the trading system. The Wall Street Journal also states that we do not have Free Trade now as tariff levels vary across the world-(please see chart above).

Indeed, Western firms have complained for years that China routinely steals their trade secrets, through outright theft and hacking, and also through domestic rules that require foreign firms to turn over technological know-how as a condition of doing business in China. Keith Alexander, former chief of the National Security Agency, has frequently characterized such intellectual property theft as "the greatest transfer of wealth in history."

Intellectual property theft could cost the U.S. economy as much as $600 billion per year globally, with China accounting for most of that, according to the National Bureau of Asian Research, an independent research group headed by Dennis Blair, who was director of national intelligence under President Obama, and Jon Huntsman, Obama's first ambassador to China.

Most Likely Outcome of the Tariff Debates

Since the U.S. is running such large trade deficits it is not in our trading partner's interest to have a trade war since that would end up losing the profits they currently enjoy. The most likely scenario is that trading partners will make some concessions, and some new factories will be built in the USA, but large trade deficits will still continue. Companies have until May 22nd to object to the tariffs, and then Washington has another 180 days before the tariffs are implemented. China will implement its tariffs after Washington. Between now and then the negotiation with China will take place.

The U.S. economy is still the largest in the world and is so lucrative that foreign companies do not want to lose access to American consumers. Indeed, the Trump administration may feel embolden by its earlier success this year with tariffs in which large foreign companies immediately built U.S. factories when tariffs where placed on their products. Tariffs on foreign washing machines caused Samsung to announce on January 20th it is building a washing

An exterior view of Samsung's Newberry, South Carolina manufacturing facility.
Samsung

machine factory in Newberry, South Carolina. Moreover, a week after the Trump administration unveiled tariffs of up to 30% on imports of solar panels, one of China's biggest manufacturers, JinkoSolar, announced it will build a new factory in Florida to avoid the tariffs. However, if the administration pushes too far too fast, the risk of a larger trade war increases as China tries to keep the factories in China.

The current proposed tariffs represent only a small percentage of total economy of China or USA (under 1% of each country's economy), and at the present time the tariffs are only focused on China. This should alleviate fears of a global trade war with all trading partners. While steel and aluminum tariffs were enacted earlier this year, many nations including Canada, Mexico, South Korea and much of Europe have already been given waivers.

In conclusion, rising interest rates, increased government spending and debt concerns, and a threat of trade war, have caused an increase in market volatility for the first quarter of 2018, including an 11.7% market pullback from the market top on January 26th. The good news is that the market has now pulled back to close to historical valuation levels of 16.1x forward earnings, and the S&P 500 is still looking for double digit earnings growth this year. This makes the stock market more attractive on a valuation basis. Moreover, we feel 2018 will be much more volatile than last year but also that the volatility will create opportunities to buy companies who are returning cash back to investors though both dividends and stock buybacks at opportunistic prices and increasingly make bonds more attractive as well. As always, we thank you for your continued support.

Sincerely,

Bill　　　　Jim　　　　John

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