HISTORY IS AN UPWARD TREND

Very experienced men would retire from our firm during the first years of my professional employment. Before they left they gave me and my equally young co-workers their hard-earned lessons for the care of other peoples money. Ridiculed as out of touch at the time, trust departments were said to be too cautious. History has proven otherwise and, in fact, with the attention today finally paid to the fiduciary duty, they had it right all along. Families were protected, their assets grew, and we were trained.

These men had lived through the Great Depression and a few had been schooled by men who worked at investments before the turn of the century. Their duty, the fiduciary duty, was deeply ingrained. They took new employees down some very strict, very detailed roads including, in my own case, nearly a year sitting daily in Probate Court listening to nine (yes, nine) very expensive and famous lawyers debate the duties of a trustee in one particular estate. That is a book in itself.

I bring this up by way of disclosing more of my beliefs and learnings. Among them I would list:

- People and corporations go bankrupt and disappear but nations muddle on, one way or another, in one form or another.

- Ownership of some kind can survive bankruptcy; bonds most often do not as witnessed by the German hyperinflation of the 1930s.

- Bonds that do survive have assets of value behind them, are more than simple junior loans. My favorite learning from those early years was a “bond guy” in the old firm who bought, for pennies, railroad bonds at the depth of the Great Depression. The railroad was bankrupt, the right-of-ways they owned were taken, nothing was left, and the stock in this case was worthless. Certain bonds, however, had been issued to buy rolling stock, boxcars and the like, and the bondholders had claim to that rolling stock which was now deteriorating, sitting idle. It seems, though, that their scrap steel value at the bottom of the Great Depression still far exceeded the pennies the bonds sold for. Rest well, Mr. L, a few of us remember the small fortune you made.

- Time, more often than not, resolves most economic issues. Governments can speed or slow the process at best because people will act in their own self-interest every time.

- Few true investors remain.

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- No corporation grows without stumbling; suspect those that never do.

- The experienced analyst sees well beyond predicting next quarter's earnings and labors, instead, to predict the longevity of the product, the life of the firm. He is rarely rewarded for that longer view.

- Experts are in great abundance for any point of view you wish to take on any matter financial. Most are completely inexperienced, parroting only the last thing they heard.

- You can both under- and over-diversify. Forty utility stocks is not diversification.

- Credit is a drug and when regulated, is useful; unfortunately, few can self-regulate.

This list could go for pages. I felt some baseline was needed, however, for what judgments I make in what follows.

INFLATION

Mike E. raised the issue this way: "When and how rapid (given) the enormous amounts of money pumped out . . . do we get inflation . . . ?"

To date, all forecasts of imminent inflation, including my own, have been wrong. At the extreme – hyperinflation of the 20% kind – the forecasters are now softening their view. My thoughts of 3%-4%-5% inflation remain. The tool that will be used to control inflation will very likely be the same one Arthur Burns used when he was Fed Chairman – a very hard, quick rise in interest rates and increased reserve requirements on banks.

We are now watching global economies (except ours) soften once again. With that has come a decline in commodity prices and those commodities do flow through near all industrial production, food, services, etc.

The equation of slowing global growth most influenced by lack of demand will make it very hard for manufacturers to hang on to the cost savings they might get from, say, lower energy costs. The why is straightforward: They will likely have to hold, if not cut, prices to achieve sales given such weak demand. To wit, deflation – falling prices. Oil is already in that mode as gasoline prices soften because of it. (We are addressing inflation in the broadest sense – the raw commodities, the index of prices the producers pay, the wholesale price change – the whole lot, not just the food price data).

We are all aware of inflation in packaged food, utilities and some rents among other daily necessities. I suspect, though, that the pressure on prices will continue even as the consumer becomes more confident. I see two reasons for that: 1) The demographics (old) of those with the ability to use credit aggressively simply won't go back to their pre-

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retirement spending mode and create new levels of demand and 2) consumer optimism is too fragile for those with marginal credit to use it aggressively. Pockets of exception, such as the San Francisco Bay area or Texas exist, but for the nation as a whole, caution and prudence with limited funds remains.

So it might come to whether all or just some of those trillions of created funds will be needed. Corporations are issuing debt at record rates to capture the low interest rates available. One should question just how much and how fast bank loans grow. Some, yes, but golden days for banks? Not likely.

Yes, student loans and cheap mortgages with no credit check will continue. These and other programs that induce spending cannot carry the whole economic growth rate higher, however, and are barely fueling the muddling 2% we have. I've written many times that taxation, regulation and raw politics are the barriers to growth, not lack of money. Of late, those who see that are growing in number, in my opinion.

But what's wrong with zero inflation? The answer, no joke, is that it's too close to deflation, which is bad for anyone who owes money. Inflation gets you the ability to pay back your debt with "cheaper" dollars; deflation gets you the opposite. When too many Americans owe too much and deflation then arrives, banks start to fail. Oh, deflation, in theory, is good for banks, but in practice simply accelerates defaults and people walking away via bankruptcy. Thus, "we need a little inflation" (as if it was a water faucet you could control), is more a life preserver for banks than a gift to we borrowers.

The question of where to put money today, for a long-term commitment, is in the list of beliefs. Easy? No. The peasant buried under the hearth what few coins he acquired – and remained a peasant for generations. History, we find, moved on. I think serious inflation is a 5% probability, "normal" 3% to 5% is very likely and let's give it another year to hit the high end of that range. The rate rise will be part of the equation and that impact on stocks is discussed further on.

BONDS

The frequent question is whether it's time to sell bonds and buy stocks. In part, yes. I am no fan of "junk" debt in a muddle economy and junk includes most of the European Banks and certainly dozens of U. S. corporations that couldn't get a bank appointment much less a loan in normal times. I cannot, going further, fathom why the individual investor would own long-term bonds – meaning maturities beyond 7 to 9 years. The long bonds – the 30-year items, have had their run up for over a decade and now yield less than many stocks with solid dividends (particularly true in the 10- to 15-year window). I must repeat – the long bull market in bonds is over and here is a classic case of vendors pointing to the great record bonds have given as they fell from high yields to low. That's done, that record is past and to extrapolate it forward is far too risky, especially under any normal inflation forecast. With 4% inflation your 4% 20-year taxable bond yields you nothing . . . and after

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tax costs you money. Leave long bonds to pension and insurance plan managers who have to match actuarial needs to specific investment returns.

We have two questions: Time to sell bonds and time to buy stocks? I will not be selling clients' municipal bonds (due within the next 5 or 6 years only) – the tax-free yield to the client exceeds the taxable yield on most stock dividends for now. But as these bonds mature each year, I will roll the proceeds into stocks. Having fresh cash arriving regularly is a great help to my clients. I note the columnists are pushing, once again, a "balanced" portfolio of 50-50 bonds-stocks. For the older investor this is a very poor strategy, for the younger it's even worse. It's just easy, not reasoned.

So that leaves what to buy if you are selling junk debt and long debt. Stocks, only if you are truthfully a long-term investor willing to suffer the swings along the way. A regular program of "easing in" is suggested. Much introspection here, please. If you don't have the stomach for it, if you can't resist the latest hot new story, well, find someone who can. It's likely not someone on commission . . . not an annuity . . . not just an index fund.

It's of some insight to consider that Europe has begun its long journey into increased printing to stimulate demand. Europe has the same problems we do, but in far greater form. Cradle-to-grave entitlements, very high taxes, very high government debt relative to each government's size to provide those entitlements, increasingly discouraged youth, significant regulatory, labor and "social fairness laws," exceedingly close-minded unions, businesses and governments – we truly do look far, far better. Here also the stimulus expected from printing will create a momentary aura of success and end up creating asset inflation, particularly in stocks as their bonds have already been inflated in price. We have seen this before.

I believe Europe won't have an inflation problem before she faces literal deflation. Internal demand for business loans is so weak and austerity to control spending is so very ineffective that I think Europe has to print even more aggressively than announced. The fast weakening Euro is evidence that they "will do whatever it takes" to rekindle the hot mess they call a Union. The race to debase currency continues; the race to the bottom, however, is being won by Venezuela. Not that this debasing will do much beyond buy time – it will work for a bit and it does give their stock markets a boost. Maybe it will help U. S. investors get out at higher prices. Sadly, it won't stimulate growth. No, here also it's tax and regulatory issues in bad need of reform. If pushed, I like the Emerging Markets and ours, only.

Look to Japan for clues: Printing, devaluing the yen in the process, to drive the country out of de facto deflation towards real growth by cheapening their exports and the virtual instant it showed promise, they raised taxes on their own citizens. Any bets on a 200 to the dollar yen?

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THE FED

Bill K. raises the question of possible distortions (further) from QE and zero interest rates. At root, the question is what happens to stocks? Bonds? The U. S?

Some of the pieces to this puzzle lie in separating stocks already in bubble mode from what I may call real, sustaining businesses that are not at bubble levels.

There is no question QE has already done the deed of distorting stock prices and the price of money, i.e. e. interest rates. The bubbles are pretty obvious to we practitioners and if you liked playing musical chairs as a kid you'd be right at home in the current IPO and "green" markets and certainly in the bond market – the whole lot is "fully priced," to use an old euphemism.

QE is substantially done, though. What we await is a Fed move to raise rates because zero rates are over. This will occur when the Fed judges that prices and the economy are moving up too fast. A rise in rates should be, initially, good for stocks. Counter intuitive, I know, but it 1) increases the income of savers; 2) allows some price increases to manufacturers; 3) reduces the number of junk loans being issued; 4) improves bank profitability; and 5) tells the world we are closing in on normalcy – the most important point. There is some good historical support for this view. A rate rise is good for the Unites States, bad for stock traders, of passing technical interest to serious stock investors and a holy cow moment for bond holders.

The problem is now how terribly delicate raising rates will be. Done a year or two ago would have been easier on all concerned, done now the risk is, as always with the Fed, too much, too late. This isn't a math problem; it's pure behavioral economics with a touch of game theory. The Fed thinks it's math – science, even.

We will have stock market corrections. Having one is not something that can be timed. Investors may delay new purchases a bit or give their portfolio a hard look for excesses, but corrections are part of the process of owning a business. We own a trend, a secular path, and are not terribly interested in cyclical swings – especially when caused by the media mindset of " . . . we haven't had one so it's (somehow) due . . ." The takeaway, to me, is to <u>expect</u> the Fed to screw up rate moves, either here or abroad, and deal with <u>that</u> when it arrives. Expect corrections, expect your favorite stocks to stumble, expect the talking heads to babble about an Armageddon. Businesses, though, don't sell out and close their doors on a whim or a feeling, nor should serious long-term investors. Think like an owner, expect the cycles.

I looked for some historic patterns around upward rate moves by the Fed, Peter L. That very loose link of "initially better" was all I found. Generally, the end of a bull market is more than a year, often two, after the first meaningful rate hike. Too much – meaning

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going from, say, 2% to 4% in one jump, probably doesn't engender confidence and pushes the threat of a bear market into the one year or so, window. In this current case, I suspect that because short rates are at such low levels, i.e. e. one-, two- or three-tenths of one percent, most any small move would be only a directional indicator, not an indicator of real tightening, not a signal to end the bull market. This is why I am staying with the idea of a rate change (1/10 of 1%?) by year end – directional, only. Frankly, it would be near meaningless on a cost basis to most users of funds. Initially, it is likely to be very orderly. Order will collapse with too big a first move, but some move is now the Common Knowledge, as it should be.

INVESTING

The issue then, Leet, is as you asked: How long can rates stay low? If you will grant low to be the 10-year Treasury under 3% (now 2.5%) then a guess would be 2017 – I wrote that Quarterly titled ***2017*** to help me define when "normal" would return – when the Treasury 10- year rates would exceed 4% or 5% at times. Normal would be rates high enough for the Fed to be able to lower them should the recession of 2018 grow more likely, implying a passage of enough time to get them higher. They MUST have this tool of lowering rates to stimulate slowdowns back on track and it's, frankly, one of the few tools that work.

Normal would be upward moves of quarter or even eighths of a point. Normal would a GDP growth regularly over 3% and normal would be 3% inflation. Recall we, as a people, are frightened of too fast, too high economic growth. I'd like to think it's because we don't know how to sustain it, much less manage it, but in reality, I suspect we are, deep down, no longer a nation of risk takers. We are older, simply put. There is something oddly comforting about "muddle" – the world of 2% means not too far to fall and some room to do better. A decent analogy might be knowing a Ferrari can handle a given turn at 140 miles an hour . . . but you can't.

For the long-term investor, the current imbalance of stock prices vis-à-vis overall corporate and, thus, economic growth, is very disconcerting. It means it's hard to put new money to work. It means it's times around 3 AM thinking, "Nuts, I'll sell it all and buy a boat." It means they have to think about China imploding from its real estate excesses (not likely and of little impact on our economy if it does), but it will spook our markets. Kipling comes to mind . . . about keeping your head when all about you, etc. It means worrying about the endless wars around the globe and their impact on the portfolio. (Buy defense stocks on the news, sell on the early victories.) It means being susceptible to a better plan, a new theory, a quicker way. It means patience is needed. A Zen state is required. Start by turning off the TV financial news and start thinking like an owner. Check easily-available data like overall company sales, per share changes in earnings, corporate "spin" in the Chairman's Annual Letter, see if the product or service makes sense and for likely how long. Oh, and always, always look at the quality of the Board of Directors . . . are any of them running a successful firm or are they friends and tokens? Not hard.

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The core issue is how we grow, not whether we have the wherewithal. With the Fed trying to control and, supposedly, grow the economy, I am left with the strong feeling that in the total absence of Congress (which can control the economy), the Fed has simply filled a gap in leadership. Altruistic? I doubt it. I think the temptation to take total control was too tempting, too hard to pass up those endless opportunities to experiment. The point is, for this environment they have none of the tools needed.

The answer to our future growth lies in Congress. Not the White House, not the Fed, not in the major corporations or China or the European Central Bank. Congress.

I should not have to describe to any reader the scope and depth of our regulated society.

The issue is greater than politics – it's a national malaise – an ennui of "someone else is at fault, someone else will fix it." Some say we are complacent – I doubt it. I think we are lacking long-term faith in our country and, by default or practicality, compelled to short-term trade, not long-term invest, take immediate benefits, not work, avoid long-standing social needs, not confront and always, always pray for the winning lottery ticket. Politicians see that and offer short-term "solutions." As long as that "solution" mentality persists, normal growth will be hard to come by.

We seem to want to find flaws. The dollar, for example; how can it retain its world reserve currency status with all this debt, all this unemployment, and on and on. Well, because nothing comes even close, including a bundle of currencies. The largest, the Yuan and Euro are, respectively, lacking order of law and credibility. The Swiss Franc, you say? Lovely currency. So small it couldn't fund the economics of California, much less the globe. Gold, you say? Sure – I wrote in *QEternity* that gold would work when we are out of debt because going to gold with all our outstanding debt would not eliminate it. If we paid it all off, by the way, we wouldn't need gold. Recall, too, we can repudiate the liabilities of Medicare, Medicaid, Social Security, all the entitlement programs, as they are not U. S. Treasury debt. Seems nations survive, in one form or another.

UNEMPLOYMENT

It seems to me that although we need over 150,000 new jobs each month just to stand still, the fact remains that less than that is the current running number and may well be the best it will be for some time to come. The constraints – corporations unwilling to bump wages for those that helped them through the last 7 years, regulations, limited numbers of badly needed skilled workers, labor's inability to once again move about to find work (house issues) and, for those working, a reluctance to give up the known for the unknown, all seem to limit growth in the labor force. Immigration was the solution in past decades and can be again.

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David Rosenberg notes that the pool of available labor has shrunk by 1.6 million in the past year – be it demographics, unwillingness or a better deal in some disability program. Add limited immigration or any incentive for porch sitters to return to the labor force and we could easily run out of workers over the next decade.

Dave points out that there are 24 million Americans between 25 and 54 (the prime work years) who are officially not counted in the labor force and 7 million are men – a record. They say it's because of "family responsibilities," this reason being up over 40% in the past year. The number who say they want a job is down another 3% of late.

The Fed calls this "discouraged workers." I think quite the opposite – they simply aren't even looking.

When queried for reasons, "health" and "disabled" is up 30% over the last 12 months. Why would they return – to give up free medical care and, in fact, have to buy it? To get up, get dressed, ride the bus and work?

The point, it seems to me, is that this static pool of potential labor is a structural event, not a temporary or cyclical one and will remain so until the day we learn to effectively manage the process of caring for the legitimate needy. There is, to my mind, little or no "slack" in the labor supply – what do you expect when you pay people not to work? No complaints here if it's needed, but the significant and rapid rises in "health," "disability" and "not looking" are well outside any norm for such trends. Double-digit growth in those reasons is about all the evidence needed.

So, Pat , we face the conundrum: What does the unemployment rate signify?

So far, not much. I think we are seeing why France, for example, pays so little attention to it, having already created a massive cradle-to-grave safety net. Much like your example, many French work because it's convenient. I'm sure they, too, would work full time – if it was compatible with their life style. That open-ended safety net allows this decision and we have caught that disease. We are now into the economic world of J. S. Mill, Hobbs, the Webers and the purpose of the State – a paper for another day.

More and more I believe the trillion or so dollars pumped into student loans has, of course, provided tuition. But a fairly large number of recipients are what my dad called bums – able people sitting out life in their parents' home using tuition money to live because what jobs are available aren't immediately in roles that fit their self-perception or, more likely, too much like, well, work . . . and there are these safety nets, you see, to pay for the video games, coffee house trips and the latest smart phone.

That, however, does not stop the Fed from taking on the role of job creator. The tool is the same blunt one used for growth – more money, more loans, more forgiveness and less and

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less oversight. As I noted earlier in this diatribe, Congress abdicated and the academics got the test tube for their latest theory.

That said, the participation rate likely tells us the most accurate data, but the rest of the data around working/not working is rapidly becoming worthless.

By caring about each other we created, with our votes, an entitled class of people and are now seeing the end game. I am looking for a study I had that calculated the total benefits available to a distressed individual – benefits including tax “rebates,” free medical, housing and food allowances, et al. As I recall, added up, they need $38,000 a year in salary to, after tax, end up just about even with the stay home, tax-free package. That’s $19.00 an hour, more or less. Oh, and show up and work, too. Talk of being incented not to work.

I think we are taking some of these secular trends (like housing, also) and predicting they will be only cyclical with enough money. All of history, all of mankind’s improvement occurred around, through and over setbacks of this and many other kinds. War, the birth of the Nation State, the collapse of nations, hyperinflation . . . yet history marched on. We hopefully will see the end of this current trend, this “muddle” world of 2%, sometime soon. The danger, in the meantime, is to accept that the future must be more of the same. It could be worse. It could be better – but the same? Not at all likely.

If your concern stems from impatience, believe me when I say you are not alone – this is a difficult enough job in good times. If your concern stems only from a sense that we, and you, are now defeated, I know of no remedy. You will, however, be betting against the upward trend of history if you fail to act appropriately.

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