Holiday 2015

THOUGHTS FROM OUR CHAIRMAN

Right now, many things are occuring in the USA and around the world that have and will continue to make investors nervous. Wade Walbrun, in this *As We See It*, reviews some issues of importance in this country. At this point, emerging markets most affected by lower energy and other natural resources prices and China are in various stages of adjustment. There is no really bad news in the U.S., nor great news. But generally, our situation, in the eyes of many investors around the world, is that we are the best and safest, so they are investing in our markets. They may be reading the same tea leaves as Wade. Enjoy his observations and Happy Holidays.

Alfred B. Van Liew

Everything in Moderation?

Wade M. Walbrun

Derived from Aristotle's Doctrine of the Mean, "everything in moderation" is an ethic based upon finding the mean, or middle ground, between excess and deficiency. It is essentially a shorthand formula to better living for mankind. Too much, or too little of something, it is said, can cause problems and lead to unhappiness. From an economic standpoint, extremes can also spell trouble. Excesses in the economy can, over time, trigger events such as recessions. Lately, the economic numbers coming out of the US have been less than inspiring, prompting some analysts to speculate the pace of economic activity could slow further, with some even suggesting the possibility of the "R" word (recession) for 2016. History indicates extremes in household and corporate debt, inventories, and market valuation have contributed to economic recessions. Likewise, asset bubbles, excesses in inflation and interest rates acutely increase the likelihood of a recession. Is the US economy ripe with excess? Let's take a look.

Household and Corporate Debt – Indicative of the general capacity of consumers to spend, and corporations to fund future growth, both household and corporate debt rose to record levels just prior to the last recession in 2008. Since then, consumer household debt (as a % of US GDP) has fallen about 20%, with current levels comparable to those in 2002, while corporate debt has pulled back modestly.

Inventories - When businesses hold too many goods in inventory, they may reduce or delay purchasing orders until such items can be moved from store shelves, thus negatively affect rates of manufacturing. The latest US inventory to sales ratio has ticked up modestly, tempering inventory accumulation to the tune of a 1.44% reduction in third-quarter GDP. Yet, the current level of inventory accumulation is far from historic extremes and is expected to be worked off in a quarter or two.

Market Valuation – The stock market is a leading economic indicator of the economy. Often, excessively high market prices, relative to underlying corporate earnings, presage an overall price pullback that can push the economy toward recession. At a current price/earnings (P/E) ratio of 19, and a one year forward P/E of 16, the S&P 500 Index, while above historic average, appears modestly valued,

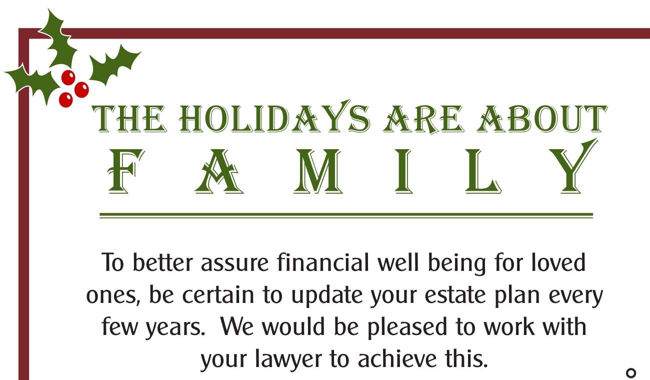
quite unlike the upper 20's P/E ratios we consistently saw prior to the 2000-2001 bear market.

Asset Bubbles – Few would argue with the notion that the excesses, and ultimate collapse, of the housing industry were the root cause of the 2008-2009 recession. Prior to that, the dramatic fall of overvalued tech stocks sparked the 2000-2001 recession, while high oil prices induced a number of recessions in the 20th century. During much of 2015, biotechnology stocks enjoyed, what many viewed as frothy speculative valuations, but have since pulled back. There is little in the way of irrational exuberance among other asset classes.

Inflation – When the demand for goods and services outstrips supply, prices for those goods and services tend to rise. Significantly higher prices can limit consumption among consumers and businesses alike and, in turn, decrease economic activity to the extent that it can lead to recession. The dramatic fall in oil prices this year has served to quash all but a whiff of inflation in the US. The year-over-year inflation rate, as measured by the Consumer Price Index (CPI), is essentially unchanged, far from the long run average of 3.1%, while core inflation (CPI excluding food and energy) sits at a quite reasonable 1.9%.

Interest Rates – Interest rates that are too high can discourage growth and investment by making it too costly for businesses to take on debt to purchase new equipment and expand production. High interest rates also affect consumer's demand for mortgages and car loans. When business and/or consumer activity wane dramatically, recessions can result. The 10-year Treasury bond yield is currently at 2.16% and has been under 4% since October 2008, while the Fed funds target rate, the interest rate at which depository institutions (banks and credit unions) actively trade balances held at the Federal Reserves, has been at 0% for the last five years. Current rates are very low and Fed policy is considered quite accommodative. Yet, many on Wall Street suggest the Federal Reserve's policy of maintaining low interest rates for such a long time is an extreme measure, and an unnecessary one, too. Considering that such policy was implemented at the depths of the US recession in late 2008 as an emergency measure, the continuation of dramatically low interest rates in the current face of distinctly, non-panic level economic activity presents investors with an artificial and excessive environment. It is unclear exactly what the undesirable effects to the economy will be over the long-term under this Fed policy. One thing seems certain, future interest rate increases, as outlined by the Fed, are likely to be modest and measured, and as such, it may be some time before interest rates reach levels viewed as restrictive to economic activity.

In summary, there seems to be little evidence of an impending recession. Is everything in moderation? Yes, and no. Fed policy seems to be the one big factor out of line. How that story plays out remains to be seen. In the meantime, the market continues to recover from the extreme August swoon and has recently moved back into the black for the year. Just the kind of moderation investors like to see.



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