July 26, 2017

Another week, another record. The Standard & Poor's 500 index and the Dow Jones Industrial Average ended on Friday at record highs…while the Nasdaq Composite posted…its second-highest close on record.

--Barron's, *July 17, 2017*

Dear Fellow Investor,

Another record high indeed! And we, Fellow Investor, are glad to hear the news as we are fully invested in common stocks—mostly U.S. but a smattering of foreign companies as well—for years now.

For the six months ended this past June 30, the Standard & Poor's 500 index returned 8.24% (9.34% with reinvested dividends). By far most of the accounts for which we at Weybosset Research & Management LLC are responsible performed as well or better than the broad averages. Furthermore, the averages were led by the so-called mega-cap technology stocks—Facebook, Apple, Amazon, Netflix, etc.—while our portfolios consist of much less glamorous—and much less expensive—names.

In my last letter to you, I argued that the surge in the stock market, which began early last year and continues to this day, was due not so much to some sort of celebration of the outcome of the 2016 elections in the United States, a "Trump Bump", as to a recovery in corporate profits from a "profits recession" that began in 2014, bottomed in late 2015, and began to recover in the first part of 2016. I write to you today toward the end of the second quarter 2017 earnings reporting season, when companies publish financial results for the first half of the year. On balance, results so far this year have been somewhere between just fine and very good; and the market is responding with approval as the quotation from *Barron's* cited above indicates.

The new highs come despite the chaos and scandal in Washington DC and the further erosion of globalism abroad. The new highs also come as the Federal Reserve Bank here in the U.S. and central banks around the world back away from the extraordinarily stimulative monetary policy prevalent since the 2008-9 financial crisis. Indeed, nothing seems to shake this market.

In case successive record highs in the face of ugly headlines is not enough, the advance has also come with very little volatility. To return to the *Barron's* article quoted above, "…the climb has totally lacked anything approaching excitement. Most obviously, that most overused financial statistic, the CBOE Volatility Index, or VIX—the gauge of S&P 500 options volatility—has slunk back into single digits." Recently VIX traded at its lowest level since 1993 (!!). (The low level of volatility was entirely predictable because in epistle after epistle a few years ago I informed you—warned you! —that heightened volatility was a fact of life with which we just had to learn to live. Fortunately, we do not invest your money based on any particular opinion regarding the direction of markets or the level of volatility. We try to focus on the fundamentals of the businesses in which we invest.)

And speaking of volatility, we have not had as much as a 5% pullback in the stock market since early last year. Going this long without even a minor retreat has happened only twice before in stock market history, once in the 1950s and again in the mid-1990s. In both cases the long periods without as much as a 5% retreat were associated with major bull markets. That of course is the case again in 2017.

The good news is global in scope. Though well below record highs, emerging markets have rallied strongly since early 2016 and have substantially outperformed the S&P 500 this year. Developed markets such as Germany, Japan, France and the UK also turned in respectable returns, in some cases surpassing the S&P 500. Like the U.S., the gains in these markets correlate with a recovery in corporate profits. And the recovery in corporate profits correlates with improvements in overall economies. In the U.S., for instance, a slow but steady growth in GDP remains uninterrupted, employment has (finally) recovered to pre-crisis levels, and consumer and business confidence levels are the best seen in many years. In the emerging markets, the ten-ton gorilla, China, is handling a policy change from investment-driven to consumer-driven growth remarkably well given the magnitude of the challenge, to the great benefit of what used to be called the "Third World." Chronically sclerotic economies such as those in Europe and Japan are showing fresh signs of life.

So markets are up substantially but without the kind of giddy enthusiasm and upside volatility associated with market tops, supported by rising corporate profits and improving economies—what could be better? That is exactly the question bothering us. When everything looked truly terrible a little more than a year ago, the right question was, what could go right that might change the game? Now that all looks clear and good, the question is, what might spoil the party?

The fly in the ointment here is that all these agreeable developments are beginning to be reflected in share prices. In a general sense, market prices are nowhere near the nose-bleed levels we saw in 2000, right before the worst decade in stock market history, the one ended December 31, 2009, or the crazy prices paid by the generation of our parents and grandparents in the late 1960s and early 1970s for "perpetual growth," "Nifty Fifty" stocks. But prices are stretched by historical standards. That means risks are skewed to the downside. A stock selling at, say, 30 times earnings is much more vulnerable to disappointment than one selling at, say, 8 times earnings. (At 8 times, risks are already largely discounted.)

So you may notice us lightening up **A LITTLE BIT**. We are not trying to time the market, we are not calling a market top. We are simply acknowledging that some of our securities are selling at multiples of earnings far higher than ever seen before, and we believe the prudent response is to give some small portion back to the market. The proceeds of our sales are to be held for a rainy day. It is not a matter of if, it's a matter when volatility returns to the market and we would like to be able to take advantage of any opportunity that might come along. Who knows what might drop in our laps? And rest assured, we are cognizant of tax implications, if any, that our transactions might produce. We don't want our clients doing any more than they must in the struggle to close the Federal budget deficit.

I hope you are satisfied with the performance of your investments thus far in 2017. We remain optimistic, particularly about the companies we own, but feel a little more cautious.

Stay tuned! And never hesitate to get in touch with us with all questions, comments or complaints, particularly if your financial status is about to change. We'd love to hear from you. And, as ever, thank you for your business.

Yours very truly,

Fla Lewis III

Principal