April 28, 2017

Dear Fellow Investor:

The bull market in stocks continued on its merry way the first three months of 2017, with the major averages reaching all-time highs (S&P 500 at 2400, Dow Jones Industrial Average above 21,000) during the quarter. This is good news for Weybosset Research and Management clients as we are heavily invested in U.S. common stocks. (The concentration in stocks is due, among other things, to the lack of appeal from competing asset classes such as bonds, cash or commodities. These latter seem to us to offer little more than substantial risk without much in the way of reward.)

The S&P 500 was up 5.53% in the quarter (6.06% with reinvested dividends). The accounts for which we are responsible mirrored the results for the indices very closely.

The latest phase of the bull market has been labeled “the Trump rally” in the media due to the fact that the two most recent major thrusts occurred right after the 2016 election and then again right after Inauguration. This narrative posits that the Trump agenda prioritizes deregulation, tax reform (read: tax cuts), and major infrastructure spending and that implementation—highly likely given Republican control of both houses of Congress—would stimulate the U.S. economy and corporate profits; hence the rally in stocks.

Although this description explains some of what is going on, and certainly helps attract viewers and sell newspapers, we think it ultimately inadequate and misses a bigger, more fundamental, though perhaps more mundane, story.

The idea that we are enjoying a “Trump rally” carries with it the implication that if Trump is unable to implement his priorities, or if they don’t work, the markets are cruising for a bruising. We have received numerous calls from clients voicing precisely that well-conceived concern.

I suggest a different narrative, one dating back to mid-2014. Somewhat earlier (late 2010-early 2011) the government of China decided it needed to change China’s model of development, away from intense investment in things like roads, airports, apartment buildings and factories (for years half of China’s GDP was investment versus less than 20% for developed economies such as North America, Europe and Japan) and more toward consumer demand as in developed economies. This is an ambitious undertaking, one bound to elicit mistakes, even mini-disasters. The Chinese economy, second largest in the world and by far the world’s most populous, is a very large ocean liner to turn.

One perhaps unintended effect of the model change was a collapse in commodity prices. When the ten-ton gorilla of global commodity demand decides it needs less copper, less cement, less iron ore and not as much oil, producers need to start discounting heavily and quickly to sell excess supply. They also need to start closing operations that are not economically viable in the new, lower-priced environment. The effects echoed around the world, from tractor manufacturers in Illinois to miners in Chile to oil and gas companies in Arabia or mid-America. The most dramatic instance was Saudi Arabia's decision just before Thanksgiving in 2014 to no longer defend the price of oil, but to go instead for market share in Asia. The price of a barrel of oil dropped with stunning speed from more than $105 in late 2013 to less than $30 in early 2016.

The results reverberated globally, with manufacturing and extraction companies particularly hard hit. Bankruptcies swept away weaker companies, but even the strong saw profits drop or at best flat line. Lower profits and deteriorating finances are not the kind of things that cheer stock market participants, so the markets stumbled badly in late 2014, mid-2015 and again in early 2016. (January 2016 was one of the worst Januaries in history).

But in the final analysis, most of us are consumers of commodities, not producers, so lower oil, food and materials costs are a net good, not the other way around. Companies and consumers made their adjustments to the new reality of lower commodity prices and people got back to the task of trying to make life better for themselves, their families and those for whom they are responsible. Corporate profits bottomed in the fourth quarter of 2015 and began slowly resuming their upward march. Not surprisingly, the stock market also bottomed in February 2016 and is up by about a third since then.

From this point of view, the "Trump rally" is no more than the continuation of a trend that began in early 2016 and continues to this day, juiced no doubt by some of the sizzle of campaign rhetoric, but not dependent on it. (Rich Bernstein of Richard Bernstein Advisors in New York proposes February 11, 2016, the date of the stock market bottom, more important to investors than November 8, 2016, the date of Trump's election. I agree.)

I write toward the end of the first quarter earnings reporting season (most companies report financial results from January through March in April), and the news has generally been quite encouraging, particularly for sectors affected by the "profits recession". General economic conditions have also been improving, especially here in the U.S. where consumer confidence, business confidence and employment are at the best levels seen in years. This is important as full-blown bear markets in stocks rarely occur in the absence of an impending recession. If anything, the likelihood of a recession is more remote today than a year ago. Sudden violent, unnerving "corrections" in the market are endemic to life as an investor in the 21st Century, and we will undoubtedly encounter them from time to time. Be forewarned. But economic contraction and a concomitant derating of share prices do not appear to be much of a threat for the time being.

Nevertheless the market has moved up quite a bit in the last year, indeed, in the last eight years, and this brings us to the topic of valuation. Have share prices gotten ahead of fundamentals? Is so much optimism built into stock prices that the next down cycle, whenever it comes, is bound to be truly painful? The question of valuation in the post-2008 environment, characterized by central bank-mandated ultra-low interest rates and pervasive sub-par economic activity ("secular stagnation" is the term used by economists to tell us not to expect much from our or any other economy for the foreseeable future), is a conundrum with which we at Weybosset Research wrestle recurrently. I hope to take it up in an ensuing epistle, feeling that at present I've taken enough of your time.

Still I can't resist a short answer that harkens back to the early 1950s. At that time the U.S. stock market was booming, but, somewhat like today, was greeted more with apprehension than enthusiasm. Memories of the run-up to the crash of 1929 were still fresh, and no one wanted a quick reversion to conditions of the 1930s. Ben Graham, a famous professor of finance at Columbia University and teacher of many a star investor (including Warren Buffett), was asked to testify before a Senate panel concerned that a collapse in the stock market and general economy was imminent. Quoth Graham, "The stock market looks high and it is high. But it's not as high as it looks." I think the same is true today.

In any case, you would have been a fool to ditch your stocks at the time of Graham's testimony. The Dow Jones Industrial Average was around 350 at the time and has appreciated nearly SIX THOUSAND PERCENT subsequently, in addition to throwing off generous and rising dividends.

We remain committed but wary. So far the giddiness, nosebleed valuations and reckless risk-taking typical of major market tops are not evident, but we are certainly on the lookout. At some point these conditions will arise, and you can be sure we will be dialing back when the time comes.

In the meantime, we hope you are pleased with our results. We would love to hear from you with any questions, comments or complaints. (Well, questions or comments anyway.) We would also enjoy getting together with you to review your portfolio, your financial situation and our efforts on your behalf. Give us a call, an email or a note in a bottle and we'll get together.

Yours very truly,

Fla Lewis III
Principal