April 23, 2018

[*It is] unreasonable to believe the very low level of market volatility we saw in 2017 will continue…*

--Fla Lewis III, letter to Weybosset Research & Management clients, January 11, 2018

Dear Fellow Investor:

What insight! What prescience the author of those words displays considering what subsequently transpired in financial markets in the first quarter of 2018!

I pat myself on the back because, following the least volatile year on record, 2017, financial markets spent most of the first quarter of 2018 in corrective mode, with the Standard and Poor's 500 declining more than 12% peak-to-trough in February. The turbulence included the biggest single-day point drop in the history of the Dow Jones Industrial Average, Feb. 8, down 1033 points! (On a percentage basis, the basis that really counts, Feb. 8, 2018 was not nearly as bad as many past one-day declines. Nevertheless, a drop of 1033 is bound to attract attention!)

For the quarter, the S&P 500 ended *down* 1.2% (-.8% with reinvested dividends). At Weybosset Research and Management (WRM), we fared better with only a handful of our accounts in negative territory for the quarter, and those for idiosyncratic reasons. Most of our accounts were up modestly--very modestly--but up nonetheless.

And we do regard the first quarter's turbulence as a correction in an ongoing bull market for stocks, as opposed to a harbinger of grimmer things to come. I have pointed out in past missives that bear markets—prolonged declines usually defined as down 20% or more—rarely occur absent an economic recession, and no such thing is on the horizon presently. Indeed the U.S. economy is in the best shape it's been in for more than ten years. GDP growth is running above 3% per annum for the first time in a long time while unemployment is at levels not seen since the middle of the last decade. Wages are moving up and business confidence, particularly small business confidence, is high. Congress approved, and the president signed a tax reform bill that makes U.S. companies more competitive internationally and provides for the repatriation of trillions of dollars of off-shore profits. A survey known as the Purchasing Managers' Index (PMI), often regarded as one of the best economic forecasting tools, shows expansion in 17 of 18 industries surveyed. (The sole exception is Apparel and Leather Goods. WRM has no investments in Apparel or Leather Goods.)

As I mentioned in my last letter, the whole world enjoys simultaneous economic growth for the first time in more than a decade. Strategas Research Partners recently surveyed countries representing 80% of global GDP and found all in expansion mode.

I have noted repeatedly in the past that the giddy psychology typical of market tops is nowhere to be found. This remains the most hated bull market in my experience, possibly because not that many are participating, or fully participating, in it. For a while cryptocurrencies like Bitcoin evinced a tulip bulb-like mania, but that has largely died down as the force of gravity has asserted its pull on Bitcoin prices.

But markets can get ahead of economic reality and the subsequent adjustment is what sets the stage for corrections. Full employment, rising wages, rising commodity prices and the Fed's acknowledgement of the good economy by allowing interest rates to normalize sparked fears of incipient inflation. ("Things are too good! Sell!!") Anyone who had the bad luck to be an investor in the 1970s can attest to the devastating effect of rampant inflation on asset prices. But for the time being at least, inflation of the 1970s variety is a fear, not even close to a fact. Indeed, the Fed has maintained an inflation target in its deliberations and that number is 2%. For the past ten years, the economy has only rarely—and then only briefly-- met that target. And 2% is a long way from 1970s-style inflation.

A further concern bubbled to the surface and has to do with President Trump promoting protectionist proclivities professed during the 2016 election campaign. First came duties on steel and aluminum, then duties on sundry Chinese imports then further duties on Chinese imports. China was clearly prepared and immediately announced retaliatory measures aimed shrewdly at a big swath of Trump's political base, Midwestern farmers. There is no doubt a full-blown trade war, particularly between the world's two largest economies, would be bad for everyone. Recall the Smoot-Hawley tariff act of 1930 contributed mightily to turning the recession of 1929 into the Great Depression of the 1930s. Certain of the businesses in which we at WRM are invested would surely suffer should global trade and investment meaningfully erode.

But as is so often the case with President Trump, it is difficult to discern what is bluster from what is in fact intended. The Chinese, as I mentioned, are prepared and shrewd in their response, but also appear conciliatory. After all, a trade war is not in the interest of China by any stretch of the imagination. We at WRM are keeping a wary eye on the situation but remain hopeful.

A further disruption in the stock market has to do with a sudden perceived vulnerability to the reigning market darlings, the so-called FAANG (Facebook, Amazon, Apple, Netflix, Google) stocks. A series of scandals has made the world of social media look substantially darker than previously, and naively, perceived. President Trump, who makes a point of never being shoved without shoving back, has let it be known that Amazon, whose founder and CEO Jeff Bezos owns Trump antagonist *The Washington Post*, is in his cross-hairs. There are signs Apple may abandon or substantially modify the iPhone X, the price of which, $1,000, is proving problematic. Google follows a business plan, ad-driven, like Facebook's and may face similar problems, particularly with respect to privacy. Netflix has recently traded at all-time highs, but I'm cancelling my subscription—no Ingmar Bergman or Robert Altman movies! In any case, we own no FAANG stocks.

Long-time market commentator, author and perma-bear James Grant has described market corrections as "the value restoration process." ("There sure has been a lot of value restored!" quipped a client on perusing his February statement.) This is certainly true of the early 2018 correction. The persistence of a good economy and the prospect of much improved corporate profitability combined with lower prices due to normal market processes means much better value for the rest of 2018 and beyond. In my last letter I told you that valuation was high on my list of concerns at the end of last year. The tumult of the first quarter of 2018 has done much to ameliorate that concern.

The market in general is much more reasonably priced, but certainly many of *our* investments are downright cheap. These are strong, well-financed, established businesses with excellent prospects for the long term. In my opinion their growth trajectories just got longer. And the "value restoration process" restored value to a name or two in which we've long been interested. We could not resist and added a few positions to our portfolios.

So, we remain constructive in our outlook for the market but, as always, cautious. We regard recent commotion, though at times highly unsettling, as normal and healthy and not the beginning of something more sinister. We very much appreciate your loyalty in sticking with us as things shake out and welcome any and all inquiries. Feel free to get in touch—we'd love to hear from you!

Yours very truly,

Fla Lewis III
Principal